

# ETF DUE DILIGENCE WORKSHEET



Choosing from the increasing number of exchange traded funds (ETFs) can be confusing and time consuming. This worksheet provides a framework that allows you to isolate the ETF that best fits your client's needs.

## Provider

How well do you know your provider?

### Critical Questions

- ▶ What is the level of expertise and experience of the firm's investment professionals?
- ▶ How experienced is the firm in developing, managing and supporting ETFs?
- ▶ What are the firm's total assets under management (AUM) and total ETF AUM? What is the competitive market share of each?
- ▶ What are the firm's risk management processes?
- ▶ What is the firm's service model?

### Key Considerations

- ▶ Experience in the ETF market.
- ▶ Size, scale, expertise, track record and level of commitment to the ETF industry.
- ▶ Experience and relationships with market participants, index providers, the exchange and the regulator.
- ▶ A business model that supports and advocates the role of the adviser as the key to investor success (education, consulting and solutions to investment professionals and market participants).

## Exposure

What's in your ETF?

### Critical Questions

- ▶ What is the name and objective of the index the ETF seeks to track (or exposure, if non-index)?
- ▶ What is the index methodology (component selection criteria, rebalancing, reconstitution, initial public offering [IPO] inclusion, etc.)?
- ▶ How accepted or widely followed is the index? How long has the index been in existence? Is performance history back-tested?
- ▶ Are index and fund holdings available on a sufficiently frequent basis? How often are index and fund holdings published?
- ▶ What is the ETF's method for tracking the index (replication, optimisation, representative sampling or other)? Why was this method chosen?
- ▶ How does the investment team manage and execute index reconstitution and rebalancing?
- ▶ What is the predicted tracking error of the ETF?
- ▶ Is the ETF a leveraged/inverse product or does it employ leveraged/inverse strategies?

### Key Considerations

- ▶ Targeted exposure — whether the Australian market or an international region, a single developed or emerging market country or a specific sector or industry theme.
- ▶ Index name recognition. The most widely recognised and respected benchmarks in the industry are supported by index providers who ensure that their indices are trackable, complete and accurately represent the investment opportunity.
- ▶ Frequency of disclosure and level of transparency. While some indices report holdings on a daily basis, not all do — which impacts investor ability to see exactly what is inside the ETF on a given day.

## Structure

What are the implications of the ETF's structure?

### Critical Questions

- ▶ What is the AUM of the ETF?
- ▶ How do Australian regulatory requirements affect the ETF's structure and methodology?
- ▶ What type of securities does the ETF hold?
- ▶ What are the diversification guidelines?
- ▶ What is the creation/redemption process?
- ▶ What are the tax implications of the structure?
- ▶ Is securities lending utilised? If so, what are the collateralisation process, performance impact and risk management techniques?

### Key Considerations

- ▶ A structure that provides transparent benefits to the unitholder, minimising unintended risks or costs.
- ▶ Product design that balances desired exposure and helps to ensure cost and tax efficiency and liquidity.
- ▶ An independent, dedicated ETF structure that helps insulate ETF unitholders from unintended tax consequences and inherent conflicts of interest.

## Liquidity

Can you trade when you need to?

### Critical Questions

- ▶ What is the average daily volume of both the ETF and the underlying basket of securities?
- ▶ How is liquidity maintained in the ETF?
- ▶ How is liquidity enhanced in the ETF?
- ▶ How has liquidity been affected in past stressed market conditions?
- ▶ Are options available on the ETF?
- ▶ What is the options' liquidity?
- ▶ Does the ETF provider offer resources to help advisers achieve the best possible execution for clients?

### Key Considerations

- ▶ It's critical to examine the real liquidity of the ETF through both its market volume and the liquidity of the underlying securities.
- ▶ Liquidity and access in volatile market conditions.
- ▶ ETF provider support for liquidity — strong relationships with index providers and market participants to help provide deeper, more liquid products and the insights to access and exit them.

## Costs

What does it really cost?

### Critical Questions

- ▶ What is the expense ratio?
- ▶ What are the trading costs?
- ▶ What is the average spread?
- ▶ How do the spread and volume factor into overall cost on a trade and per-annum basis?
- ▶ How are internal transaction costs (including rebalancing costs) minimised?
- ▶ How tax efficient is the ETF?
- ▶ What are the historical capital gains distributions?

### Key Considerations

- ▶ Expense ratios are important; however all implicit costs — trading, market impact, rebalancing — should be factored in to determine the true total cost.
- ▶ Tight bid/offer spreads, which lower the cost for investors to enter and exit positions.
- ▶ Institutional grade ETFs focused on maximising liquidity, tax efficiency and transparency while minimising transaction costs for investors.

## Notes

### IMPORTANT INFORMATION

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