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The Differences Between ETFs and Unit Trusts

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On the surface, ETFs and Unit Trusts have many similarities. These include:

- Both ETFs and Unit Trusts are structured in accordance with the requirements of the Collective Investment Schemes Act (2002). This requires, inter alia, that all assets be held in a "ringfenced" trust, under control of an independent Trustee and Administrator, approved by the FSB.
- Both ETFs and Unit Trusts manage portfolios of assets or shares and investors can purchase participatory interests in such portfolios. In the case of ETFs, such participatory interests are issued and traded on the JSE in the form of securities.

Given these broad similarities in structure, regulation and administration, the question then arises, why are ETFs and Unit Trusts perceived so much differently in the marketplace?

To answer this, one needs to dig a little bit deeper into the differences between these two investment instruments.

Secondary Trading

The FSB Rules allow for ETFs to be transacted and traded through a registered stock exchange (JSE). As such, ETFs trade throughout the JSE trading day, like any other listed securities, so investors can take advantage of intraday price movements, etc.

In order to ensure liquidity and to compress bid and offer spreads, the Rules require all ETF Issuers to appoint at least one market maker, who will provide bid and offer spreads at the fair value of the ETF.

Unit Trusts can only be purchased in the primary market, i.e. through the issuer of the Unit Trust. Although, in practice, many transactions are channelled through LISPs and Investment Platforms, these intermediaries still need to deal with the primary issuer. In the case of ETFs, the secondary markets (JSE) has sufficient liquidity to deal with nearly all supply and demand for ETFs, so the primary issuer is seldom involved.

Transparency

In order for "live" trading in ETFs to take place, at all times during the trading day and not just at the close of business - as is the case with Unit Trusts, which trade only once a day - the stockmarket needs to know the fair value of the ETF all times.

Accordingly, the ETF issuer has to publish daily, not only the total NAV of the ETF, but also all its portfolio constituents and weighting allocations, together with any cash component still to be paid in the form of dividends. This complete transparency means that the market can calculate at all times the "true value" of the ETF, even in times of market volatility.

Unit Trusts publish a daily NAV, but not the portfolio constituents. For competitive reasons these are not disclosed, other than retrospectively.

Accordingly, for the investor, the complete transparency of ETFs is a big plus, they know exactly what they are buying or are not relying on the historic performance of the Unit Trust manager, who may now hold an entirely different portfolio to the one the past performance was based on. The "see through" characteristics of ETFs also help the portfolio manager to manage risk and concentration levels using ETFs as the building blocks in the construction of portfolios.

Physical Delivery

The FSB Rules for ETFs, allow subscriptions or redemptions to be made "in specie" i.e. in physical basket form. This is not the case with Unit Trusts for whom all subscriptions and redemptions need to be in cash.

This means the ETF investor can request delivery of the index constituent basket when redeeming ETF units, which forces the ETF issuer to hold the exact index basket at all times. If he does not do so, it creates arbitrage opportunities for the market, which can either deliver or request delivery of index baskets from the issuer when the ETF tracking error strays outside certain parameters.

Accordingly, the investor benefits as the ETF will typically exactly track the performance of the index it is benchmarking, net of costs.

Costs

If the investor has a "put" to demand the physical basket of index components, should the tracking error of the ETF stray outside the costs of doing such physical delivery, it forces the ETF issuer to operate the product at low costs. If the TER of the ETF pushes the tracking error beyond the arbitrage threshold, it is effectively not possible for the ETF to stay in business.

One impact is to force down the TERs of the ETF industry to levels some one-third or less of those of the average Unit Trust.

In summary, the listing of Collective Investment Schemes on the JSE, in ETF form, creates significant advantages for the investor in the form of transparency, tradeability, lower costs and the disciplines imposed on the issuer.

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