

Why structure matters when choosing an ETF

January 2024





What are ETFs and what do they do?

An Exchange-Traded Fund (ETF) is an investment fund that trades on an exchange just like the shares of a company

How ETFs track an index

Unlike most actively managed funds that employ someone to try to beat an index, most ETFs are passive investments. This means an ETF simply aims to track the performance of a specific index, such as the FTSE 100 in the UK, the S&P 500 in the US or indeed any of the millions of indices that exist around the world today.

Nobody can invest directly in an index – they’re just theoretical baskets of securities used for performance measurement. Someone could try to replicate an index by buying all the securities in it, but that would be extremely difficult and very expensive even for an index with ‘only’ 100 securities, for example. A cheaper and more efficient way to gain the index performance is through an ETF that’s designed for that exact purpose. An ETF provides exposure to the entire index in one simple transaction.

Our philosophy and what we do

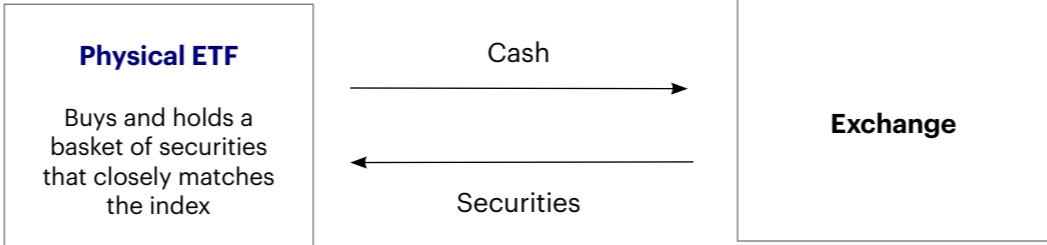
We create products that we believe will meet our investors’ financial objectives most effectively.

For our passive ETFs, this includes not only selecting the right benchmark indices but also the way in which our ETFs seek to track them.

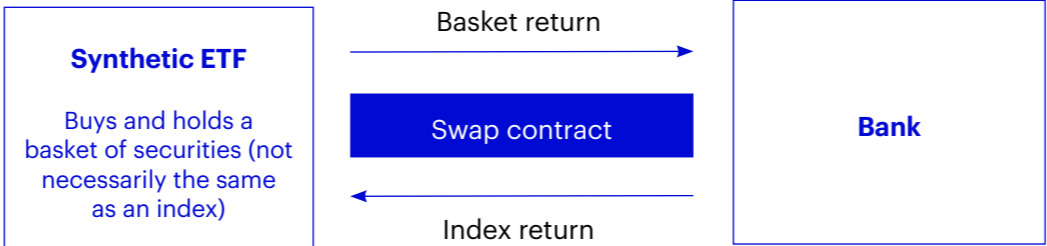
We don’t favour one replication method over another and, instead, decide on a case-by-case basis, driven by what we believe will offer the best overall outcome for investors.

There are some complex terms used within this document and these have been included in a Glossary on page O6

Types of replication methods



The ETF tracks the index by buying and holding a portfolio of securities that closely matches the index’s composition. When the index rebalances, the ETF will need to buy or sell securities so that it continues to resemble it.



The ETF also buys and holds a basket of securities but not necessarily those of the index being tracked. The ETF will aim to deliver the index performance through a financial agreement (swap contract) provided by an investment bank (swap counterparty).

For illustrative purposes only.



Introduction to synthetic ETFs

A synthetic ETF uses “swaps” with the aim of delivering the precise performance of its index

What is a swap?

A swap is a type of contract arranged between two counterparties, in this case an ETF and a bank. The terms of the swap would typically involve the ETF paying the bank a fee and, in exchange, the bank agrees to pay the ETF the returns of the index.

The swap fee amount paid to the bank (the swap counterparty) can vary according to how competitive the swaps market is for a particular index. The fee, which is quoted as a percentage of the value of the swap contract, will generally be lower for a widely traded index than for one that is perhaps not as well known, or where the securities are not traded as often.

What are the risks of synthetic ETFs?

Any ETF has risks associated with the underlying assets, such that emerging market investments are considered riskier than developed market and high yield bonds riskier than government bonds. Counterparty risk is a key additional risk that applies to synthetic ETFs, although it's worth pointing out that ETFs using physical replication are also exposed to the same type of risk if the ETFs engage in securities lending.

In relation to a synthetic ETF, counterparty risk refers to the possibility that the bank is unable to honour its agreement to pay the index performance to the ETF. In this case the ETF would still own the basket of securities, which may have performed better or worse than the index during the period. The worst-case scenario is the bank defaulting on its contract and the basket of securities the ETF is left holding underperforming the index.

How can an ETF provider minimise the risks?

Accept only quality securities into the basket. An ETF provider can choose what securities it will accept into its basket and what it deems unsuitable. Ideally, you want securities that are easy to sell when required. Investors can find the basket of securities, for each ETF, on the ETF provider's website.

Reset the swaps frequently. An ETF and its swap counterparty (or counterparties) are required to “reset” the swap agreement – and settle the difference – if the value owed to either party exceeds a specified amount. That's an important safeguard in the event the performance of the index greatly exceeds the basket of securities held by the ETF. Resets are the mechanism by which that difference is kept within a manageable range. At Invesco, we will reset the swaps whenever certain conditions are met, a policy designed to further limit the amount any swap counterparty can owe the ETF.

Assess and monitor swap counterparties. Most ETF providers will normally only enter into swap agreements with large banks, but that's really only a starting point. At Invesco, for instance, we apply strict financial assessment criteria when considering any counterparty and continually check each chosen counterparty to ensure it remains in a healthy financial position to meet its obligations.

Use multiple counterparties. An ETF provider may choose to use only one counterparty or use a range of banks to provide swaps for its ETFs. Using multiple counterparties can be important because it helps diversify the risk of being over-reliant on a single bank. If an ETF has, let's say, five banks providing the swap exposure, and one of those banks is unable to fulfil its obligations, the financial impact should be much less than if the ETF had only one swap counterparty.

The case for synthetic ETFs

The choice between using a synthetic or physical replication method depends on a variety of factors

Tax Treatment

An example of a synthetic ETF having an advantage is in the US equity market. A specific piece of tax legislation in the US makes it possible for a swap counterparty (bank) to pay a non-US domiciled ETF the total return of certain US equity indices without the normal deduction of tax on the dividends.

In contrast, a physical ETF would be subject to a 15% tax rate on the dividends paid by companies in the same index. That's even after any reduction in the tax rate a European-domiciled physical ETF may be able to obtain due to tax treaties (US dividends are normally taxed at 30%).

Example: A company pays \$100 dividend

	Tax rate payable	Dividend received
US taxpayer	30%	→ \$70
European-domiciled physical ETF	15%	→ \$85
European-domiciled synthetic ETF	0%	→ \$100

For illustrative purposes only.

As a result of the differing tax treatment, a synthetic ETF tracking a US index has the potential to outperform a physical ETF. And because it's the dividends that are being taxed at different rates, the advantage should be particularly noticeable on indices where the companies pay higher dividends.

Lower costs

There can be cost savings when using swaps to replicate UK and European equity indices. A physical ETF would be liable to transaction tax on the purchase of stocks (Stamp Duty in UK or Financial Transaction Tax in some European countries). However, a synthetic ETF, replicating that same index, would not be charged the tax if it fills its basket with stocks from other countries.

Beneficial market dynamics

In China, a high participation rate of retail investors (people buying individual shares) has the potential to create a compelling opportunity for certain hedge-fund strategies. However, the absence of an onshore swaps market or securities lending programme means hedge funds would need another way to hedge their risk.

Investment banks offer swap contracts to the hedge funds in return for a hefty fee. But the banks don't want this exposure to the stock market, so they need an inventory of stocks to sell to offset their side of the trade. Currently, synthetic ETFs are among the only investors wanting this index exposure.

A bank may even be willing to pay a fee to the ETF, which would mean the ETF receives the index performance plus the swap fee. There's no guarantee this unusual situation will continue forever but, when the synthetic ETF receives the fee from the bank, it should have a meaningful advantage over a physical ETF tracking the same China index.

Markets that are difficult to track

If an index has several thousand stocks, especially if many of them are small and difficult to buy and sell, it may make sense to replicate the index synthetically. Emerging market indices are an example of this being the case. The swap fee would generally be higher than on an easier-to-trade index but the additional cost might be worth it if the alternative is a physical ETF that is unable to buy all the stocks.

Wrapping up

Physically and synthetically replicating ETFs can both have a place in a portfolio

At Invesco, we believe the choice between using a synthetic or physical replication method for a particular index is driven by a variety of factors, including investor demand, costs, tax treatment, regulations and any relevant market dynamics. The combination of those factors will tilt towards physical replication for some indices, while a synthetic approach can have an advantage for replicating other indices.

Physical and synthetic replication methods both have their pros and cons. In the past, some investors have opted to stick to using only physical ETFs, possibly because they seem easier to understand. The growth of assets into synthetic ETFs over the past five or so years suggests the tide has turned, not necessarily favouring one method over the other, but simply levelling out the playing field.

We believe this trend is indicative of investors taking a more unbiased approach to selecting ETFs, choosing the method that they feel will deliver the best overall result for what they're looking for, and doing so on a case-by-case basis. And that makes perfect sense. After all, it's the same approach we take when creating each of our ETFs.



Glossary

Exchange Traded funds (ETF) - Funds that can be traded on an exchange. Like traditional funds, they can be created and redeemed at the daily Net Asset Value and are open-ended investment funds. However, they can be bought and sold on a stock exchange, like ordinary shares. In Europe, ETFs are typically UCITS funds.

Hedge fund - They're pooled investment funds whose managers use a wide range of investment strategies and are typically more complex than most mutual funds.

Net Asset Value (NAV) - The official value of a fund. ETFs publish a NAV once a day. The market price, at which an ETF trades on exchange, may differ from the NAV.

Ongoing Charge Figure - The ongoing charge includes management fee, custody, administration costs but excludes transaction costs such as swap costs.

UCITS - Undertakings for Collective Investment in Transferable Securities, a set of European Union Directives. The directives provide a regulatory framework under which funds authorised in one EU state can be marketed across the EU.

Swap or 'swap contract' - An agreement/contract where two parties agree to exchange cashflows. Some Invesco ETFs use total returns swaps, where the ETF exchanges the total return on its portfolio of assets for the total return of the relevant benchmark index.

Swap fee - The swap fee is the all-in amount paid by the fund to the counterparty for the service of replicating the index return.

Swap counterparty - A Bank that enters into a swap contract with the ETF

Securities Lending - Securities Lending is a well-established practice involving the short-term transfer (loan) of securities, for either a defined or open-ended time period.

Important information

Data as at 31 December 2023 unless otherwise stated.

This marketing communication is for use in the UK.

UCITS ETF's units / shares purchased on the secondary market cannot usually be sold directly back to UCITS ETF. Investors must buy and sell units / shares on a secondary market with the assistance of an intermediary (e.g. a stockbroker) and may incur fees for doing so. In addition, investors may pay more than the current net asset value when buying units / shares and may receive less than the current net asset value when selling them.

If investors are unsure if these products are suitable for them, they should seek advice from a financial adviser.

Current tax levels and reliefs may change. Depending on individual circumstances, this may affect investment returns.

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