How do Exchange Traded Funds work?

Exchange Traded Funds (**ETFs**) are open-ended funds that are listed and trade like stocks on a stock exchange. ETFs are usually designed to provide, to the extent possible, the return of a broad asset class such as Asian equities and Asian fixed income, or of a narrower industry or sector within the asset class.

The listing and trading on exchanges represents one important way that ETFs fundamentally differ from mutual funds. Units of mutual funds can be purchased only once a day, at the fund's closing Net Asset Value (**NAV**), whereas an ETF can be traded at any point throughout the trading day. The benefits of the ETF structure include:

- low management fees
- portfolio transparency
- investment flexibility
- high liquidity
- diversification
- tax efficiency

Unit creation

An ETF may be created to track an index either by holding a representative basket of securities to match or sample the index, or by using derivative products to simulate the index return. An approved underwriter, usually a large securities dealer, will generally deliver the underlying basket of securities to the Fund Provider in exchange for the units of the fund. The underwriter will then continue to create or redeem units based on the demand for units from investors in the secondary market on the exchange. If demand exceeds supply, or the spread between the **bid and ask** on the exchange is growing, more units will be created. If the supply exceeds demand, the underwriter will redeem units. The ability to create additional units to meet demand is an important part of the liquidity of an ETF, which is best reflected by the liquidity of the underlying securities, not by the liquidity of the ETF itself.

Market tracking

The purpose of an indexed ETF is to track as closely as possible the return of a specific market benchmark or index. Deviation from the benchmark return, known as a tracking error, can occur for several reasons. One of these is fund trading costs. Since the underwriters deliver, or take possession of, the underlying securities during subscriptions and redemptions, ETFs negate the need for the Fund Manager to trade securities on the exchange. Therefore, trading and commission costs are kept to a minimum.

Another significant source of tracking can be **cash drag**, which is the result of an uninvested portion of a portfolio's net assets. ETFs maintain low cash levels due to the subscription and redemption mechanism. An ETF will seek to further minimize cash drag by reinvesting the proceeds or providing quarterly income distributions to investors.

Uses of ETFs

ETFs can be important investment tools for both institutional and individual investors. They are used to gain exposure to markets and sectors. ETFs are valuable tools for core satellite investment strategies, for asset allocation, as well as for equitizing cash positions. Furthermore, investors can use ETFs to implement positive or negative views by investing long or short in the appropriate ETF.

BMO Exchange Traded Funds is a diversified family of ETFs that includes a broad range of domestic and global investment solutions. With BMO ETFs, investors can construct efficient multi-asset class portfolios using a risk allocation framework.

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07/16-1569