Q #1 Why did EFAMA members feel the need to publish this ETP investor guide?

The reason is two-fold: firstly, investor flows into exchange-traded products or ETPs – the lion’s share of which are exchange-traded funds or ETFs – have been constantly rising in the course of the last decade to reach over 7 trillion US Dollars globally and just above 1 trillion US Dollars in Europe in September 2020. This trend is expected to continue in the coming years, with an ever-greater retail investor take-up, so it is important for the industry to introduce and explain these products to investors before they commit their money.

And secondly, from the Covid-induced market corrections earlier this year, certain commentators from regulatory, academic and media circles have too often bundled ETP products together, overlooking some of their key differences. I recognise that the broad ETP category represents a convenient short-hand label to identify instruments that are listed and trade daily on an exchange. But there are nevertheless fundamental differences between them that must be recognised by investors and in the public domain.

Q #2 From a risk management standpoint, what are the main distinguishing features of ETFs compared to other ETPs?

The “F” at the end of the ETF acronym stands for “fund”, which is an open-end collective investment scheme that in Europe must meet the extensive requirements of the UCITS Directive. From a risk management standpoint, adherence to UCITS standards implies the ETF must observe strict portfolio and/or index diversification limits and collateral diversification...
requirements, as well as index quality requirements - for instance, the index must be transparent, fairly represent the market the ETF intends to track and its calculation must be independent of the ETF issuer. But there is also asset segregation and depositary oversight requirements, as well as the expectation to offer daily liquidity. These requirements are a natural fit to what the ETF product has generally been designed to do: offer investors a well-diversified, transparent and cost-effective access to the underlying market of their choice.

These features are in contrast with those of non-fund ETPs, which are structured for the most part around less diversified and non-rated exposures or asset-backed securities like commodities. Additionally, the issuing entity is typically not an authorised fund management company, as for an ETF, but a special purpose vehicle or SPV supported by an affiliated bank sponsor. In the latter case, apart from market risk, investors therefore also bear significant credit risk as an important factor that needs to be considered prior to investing.

Another important difference relates to how invested amounts are secured against the default of the issuer. For an ETF, investors can rely on UCITS requirements to guarantee that their investment is secured by an underlying portfolio of securities representative of the index the ETF is tracking. These are duly segregated and held in custody by a specialised depositary institution on a separate account, booked in the name of the fund. By contrast, non-fund ETPs may not always provide for a secured exposure, and where they do, the nature of the guarantee or collateral may vary considerably, be highly correlated with the issuer or even illiquid, for example physical quantities of a commodity.

Lastly, one must consider leverage. In this regard, a UCITS ETF has strict limits of up to no more than twice its net asset value, unlike the other ETPs whose performance is magnified through a leverage factor that is commonly a multiple of the invested amount.

Some commentators from regulatory, academic and media circles have too often bundled different ETP products together.

Q #3 How did bond ETFs fare during the Covid-induced market turmoil of 1Q20?

The market events that characterised March 2020, especially in the corporate fixed income ETF segment, offered a rare opportunity for ETFs to prove their value and resilience in investors’ eyes. As with most financial instruments during bouts of severe market volatility,
ETFs witnessed widening spreads and a reduction in displayed liquidity. This emanated from dealers, so-called “Authorised Participants” or “APs” as they are called in the ETF ecosystem, and their difficulties in reliably deriving the price of the ETF’s underlying securities, such as corporate bonds in this specific case. This also affected their natural role as arbitrageurs between the ETF’s net asset value or NAV and its quoted intraday price. As expected, large differences - discounts - were observed, in particular for some corporate fixed income ETFs, beckoning some to question the sustainability of the ETF’s underlying arbitrage mechanisms altogether.

Yet, elevated levels in daily trading volumes for these specific ETFs were recorded in their respective secondary market, signalling investors’ vibrant appetite to trade the ETF’s exposure by adequately matching supply and demand. As more investors turned to fixed income ETFs, these became a more reliable indicator of real-time prices for the underlying bonds throughout the initial March sell-off phase, as well as throughout the following recovery in April 2020. This proved that secondary market trading provided a deeper pool of liquidity, compared to the far less frequent trading in the underlying bonds. As a result, market participants and pricing services began to use ETFs to essentially estimate the price of those bonds that were not trading. In this way, rather than distorting the price of the underlying bonds as some have alleged, it can be argued that fixed income ETFs were able to signal relevant and timely information about where market participants valued corporate bonds in the heat of volatile trading and until market conditions normalised.

The March turmoil was also a useful test in that it confirmed the role APs and market makers play within the ETF ecosystem, demonstrating that the withdrawal of any one such market participant did not limit investors from buying or selling ETF units, nor significantly impair the functioning of the ETF ecosystem as a whole.

Access the guide [here](#).

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