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Exchange-traded products on the rise

Choosing the right strategy

Independent research and consultancy firm ETFGI reports there are 5,410 exchange-traded products (ETPs) globally, with 10,477 listings from 222 providers listed on 60 exchanges. These ETPs represent US$2.62 trillion as at the end of July.

The most popular ETP is the Exchange Traded Fund (ETF). These open-ended funds combine the benefits of both stocks and mutual funds. They trade on the exchange; can be bought or sold at any point during market hours; can be shorted or purchased on margin; and can be managed with techniques such as stop loss and limit orders. And, they tend to be considerably more cost efficient than mutual funds.

Because they represent broad portfolios of securities, ETFs lower volatility and minimize company-specific risk. They can track indices or represent specific types of investments or sectors. They trade at prices closely linked to the net asset value of their underlying assets and must disclose the exact holdings of the fund on a daily basis. Additionally, their versatility facilitates asset allocation.

According to The Vanguard Group, analysis of portfolio return variances from one period to the next shows asset allocation is more important than either stock picking or timing. Over time, asset allocation decisions are responsible for 88% of a diversified portfolio's return patterns. Because ETFs are extremely flexible, they can be used as building blocks in an asset allocation program.

Some investors opt for a strategy called the investment pyramid in which they construct a base portfolio comprised of conservative investments such as bonds, money market, and broad market indices. They then add layers to the portfolio, with each successive one containing riskier investments but smaller weightings.

A basic pyramid strategy might start with a conservative core and then build by adding growth ETFs, mid- and small-cap ETFs, sector/industry ETFs, followed by single stock exposure as the highest risk/reward.

Investors who do not have sufficient proficiency in a sector or style, but want broad exposure, often use the portfolio completion strategy. By adding ETFs to a portfolio, they can gain targeted access to a specific sector or style. For example, if investors wanted access to the emerging markets but were wary of assuming single stock risk, they could purchase an emerging markets-focused ETF and obtain diversified exposure.

Investors wanting to use ETFs, but not wishing to be involved in the construction of their portfolios or the day-to-day management, have choices. They can opt for a Separately Managed Account (SMA) focused on ETFs. These are professionally managed investment portfolios where investors

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have direct ownership of the individual ETFs but institutional-caliber managers handle all the investing and ongoing rebalancing.

Another route is the ETF wrap. The key difference between it and the SMA is that investors do not own the underlying investments directly. They are often referred to as a "one-stop" solution because the investor can gain exposure to a number of exchange-traded products through a single purchase.

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