Introduction to Exchange Traded Funds

In the current world, the financial market has become increasingly complex. Many dynamic investment instruments are created to meet the diverse needs of the investors. One of the instruments which is becoming increasingly popular is Exchange Traded Fund (ETF). Malaysia's first bond ETF, namely ABF Malaysia Bond Index Fund, and first equity ETF, FBM KLCI etf[1] are managed by AmInvest.

What is an ETF?

An ETF is a collective investment scheme that is listed and traded on a stock exchange. It usually tracks or replicates the performance of a benchmark index. This means that ETF investors hold units of a fund that invests in a number of securities.

By investing in ETFs, investors enjoy a cheaper and easy way to gain exposure to a basket of securities represented in an index through a single transaction. The basket of securities could consist of either stocks, bonds, commodities or others.

Investors can buy or sell units of the ETFs on the stock exchange through any remisier, just like how they buy or sell stocks. They are required to have a Central Depository System (CDS) account and a trading account – that they use for trading stocks – to trade ETFs. In Malaysia, a single trading lot for ETF consists of 100 units. This means investors can buy or sell a minimum of 100 units for each lot.

How do ETFs track an index?

As ETFs are endeavour to track a given index, it is important to know what is an index and how do ETFs track its respective benchmark index. An index is a "basket" or portfolio consisting of either stocks, bonds or other securities which are grouped to reflect the performance of a broad market or sector. The securities that form an index are called index constituents. The underlying securities of the index are chosen by the Index Provider to represent the broad market or sector. For example, Standard & Poor's is the Index Provider for the S&P 500 stock market index, which comprises 500 stocks with the largest market capitalizations in the United States.

ETF tracks its benchmark index by holding securities in the same composition as its benchmark index. ETF could also hold a sample of securities that statistically tracks its benchmark index closely, which also means an ETF could invest in fewer number of securities as compared to its benchmark index.

The objective of ETFs is to give returns that are very similar to the performance of the bechmark index that they respectively track. ETFs do not seek to outperform or underperform a particular benchmark index. For instance, if the benchmark index increases by 10%, the price of the ETF is likely to have an increase of 10%. How well an ETF is managed depends on how closely it tracks its given benchmark index

Why should investors invest in ETFs?

There are four main reasons why ETFs can be a viable investment tool for investors. Firstly, it is easy for investors to buy and sell ETFs. Just like trading stocks, investors could buy or sell ETFs through their remisier broker during trading hours or via online trading. They could check the price of ETFs throughout trading hours and enjoy the flexibility and price transparency when they trade ETFs. In Malaysia, the prices are available real-time (live) throughout the trading day on Bursa Malaysia.

Secondly, the transaction costs of ETFs are generally lower than those of unit trusts. ETF investors do not need to pay any entry fee. They also pay lower management fees because the funds are passively-managed funds. For example, the annual management fee for ABF Malaysia Bond Index Fund is 0.10% of net asset value (NAV) of the fund[2] and FBM KLCI etf has an annual management fee of 0.50% of the NAV of the fund[3].

Thirdly, investors could diversify their investment because ETFs invest in a basket of securities rather than a single security. Hence, investing in ETFs allows them to have instant diversification. Investors could also gain access to markets that are not easily available such as emerging markets by investing in ETFs that concentrate on emerging markets.

Last but not least, it is convenient to invest in ETFs because investors get immediate exposure to the underlying securities representing an asset class in an index by just making a single transaction. Usually, it is more expensive for them to buy a large number of individual stocks to track the index, and to spend on the trading costs for each transaction. When investors buy or sell ETFs, they incur transaction costs including brokerage fee, clearing fee and stamp duty which are applicable when trading stocks on the exchange. For instance, if investors invest in FBM KLCI etf, they are gain exposure to 30 largest listed companies (based on market capitalisation) in Malaysia through a single transaction.

Sources:

[1]Bursa Malaysia (http://www.bursamalaysia.com/market/securities/equities/products/exchange-traded-funds-etfs) as at 29 April 2016.

[2]ABF Malaysia Bond Index Fund (http://www.ambankgroup.com/sites/abfmy1/en/FundInformation/Pages/default.aspx) as at 29 April 2016.

[3]FTSE Bursa Malaysia KLCI ETF (http://www.ambankgroup.com/sites/fbmklcietf/en/FundInformation/Pages/default.aspx) as at 29 April 2016.

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You should be aware that investments in exchange-traded funds carry risks. An outline of some of the risks is contained in the Prospectus dated 13 July 2009, Supplementary Prospectus dated 1 December 2014, Second Supplementary Prospectus dated 1 April 2015 and Third Supplementary Prospectus dated 10 September 2015 for ABF Malaysia Bond Index Fund (Prospectuses), and also in the Prospectus dated 7 June 2009, Supplementary Prospectus dated 6 July 2009, Second Supplementary Prospectus dated 1 December 2014, Third Supplementary Prospectus dated 1 April 2015, and Fourth Supplementary Prospectus dated 10 September 2015 for FTSE Bursa Malaysia KLCI etf (Prospectuses). Refer to the Prospectus(es) for detailed information of the specific risks for the fund. Unit prices and income distribution, if any, may rise or fall. Past performance of a fund is not indicative of future performance. Please consider the fees and charges involved before investing.

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For FBM KLCI etf, in addition to considering the fees and charges, please consider the risks involved including, but not limited to the risk that units may be de-listed from Bursa Malaysia, risks relating to the Benchmark Index, Derivatives and Zero Strike Call Options.

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