

# Dr Wise's Column

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### *Investing in Index Tracking Exchange Traded Fund*

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#### Key Messages:

- Index tracking exchange traded funds in Hong Kong (ETFs) are listed collective investment schemes that aim to track an index efficiently.
- ETFs trade on the Stock Exchange of Hong Kong and like other listed stocks, carry similar risks such as liquidity risk and risk of trading suspension.
- The performance of an ETF may not closely match with its underlying index and its trading price may deviate from its net asset value.



Index tracking exchange traded funds (ETFs) have become an increasingly popular investment tool among investors world-wide who want to track the performance of an index efficiently. In Hong Kong they are SFC-authorized collective investment schemes (“CIS”) listed on the Stock Exchange of Hong Kong (“SEHK”). Each ETF aims to provide investment results that track the performance of an underlying index which can include a stock market, a specific segment of a stock market, various stock markets in a region or commodities futures.

ETFs are similar to other SFC-authorized CIS in that they both invest in a portfolio of securities, giving investors diversified exposure to selected market(s) or sector(s). However, unlike other SFC-authorized CIS, which are mostly unlisted with subscription and redemption of units at net asset value and subject to a defined dealing frequency, ETF units are traded on the SEHK like listed shares. The ETF’s trading price may differ from the ETF’s underlying net asset value and subscription and redemption of units are normally conducted through designated intermediaries.

It is important to understand how a fund manager puts together an ETF’s portfolio of investments where there are three basic sampling methods in use. First, an ETF manager may adopt full replication (i.e. invest in a portfolio of securities that replicates the composition of an underlying index). Alternatively, the ETF manager may adopt representative sampling (i.e. invest in a basket of securities which have a high correlation with an underlying index, but where the portfolio of investments is not exactly the same as those in the underlying index). An ETF manager may also use synthetic replication (i.e. replicate the performance of an underlying index through the use of financial derivative instruments).

Like any other investment decision, it is important for you to understand the benefits and risks of investing in an ETF. This will include understanding the special features, if any, of the particular ETF product or the underlying index or assets it represents. It is also important to understand that an ETF may trade above or below its net asset value, depending on factors such as market conditions at the time, demand for and supply of the ETF units and inherent market restrictions.

By investing in an ETF, you gain exposure to the underlying index (assets or markets) without directly investing in the underlying constituent securities or components of the index. In this way, you can achieve diversification in a cost-efficient manner and the ETF manager will adjust the underlying constituent securities in line with the index. In addition, since ETFs are traded like listed shares on the SEHK, you can buy and sell ETF units during normal trading hours at market prices. You can also easily access trading information of an ETF on a real-time or near real-time basis, via the websites of the ETF or of the Hong Kong Exchange and Clearing Limited (“HKEx”).

Notwithstanding these benefits, an ETF is no different from other financial investments or collective investment schemes in that it is subject to market risks. Even though the performance of an ETF may not exactly track that of its underlying index (for reasons such as the costs, fees and charges that are borne by an ETF, foreign exchange differences between the base currency or trading currency of an ETF and the currencies of the underlying investments and basic supply and demand for units), an ETF is still exposed to risks related to the fluctuations of its underlying index. Further, if an ETF invests in financial derivative instruments, it is exposed to the liquidity risk and the counterparty risk which accompany investment in these instruments.

Since the strategy of an ETF is to track an underlying index, you should not expect the ETF manager to try outperforming the underlying index or to avoid the downturn experienced by the relevant index. Before investing in an ETF, you should fully understand the nature and salient features of the ETF and its underlying index/market and its strategy. You can then assess whether that ETF is an appropriate investment for you by considering the risks of the ETF vis-à-vis your own risk appetite.

As always, I urge you to read the offering document of an ETF carefully as it contains useful information for your assessment of the ETF. Where necessary, you should also seek independent professional advice. Finally, you can get information about an ETF by visiting its or HKEx’s website, where the prospectus, notices, announcements and the ETF’s updated trading price are posted.

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