

Investing in Exchange Traded Funds

By Christopher Chan, Chief Marketing Officer

What is an ETF?

ETF or exchange-traded fund is structured as a unit trust scheme that is listed and traded on stock exchanges worldwide. They are traded like shares, with bidding and asking prices. Brokerage commissions are charged for every transaction.

Why Invest in ETF?

ETF seeks to achieve the same return as a particular market index, sector or group of underlying securities by investing all (full replication) or substantially all (strategic sampling) of its assets in the constituent securities of the index. ETF is a security that offers a straightforward access to their performances. It also offers:

- Diverse exposure to different markets and sectors (as opposed to a share that is linked to the performance of a single company) with flexibility of a stock (e.g. liquidity, transparent prices)
- Convenient and relatively inexpensive way to gain access to many securities

Examples of ETF

There are many types of ETF, and can be categorized as follows:

(1) Geographical

E.g. By country, region etc, such as the Vanguard Emerging Markets ETF and the iShares MSCI Japan Index Fund

(2) Business Sectors

E.g. Vanguard Health Care ETF and the iShares Dow Jones U.S. Consumer Services Sector Index Fund

(3) Asset Classes

These include equities, commodities, bonds, real estate and currencies e.g. Vanguard Total Bond Market ETF and iShares FTSE NAREIT Real Estate 50 Index Fund

(4) Strategies

Did you know that investors could profit from declining US financial stocks following the recent US subprime mortgage crisis? Below is the price performance of the UltraShort Financials ProShares, an inverse ETF:



Source: Bloomberg

(5) Market Capitalization

This refers to the sub-segments of the equity asset class by size (i.e. market capitalization, or number of shares multiplied by price) e.g. Vanguard Mid-Cap Growth ETF and iShares S&P SmallCap 600 Index Fund

HwangDBS IM's Investments in ETF

The unique proposition at HwangDBS Investment Management ("HwangDBS IM") is our fund managers' capabilities and opportunistic investments in ETF. While equity and credit markets were falling, selected assets like commodities like gold and crude oil have been rallying (e.g. due to demand-supply imbalance). Higher ETF prices were also seen in inverse ETF that were linked to falling US financial stocks.

Instead of holding cash, HwangDBS IM have capitalized on the recent market turmoil to invest and profit from gold and UltraShort Financial ETF. There were also investments in a broad and diversified country ETF (e.g. Taiwan), having seen the bottoming of selected equity markets.

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The Use of Options in a Capital Protected Fund

By Christopher YS Chan, Chief Marketing Officer

The use of options in fund management and financial products is still relatively new in Malaysia, yet it **potentially offers a cost-effective way to generate investment returns.**

What is an Option?

An option is a derivative contract that gives the option investor the right, but not the obligation, to exercise a pre-specified obligation on or before a maturity date in the future.

The option investor enters into the contract with a counterparty known as the option writer, who is obliged to honor the specific feature of the contract. To obtain that right, the option investor pays the option writer a fee known as the option premium.

Why Invest in Options?

The specific feature of the option contract can be customized, as in the case of an over-the-counter or negotiated option. If a fund manager has a favorable outlook on Asia's consumer sector, he may either invest directly into the 10 stocks, or invest in a customized option linked to the performance of the 10 stocks.

In the former instance, the fund manager purchases the stocks from an exchange; in the latter, the fund manager enters into an option contract with the option writer (usually an investment bank with derivative capabilities).

Although the performance from the two approaches may be similar, the usage of an option may be more cost effective. Take for instance an fund manager with RM100,000 to invest. To gain exposure to the above 10 stocks, the fund manager may invest RM10,000 in each of the 10 stocks by purchasing directly from the stock market. If the stocks' basket appreciate by 10%, the investor's original capital of RM100,000 would rise to $RM100,000 + (10\% \times RM100,000) = RM110,000$.

The second way is to invest in an option contract linked to the same, 10-stock basket. To replicate the same performance (say, over the next 30 months), the option writer may for example charge a fee of RM20,000. In other words, the fund manager or option investor does not need to invest his entire RM100,000 allocation into the stock market.

If the 10-stock basket appreciates by RM10,000, the option may also gain by RM10,000. The result: on a gross basis, just one-fifth of the original capital (i.e. RM20,000) generated the same level of returns.

From the above, you can see that in an appropriate context, option can offer cost effective exposure to various securities and/or assets e.g. equities, index. **The option investor can benefit from the same performance without actually owning the securities and/or assets.**

Option contracts can be employed in closed-ended capital protected funds to offer a unique proposition to Malaysian investors: **maximum possible gain with downside protection at maturity date.** These funds typically invest substantially in fixed income instruments (to generate capital protection), leaving just a small portion of the fund's assets to generate returns. Here, an option can be used as a cost effective means to generate a fund's investment returns.

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