

EXCHANGE-TRADED FUNDS: A RECOMMENDED FINANCIAL PRODUCT FOR THE STOCK EXCHANGE OF THAILAND

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ABSTRACT

This paper gives the introduction to what the Exchange-Traded Fund is. It explains how the Exchange-Traded Fund is different from and its advantages over the traditional mutual funds. And lastly, the paper outlines the necessary steps to create a Thailand's first Exchange-Traded Fund, the SET50 ETF.

INTRODUCTION

One important rule of investing is diversification. Through proper diversification, a portfolio's unsystematic risk could be reduced dramatically. Though there is no set number of stocks one should hold in his or her portfolio in order to achieve effective diversification, money experts still agree that diversification is a very important and necessary rule of investing. Some money experts suggest that any portfolio should contain about 20 to 30 stocks in order to achieve relatively effective diversification.

According to the efficient market hypothesis, it is difficult for any person to beat the market. That means it is hard for any one to earn the rate of return above the market return. In Thailand, the SET Index measures the market return.

There are a number of ways an investor can do to earn approximately the market return. For example, one could purchase all securities listed on the SET with each security in a proportion that corresponds to its market capitalization relative to the SET total market capitalization. The rate of return earned from this portfolio, before commission charges, is exactly the same as the market return. But this strategy is proven to be expensive, difficult, and inefficient for a small investor. Alternatively, one could invest in an index mutual fund that seeks to

replicate the return of the SET. This seems to be a good way to invest for small investors. Because this strategy requires small initial (and subsequent) investments, with low or no commissions.

However, mutual funds seem to have some disadvantages due to how they are constructed and regulated. First, mutual fund investors cannot sell short the shares of their mutual funds. In the declining market, each and every mutual fund will see its net asset value (NAV) decline regardless of how good the fund managers are. Fund managers also are prohibited from selling short the securities they hold in the portfolio even though they foresee the decline of the overall market. Secondly, mutual fund investors can buy and sell shares of the mutual fund only at the end-of-day price based on the fund's NAV at the end of a given day. Investors can place the order to buy or sell at any time during the business hours, but the execution price is determined later at the end of the day. The market could be trending up (or down) in the morning trading session when the investor placed an order to sell, but trending down (or up) later when the market was closing in the afternoon trading session. So, there is risk that the proceeds from the sales could be lower (or higher) than expected when placing the order. Lastly, during a volatile market,

a mutual fund company may see heavy redemptions and subscriptions, which could force the mutual fund managers to sell and buy securities in inopportune time. Commissions associated with the sales and purchases of securities could reduce the fund's total return.

So, what is the alternative to mutual funds? Exchange-Traded Fund could be one alternative investment to traditional mutual funds.

What is the Exchange-Traded Fund?

2 You can think of the Exchange-Traded Fund as a closed-end index mutual fund that you can trade any time during the trading hours. Exchange-Traded Fund, ETF for short, usually is set up as a Unit Investment Trust (UIT). This UIT holds a basket of securities in the trust and issue the UIT shares against its underlying assets (the basket of securities) to be traded on the stock exchange. This newly created security, ETF, is traded continuously on the stock exchange at the price determined by the prices of the underlying assets held in the trust. ETF shares may be bought and sold any time during the trading hours, and can even be sold short. The ability to sell short is very important for someone who seeks to profit during the declining market. Without the ability to sell short, many mutual fund investors have to see their investment decline in value, but cannot do anything (except getting out of mutual funds by redeeming their shares). Unlike the case of mutual funds, the ETF's price is not determined by its NAV at the end of day, but the price is determined continuously throughout the trading session. ETF investors know with full certainty the price they will have to pay when purchasing the ETF shares, and the price they will get when selling the ETF shares.

How should the ETF be set up?:

The case for SET

For various reasons, I believe that the SET's first ETF should be the SET50 ETF. The following is just the outline of the main steps needed in order to create an Exchange-Traded Fund.

1. Set up a unit investment trust company, call this, an ETF Company.
2. Register this ETF Company with the SET.
3. Encourage and have the market participants, usually the institutional investors, transfer their ownership of a basket of stocks into the ETF Company.
4. In return for the stock ownership transfer, the market participants receive shares of the ETF Company.
5. List the ETF shares on the SET for trading.

To illustrate these steps a bit more clearly, let's explain with an example. But before that, let's first make three assumptions (which are obviously false).

1. The SET50 comprises of 50 stocks, each has equal weight in the SET50 Index.
2. Each of the 50 stocks in the SET50 has a current price of two Baht at the time the Exchange-Traded Fund to be created.
3. None of the stock in the SET50 pays any dividends.

The ETF Company agrees to issue and give one share of its ETF for any person who deposits to the ETF Company one share of each of the 50 stocks in the SET50, and also agree to give one share of each of the 50 stocks in the SET50 to any person who turns in one ETF share to the ETF Company. So at the time of the creation, each ETF share will be valued at 100 Baht. Regardless of what the SET50 Index is at the time of

the creation, a one percent change in the SET50 Index will result in a one percent change in the ETF price. At a later date, any person can trade the ETF shares at the price determined by the ETF's NAV. The price of the ETF shares will exactly correspond proportionately to the SET50 Index, until there is a change in the list of 50 stocks that comprises the SET50 Index. At that time, the ETF Company must revise the list of securities and the weight of each security to be included in the ETF portfolio. But that step is beyond the scope of this paper.

So, what is the catch?

The idea of the ETF may sound good. But, what is the catch? Generally speaking, ETFs are more suitable for large investors and institutional investors than for small investors. Each ETF purchase or sale transaction incurs a commission, unlike no-load mutual funds. Small investors may be better off with an index mutual fund. The ETF's bid-ask spread also reduces the ETF's return because the purchase price is always greater than the selling price for any stock, including the ETF, at any moment.

Conclusions

Although an individual investor can earn the market return by purchasing (market-capitalization-weighted) all securities in the SET, it is proven to be a difficult, inefficient, and expensive strategy. The ETF allows the investors to trade a basket of securities in a single stock. The ETF has some advantages over the traditional mutual funds, like the ability to trade continuously during the trading hours and the ability to sell short. With the flat rate commission structure of 0.25% (or 0.20%) plus 7% VAT, ETF doesn't provide the transaction costs saving, but it provides convenience for investors to diversify their investments and trade a basket of stocks with ease. The ETF can also be used as a hedging tool for large investors and institutional investors.

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