A guide to Passive Investment: Index Funds and Exchange Traded Funds (ETFs and ETCs)
A word from our Head of Asset Management

Thank you for considering Charles Stanley as a potential partner for effective management of your client’s investments. I hope you find our guide to Passive Investing beneficial and informative.

Our focus on clients has been consistent since the foundation of Charles Stanley in 1792, a heritage that has helped to make us one of the UK’s leading Wealth Management firms.

We understand the challenges that face financial advisers in a continually changing world, with plenty of political and economic surprises as well as significant regulatory changes. In this environment, you may not have had time to consider the benefits of passive investing. But I strongly believe that understanding the differences between passive and active investment can help ensure the investment management service you offer your client is perfectly tailored to the rest of their financial plan.

We are committed to providing you with the highest standard of investment support, and superior quality investment solutions for your clients.

This document is designed to provide you with a clear and transparent approach to when you should use Index Funds and Exchange Traded Funds (ETFs and ETCs).

If you have any queries or further questions, then please get in touch with your contact at Charles Stanley.

Christopher Aldous
Head of Asset Management
What is Passive Investing?

The principal difference between passive and active investment instruments is that a passive product has no investment manager making day to day decisions about which underlying holdings should be held. Instead, passive investment instruments aim to track the performance of a specific index – like the FTSE 100 or S&P 500 indices. They are effectively a basket of investments which enable investors to add the underlying components of an index to their own portfolios in a single trade. A passive product will therefore closely track the performance of the underlying index which it follows and its underlying holdings will only change when the index which it follows is rebalanced. For an equity product this can be quarterly, six monthly or annually while for a bond passive product this is usually monthly.

In theory a passive product should provide the return of the index being tracked less the charges applied by its provider. In practice how closely a passive product matches the performance of the index it tracks will depend on three factors: its ongoing charges/total expense ratios (TER/OCFs), the efficiency of its tracking methodology and the impact of any remunerative activities it is engaged in, such as stock-lending. In some cases a passive product can beat the performance of the index and therefore more than offset the impact of its charges due to good tracking processes, tax advantages over the index calculations and income from stock-lending. Although passive products offer a simple and cost effective way to gain exposure to a broad range of shares or bonds, some do their job less well than others, so it is important to carefully research what is available for each asset class. Generally, passive investment funds have lower total ongoing charges than actively managed investment funds. This means that given the same underlying investment market conditions and fund investments, on the basis of cost alone a passive fund is likely to outperform an active fund.

“Passive investment instruments aim to track the performance of a specific index”

There are two main types of passive products for investing in asset classes such as equities and bonds:

- A conventional passive fund or index fund is like a conventional collective fund and has an open-ended structure
- An Exchange Traded Fund (ETF) has the open-ended characteristics of a unit trust but is listed on a stock exchange and can be traded in the same way as an investment trust or equity. In addition, ETFs can be bought and sold via Authorised Participants who are able to create and redeem units in the ETF as required. This provides an additional source of liquidity if there are no natural buyers or sellers in the market.

ETFs may also be referred to as ETPs (Exchange Traded Products). ETPs cover a wide range of exchange-traded instruments which have more complex structures than straightforward ETFs and often use derivatives to provide the return of an index. Examples are ETCs (Exchange Traded Commodities) and ETNs (Exchange Traded Notes). ETNs are complex and often high risk products and Charles Stanley Asset Management does not use them in its investment products and services.

Straightforward index funds and ETFs employ three main tracking methodologies:

- Full replication – where all of the constituents of the underlying index are held in the same proportions as the index.
- Optimised or sampled – where only part of the index is owned, which may be because there are illiquid holdings in the index which would be difficult and costly to trade, or where excluding certain holdings would have very little impact on the tracking performance.
- Synthetic replication – a type of derivative called a total return swap is used to gain the performance of the index. The investor’s assets will be underpinned by good quality collateral being held by the product’s custodian. Charles Stanley does not use synthetic replication products in its solutions for Financial Advisers.
What are Index Funds?

An index fund is an investment product which invests in a basket of shares or bonds to track an index and therefore access the return of a particular asset class or sub-set of an asset class. For example, it may track the MSCI World Equity Index (global equity asset class) or a sub-set such as the main US equity index, the S&P500 (an asset sub-class). These funds work on the principle that the index represents the performance of the asset class and therefore the fund only has to replicate the index to access that performance. A change in the price of an index should produce a corresponding change in the price of a fund that tracks it, less any TER/OCFs.

The tracking accuracy of index tracking funds can vary significantly (just like an ETF) and the extent of the variation is measured by ‘tracking error’, while the actual impact on the fund’s performance versus the market is measured by ‘tracking difference’. Like active funds and ETFs, selection of a product requires detailed analysis and due diligence to select the best products available to investors. A product which has a low TER/OCFs doesn’t necessarily mean it is the best product to invest in – there are a number of other factors that should be looked at before investing in any product, active or passive.

Units in index funds can only be traded by the fund provider who set up the fund ie a Vanguard index fund can only be traded through Vanguard. Index funds can only be traded once per day, in the UK usually at midday, which can mean that some do not have an end of day NAV (net asset value) taken at the same time as the end of day index calculation which will be shown on the fund factsheet. This can sometimes lead to a "mismatch" in returns being shown.

Most Index funds still have a T+4 settlement period – trade day plus 4 days for settlement.

When trading an index fund, the units will go through a creation (for buying) or redemption (for selling) and will almost always incur taxes – meaning buying a FTSE 100 Index Fund will always incur 0.5% UK stamp duty on buying units in an index fund.

One of the key benefits of index funds is that they have low TER/OCFs which makes them attractive for inclusion in portfolios where the client is price-sensitive. However, OCFs may rise significantly once MIFID calculations are carried out. Another benefit of index funds is that they are a little more flexible for small investors due to fractional share trading – which means that an investor can buy less than one unit.

What are Exchange Traded Funds (ETF’s)?

Passive ETFs are very similar to index funds in terms of the underlying structure; like an open-ended fund it is possible to create and redeem units in them. They use the same techniques to replicate the performance of indices and can be used to follow a wide range of asset classes and sub-classes. However, unlike an index fund they can be bought or sold at any time that the stock market is open. There are two forms of liquidity; units can be created or redeemed at any time by an Authorised Participant, or can be bought and sold in the stock market. Some ETFs can be slightly more expensive than index funds but offer tracking of a much wider range of asset types as well as more esoteric options such as currency hedging, leverage and short-selling. An ETF based strategy is arguably more flexible for trading but, from an advisers stand point, using both provides your client much more flexibility.

Investors can also buy ETFs in smaller investment sizes than with some index funds – ie there are no minimum size trading restrictions.

An ETF can be traded on the stock market – the ETF units are bought and sold (known as secondary market trading) and this does not incur taxes as they have already been paid in the initial creation of the unit, like UK stamp duty @ 0.5%. However, creation of an ETF on the primary market (where units are created) will incur taxes depending on the underlying equities. Some ETFs have become so large in assets under management now that they are very liquid for trading on the secondary market without having to create or redeem units – making the bid/offer trading spreads extremely narrow in some ETFs – for a FTSE 100 ETF or S&P 500 the trading spreads can be as low as 3bps.

There is far more choice when investing in an ETF than there is with an index fund. There are thousands of ETFs available, and they cover every major index (those issued by MSCI, FTSE, Dow Jones, S&P, Nasdaq) and sectors of the equities market (large caps, small caps, growth, value). There are international ETFs, regional ETFs (Europe, Pacific Rim, emerging markets) and country-specific ETFs (Japan, Australia, UK). Specialized ETFs covering specific industries (technology, biotech, energy, cyber security, robotics) and market niches (REITs, gold ETCs). It is also possible to buy ETFs which include currency hedging. ETFs have a T+2 settlement period – trade day plus 2 days for settlement.
As mentioned earlier, some types of Exchange Traded Products (ETPs) may be in the form of certificates or notes (e.g., commodities as it is difficult to store an underlying agriculture commodity like wheat or corn). While TER/OCFs may often be slightly higher than for a conventional index fund, their benefits are tight bid/off spread trading spreads, no front end or back end fees, and no Stamp Duty taxes on secondary market purchases.

It is important to establish whether the wrap platform you use can offer investment into ETFs. All platforms can accommodate index funds, but there are a few that cannot accommodate ETFs so well. It may be either not possible to invest into ETFs or there may be dealing surcharges. A few trading platforms also offer fractional share trading on ETFs to overcome the problem of investing small amounts where the share price may be £100 or more. If available, this facility means you can buy less than one unit.

“There is far more choice when investing in an ETF than there is with an index fund. There are thousands of ETFs available, and they cover every major index and sector of the equities market.”

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**Index Funds vs ETFs - which do I buy for my clients?**

<table>
<thead>
<tr>
<th>Index Funds</th>
<th>vs</th>
<th>ETFs</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Trading considerations</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Shares and bonds are priced once per day.</td>
<td>vs</td>
<td>Shares are traded intraday and fluctuate like stock prices. Broad-based index ETFs are very liquid, but narrow categories could be thinly traded or illiquid.</td>
</tr>
<tr>
<td><strong>Expenses</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Index funds can have high internal expenses however, there are many low-cost index funds available. Creation of an index fund will always incur taxes on equity purchases when units are created, which can increase overall costs.</td>
<td>vs</td>
<td>Internal expenses for ETFs are often lower than those for index funds. Trading ETF units on stock markets means there are no taxes on equity purchases as these have already been paid when the ETF units were created.</td>
</tr>
<tr>
<td><strong>Investment Minimums</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Some but not all index funds require a minimum investment.</td>
<td>vs</td>
<td>ETFs do not have a minimum investment requirement.</td>
</tr>
<tr>
<td><strong>Diversification</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>One ETF or index fund can invest in hundreds (or thousands!) of stocks or bonds in a single fund.</td>
<td></td>
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</tbody>
</table>
The cost differences

Other differences between index funds and ETFs relate to the costs associated with each one. Index funds mainly follow straightforward indices, do not offer sophisticated enhancements such as currency hedging or even some single countries and can be very low cost.

It is possible to access a range of simple asset sub-classes for less than 0.1% per annum, although for more esoteric assets such as emerging markets, the charges will be higher.

ETFs can be more expensive (although TER/OCFs do continue to be lowered) but offer an extensive range of asset-types to follow as well as solutions such as ‘smart beta’ which offer a systematic exposure to defined market factors such as value, growth or dividends, and arguably stray into the territory of the active fund.

Important points regarding how we select Passive investments

Passive products are not selected on cost alone, there are a number of details that need to be assessed before a product can be added to our investment lists.

A product may look cheap with a low TER/OCFs but not necessarily perform in line with another product which has a higher TER/OCFs and follows the same index. In order to assess this, we look at a number of criteria, some of which are:

- Costs – TER/OCFs (total expense ratios/ongoing costs)
- Index and selection criteria methodology to ensure we are getting the exposure we are looking for
- Tracking difference of the passive product versus the returns of the index it is tracking – a product should in general return the same as the index less the cost of the TER/OCFs
- The number of Authorised Participants – these brokers create and redeem units in ETPs and also offer bid/offer trading spreads/prices on stock exchanges
- Bid/offer trading spreads are monitored to ensure they are in line with how the underlying holdings might also trade separately
- Domicile of the passive product – in terms of withholding taxes etc. as different product domiciles may have different tax treaty agreements with other countries
- Size of the assets under management in a product is important as a product that has been launched for some years with a small AUM runs the risk of closure.

“Passive products are not selected on cost alone, there are a number of details that need to be assessed before a product can be added to our investment lists.”
In summary

In summary, both Index Funds and ETFs are very low cost investment products which invest in a broad index so there really isn’t much difference between the two in terms of the investment outcomes – although the choice is much wider in an ETF than it is in an index fund. The primary difference is that an ETF can be traded throughout the day like a stock, whereas an index fund can only be bought or sold at the end of the day’s Net Asset Value (NAV) through the index fund provider. An ETF based strategy is arguably more flexible but, from an adviser’s standpoint, using both provides your client much more flexibility.

The passive approach cannot protect against broad market declines, as it follows the market or sector as a whole. In most cases, it is unlikely to outperform the market. However, when combined with a dynamic asset allocation approach, such as that used by Charles Stanley, it could make outperforming the market more likely.

<table>
<thead>
<tr>
<th>Portfolio</th>
<th>Share</th>
<th>Bonds</th>
<th>ETF</th>
<th>Traditional Managed Fund</th>
</tr>
</thead>
<tbody>
<tr>
<td>Diversification of investment within the asset class</td>
<td>Low - individual securities</td>
<td>Low - individual securities</td>
<td>High - Basket of securities</td>
<td>Depends on different funds - Basket of securities</td>
</tr>
<tr>
<td>Pricing</td>
<td>Continuous on exchange intra-day pricing</td>
<td>No centralised exchange or trade history</td>
<td>Continuous on exchange intra-day pricing</td>
<td>Daily quote after market close</td>
</tr>
<tr>
<td>Liquidity</td>
<td>Varies</td>
<td>Varies</td>
<td>Comparatively higher</td>
<td>Daily, weekly, monthly or quarterly</td>
</tr>
<tr>
<td>Transparency</td>
<td>NA</td>
<td>NA</td>
<td>Fund holdings disclosed as often as daily</td>
<td>Varies</td>
</tr>
<tr>
<td>Transaction costs</td>
<td>Varies according to brokerage</td>
<td>Varies but can have high buy/sell spreads</td>
<td>Varies according to brokerage</td>
<td>Varies according to brokerage and fund manager</td>
</tr>
<tr>
<td>Management fees</td>
<td>NA</td>
<td>NA</td>
<td>Typically less than traditional managed funds</td>
<td>Active funds generally incur higher management costs</td>
</tr>
<tr>
<td>Accessibility</td>
<td>High</td>
<td>Low for many bonds</td>
<td>High</td>
<td>Various depending on fund</td>
</tr>
<tr>
<td>Limit order</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
<td>No</td>
</tr>
</tbody>
</table>
Contact us

For more information about Charles Stanley services for professional advisers, please contact a member of our Intermediaries Sales team.

Chetan Mistry
Intermediary Sales Manager - London
Tel: 020 7149 6355
e-mail: chetan.mistry@charles-stanley.co.uk

Darrell Dymond
Intermediary Sales Manager - West and Wales
Tel: 07989 704041
e-mail: darrell.dymond@charles-stanley.co.uk

Keith Arnold
Intermediary Sales Manager - East Anglia
Tel: 07415 427232
e-mail: keith.arnold@charles-stanley.co.uk

Mark Duggan
Intermediary Sales Manager - Central South
Tel: 07989 704022
e-mail: mark.duggan@charles-stanley.co.uk

Nick Minto
Intermediary Sales Manager - North
Tel: 07989 704039

e-mail: nick.minto@charles-stanley.co.uk

Simon Lloyd
Intermediary Sales Manager - South West
Tel: 07583 013221
e-mail: simon.lloyd@charles-stanley.co.uk

Matt Honour
Asset Management Specialist – South
Tel: 07583 058364

e-mail: matt.honour@charles-stanley.co.uk

Sarita Kattoju
Intermediary Sales Manager - Midlands
Tel: 07970 127064

e-mail: sarita.kattoju@charles-stanley.co.uk

Steve Thompson
Asset Management Specialist – North
Tel: 07966 276360

e-mail: steve.thompson@charles-stanley.co.uk

020 3411 9384
e-mail: ist@charles-stanley.co.uk

www.charles-stanley.co.uk/professional-advisor-services

The value of investments can fall as well as rise. Investors may get back less than invested.

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