The Growth of Exchange Traded Funds

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Exchange Traded Funds are shares where the underlying assets mirror a specific index or sector, such as the FTSE 100 or the S & P 500. They are also commonly used these days to gain exposure to movements in the prices of commodities such as gold, silver or wheat.

There are two main approaches to investing, either through Physical ETF's or Swap-based ETF's. Physical ETF's can replicate the performance of an underlying index by simply purchasing all the securities covered by the index. Alternatively, "optimisation" strategies can be used requiring only a portion of the underlying securities to be held. Optimisation is aimed at more efficiently reproducing the index performance while improving the liquidity of the portfolio.

Synthetic, or Swap-based, ETF's use a more complex structure whereby the fund holds a basket of equities prescribed by the Swap counterparty and enters into a Swap agreement to exchange performance of the basket for the performance of a reference index. It is important to note that the equity basket itself will not contain all the securities in the index, rather, the basket will hold a selection of liquid stocks while the Swap provides the performance of the index.

Exchange Traded Funds, whether Physical or Synthetic, have revolutionised the way investors manage their portfolios and their growing appeal is that you can obtain exposure to asset classes that were until recently the domain of institutions or very wealthy investors. Enthusiasts describe ETF's as a cheap way to get exposure to equity markets. They do not levy front end charges, early redemption or exit charges, and service charges are often below 0.5% a year. Neither do they attract stamp duty. They are also very simple and efficient to trade with real time pricing within an Open-Ended structure.

The growth of the ETF market has been quite staggering and in the US, ETF assets topped $1 trillion recently for the first time, representing growth of nearly 225% since the end of 2005. The ETF market, however, remains quite concentrated, with the top three providers, Blackrock (iShares), State Street and Vanguard having a combined market share of about 84%.

As with any investment, ETF's can carry risks particularly those products that use derivatives and investors should seek professional advice about the wide range of trading strategies available.