

ETF due diligence: What to factor in

There is no such a thing as too much information when it comes to due diligence. But fund selectors need to receive good guidance on what to look out for, especially in a fast-growing area like index-based investing. Here we look at the factors to consider when choosing an ETF and its underlying index.

ELEMENTS TO CONSIDER WHEN PICKING AN ETF:

ETF



LIQUIDITY

The liquidity of an ETF determines its tradability and influences the total cost of ownership. Also, an ETF's liquidity reflects the liquidity of the underlying securities.



ETF STRUCTURE

The structure of an ETF will determine how well it can mitigate risks and support liquidity. It is useful to know the fund's investment approach, AUM, top holdings, securities lending practices and how closely it tracks its benchmark.



COSTS

ETF costs are typically lower than those of comparable mutual funds. Other than the expense ratio, costs may include trading fees.



PROVIDER

The reputation of a fund provider in the ETF market is essential, as it gives a competitive advantage over other firms in terms of AUM.

INDEX



EXPOSURE

Understanding an index's benchmark means determining if a certain ETF meets a client's objective. Investors should know how recognized and trackable an index is and whether it is concentrated in particular sectors, companies or countries.



METHODOLOGY

Knowing the rules that govern how an index works is critical to establishing how it will perform. Possible methodologies include market capitalization, fundamental weighting, price weighting and equal weighting.



TRANSPARENCY

Users need to know how often an index rebalances, how long it has existed for and how frequently holdings are disclosed.

"Transparency is one of our key principles and that's not only in the published rules that we use to rebalance the indexes, but also in the governance process any time there's a change to the index."

ROLF AGATHER

MANAGING DIRECTOR, NORTH AMERICAN RESEARCH, FTSE RUSSELL

HOW TO LEARN ABOUT INDEXES:

FTSE Russell can help wealth advisors and ETF developers to understand the nature of the indexes we provide, enabling advisors to efficiently assess funds and make better informed decisions for their clients. Here are some rules to consider:

DATA

From index research to supporting trading and reporting, FTSE Russell shares key insights for better decision making.

EXAMPLE

Available data sets exists for categories including equity, fixed income, corporate actions and dividends, sustainability and industry classification benchmark.

EXAMPLE

Analytics include ETF data, adaptive asset allocation policy calculators and PCBond analytics.

ANALYTICS TOOLS

A toolbox to inform asset allocation strategies, manage risk and examine market conditions to help achieve better risk-adjusted returns.

DESIGN METHODOLOGY

Indexes can be designed to meet certain objectives, such as diversification.

For an index to be investable, it is important that their methodology closely meets those objectives.

EXAMPLE

The FTSE Global Equity Index Series offers a consistent and flexible capping methodology to help investors meet concentration and diversification requirements.

EXAMPLE

The Russell 2000® Index has the objective to track the performance of the smallest 2,000 US companies in the Russell 3000® Index, measured by market cap.

OBJECTIVES

TRANSPARENCY

Indexes need to be designed with clear goals, including how they will achieve targeted factor exposures and how they will follow those goals in practice.