

## **Cautionary Note on Exchange Traded Funds (ETFs)**

### **Preamble**

The popularity of Exchange Traded Funds (ETFs) have grown rapidly over the recent years.

Not all ETFs are the same.

There are 2 types of ETF:-

- (i) direct replicated ETFs;
- (ii) synthetically replicated (also known as swap based) ETFs.

Broadly speaking, direct replication ETFs are ETFs which has a basket of physical shares closely replicating the performance index.

For swap based ETF, the ETF manager may invest in a basket of alternative securities and employ derivatives and swap counter parties to exchange the performance of the securities in the ETF for the performance of the underlying index.

As a word of caution, the basket of substitute shares may have low correlation with the actual underlying index.

### **Rationale and Workings for Swap Based ETFs**

Fully replicated ETFs suffer from tracking errors as it is often not possible to fully replicate an component index comprising a basket of stocks. It also has higher transaction costs.

The argument for swap based ETF is lower expense ratio and less tracking errors as the swap counter party guarantees the index performance. This is only true if the swap counter party does not fail.

### **Risks of Swap Based ETFs**

Very crudely,

- a) the trade-off between a direct replicated and a synthetic ETF is basically the higher tracking risks and transaction cost versus the credit risk of the swap counter party.
- b) if the swap counter party fails and an acceptable swap counter party cannot be found, the substitute basket under the swap arrangement may have to be unwound. A large scale unwinding of the collateral shares may amplify the market risks by exaggerating the price movements resulting in financial loss for the ETF investor.

### **Counter Party Risks**

There have been press reports recently that financial crisis in Europe and United States have adversely affected certain financial institutions leading to downgrades in their credit ratings by rating agencies.

We therefore urge investors to ascertain the following before even trading or investing ensure you understand the ETF you intend to trade / invest in including:-

- a) the type of ETFs you are purchasing and their inherent risks.
- b) the swap counter parties and their credit standing.
- c) the quality of the securities within the substitute basket and their correlation to the performance index in the event these assets needs to be sold should the swap counter party fail.

### **How to Identify Swap Based ETF**

The SGX have separately indentified swap based ETFs with a symbol “x” just before the symbol “@” used to mark SIPs.

**The investors should also read the product fact sheet and prospectus of the respective ETFs to understand the structure and associated risks before investing.**