Evercore Pan-Asset

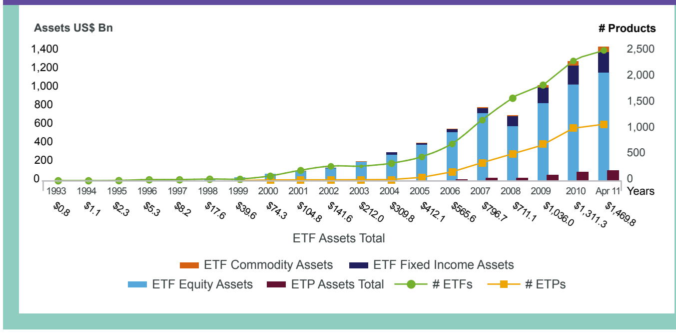
Exchange Traded Funds (ETFs) - your guide to keep

At **Evercore Pan-Asset** we believe in keeping it simple. We concentrate on the big decisions that make the big difference to investment performance. That means deciding how much to have in bonds, or shares, or property. We then buy ETFs which track the index or the asset we want to invest in. This cuts costs and risks.

This guide provides the information you need to understand the basics of ETFs and how they can revolutionise the way you think about investing – we call it "Big Picture Investing".

ETF use is growing rapidly worldwide

Global ETF and ETP Asset Growth



Source: iShares, BlackRock, April 2011.

What are ETFs?

Simple ETFs are index-tracking funds, designed to mirror the performance of an index. They aim to track the underlying market or asset class as closely as possible. Many simple ETFs fully comply with UCITs rules, like any other fund.

Like an investment trust, you can buy and sell them any time of the day that the markets are trading. Like a unit trust, shares can be created or redeemed by the ETF Authorised Participant. This helps keep the price closely in line with the underlying index or asset, rather than moving to a premium or discount according to supply and demand.

Are ETFs safe – how are they structured?

ETFs are each a separate legal entity with professional corporate governance. Their assets are held by large independent custodians, not by the ETF sponsor. Evercore Pan-Asset carry out due diligence to check that an ETF is properly set up to minimise risk. **Simple ETFs**, if properly structured, carry no more risk than the underlying asset or index they track. **Complex ETFs**, such as those which 'sell short', use leverage, track illiquid underlying assets or are not properly collateralised, can be much riskier.

What are their advantages?

Simplicity – Through one trade you gain diverse exposure to a chosen asset class reducing risk and allowing you to buy many previously inaccessible asset classes.

Settlement and custody arrangements are the same as for any other share. As sterling denominated share classes are generally available regardless of the currency of the underlying investments, there is no complicated foreign currency accounting required.

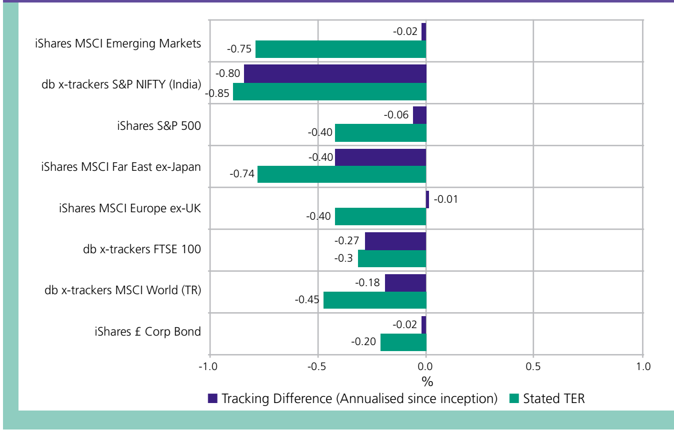
Flexibility – The ability to buy into or sell out of a whole asset class with one simple transaction means that an investment portfolio can be adjusted quickly and easily in response to changing stock market conditions. For example, in a suddenly falling market a portfolio's exposure to UK equities could be, say, halved or eliminated with just one trade. There is no need for any of the time-consuming stock by stock construction of a selling programme that is usually required.

Transparency – Since most ETFs are index trackers and the composition of their underlying indices is published at regular intervals, you know exactly what your investment exposure is within each ETF.

Liquidity – As ETFs are listed on the stock market, they are as liquid as the market. The Market Makers quote competitive buying and selling prices throughout the dealing day. Since ETFs are open ended funds the ETF sponsor can create or redeem units, buying or selling the underlying holdings, to prevent their prices diverging significantly from the underlying fund asset value. With investment trusts the share price can move to big discounts or premia compared to the value of the underlying assets. When the market in which an ETF's underlying assets trade is closed, there may still be a bid and offer price available from Market Makers. With unit trusts dealing is limited to stated times and dates.

Cost Efficiency – ETFs have no entry or exit fees, dealing spreads are tight and their internal management fees are much lower than normal pooled funds – typically only 0.2% per annum for cash and bond ETFs, between 0.3% and 0.7% for equity ETFs and 0.4% to 0.9% for more exotic ETFs. These are often half or less of the fees charged by actively managed pooled funds. Furthermore, no Stamp Duty is payable on secondary market purchases. The funds often offset some of the fee by stock lending. We look at tracking difference after costs, which can be very low for the best ETFs and represents their true cost. This is often much lower than the stated Total Expense Ratio of the ETF.

ETFs are very cost-effective. The true costs can be lower still

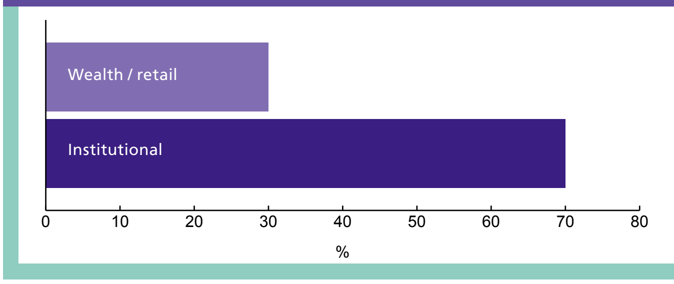


Tracking Differences as at April 2011. Sources: iShares and db x-trackers

All types of investors now use ETFs

In Europe, the majority of ETF users are still institutional although there is a growing acceptance of them by private investors. However, in the US ETFs are widely used by private investors.

ETF and ETP usage in Europe



Source: iShares, BlackRock, August 2010.

Exchange Traded Funds (ETFs)
- your guide to keep

Why does Evercore Pan-Asset use ETFs?

Most active fund managers underperform the index they track. We prefer instruments which closely track the index and reliably give us all or almost all the performance of the asset class we have chosen. We carry out extensive research on a wide range of these index-tracking tools to determine the lowest-cost and safest ones. We measure cost by how closely the instrument tracks the index, after all fees are taken into account.

How do they track an index?

There are three main ways ETFs achieve the performance of the index:

Full Replication is where every share in the index is owned by the ETF in the correct proportion. Replication may seem the most natural method of index tracking but it is not always practical. For example, the MSCI World Index has around 1600 constituents, many of which are comparatively illiquid smaller companies.

Sampled or Optimised Replication is where most shares are owned to achieve a close approximation of the index return. This is particularly useful for indices with many constituents.

Synthetic Replication is where the ETF holds a pool of assets of equivalent value to most of the value of the ETF. The ETF also holds a 'swap' or 'contract for difference' issued by a high-quality counterparty which promises to give the return of the index in exchange for the return of the pool of assets which have been posted as collateral. Swaps are a well established financial tool but are nevertheless a form of financial engineering which introduces an element of counterparty risk should the counterparty to the swap default. This is mitigated by the fact that most synthetic ETFs have collateral which can be adjusted daily to be equal to or greater than 100% of the value of the ETF shares. Under UCITS III rules the swap can never be worth more than 10% of the value of the fund.

Investment banks are often able to generate sources of supplementary revenue from swap transactions, some of which they may share with the ETF in the form of more generous swap terms. Therefore, the existence of the swap is capable of enhancing the underlying index return and offsetting part of the ETF's management fees, giving many synthetic ETFs excellent tracking characteristics.

Do they pay dividends?

Successful ETFs track the total return of the index as closely as possible, aiming to provide the same capital return and dividend yield of the index. Some ETFs pay out regular dividends while others accumulate them as capital. Synthetic replication ETFs often do not pay dividends but instead roll up the dividend income of an index as part of the overall capital return of the ETF. This characteristic can be helpful for higher-rate taxpayers but less useful for those seeking regular income.

So what are the risks?

We believe that most ETFs are safe, efficient, low-cost index-tracking solutions. Nevertheless some can bring risks, especially **complex ETFs**. Inferior ETFs may not track the index closely, others may be small and less liquid with wider dealing spreads. The tracked index may not reflect the true performance of the chosen asset class. The underlying asset or index being tracked may not be properly liquid. Short ETFs and Leveraged ETFs are only suitable for intra-day trading and may not behave in the way expected over a longer period. A UK investor has to pay income tax and capital gains tax on successful investments in ETFs and needs to take tax advice on them as with any other investment held. ETFs are investment funds like many other types of fund and ultimately depend on their Authorised Participants to buy the right assets, as advertised in their brochures. ETFs which use full replication may lend out stock to enhance returns. Although this method might be seen to carry the risk that a counterparty might fail to return lent securities, this can be mitigated by ensuring that the lender requires proper liquid collateral against all lending. ETFs are not covered by the Financial Services Compensation Scheme if they are bought by private individuals without advice from an FSA authorised entity (like Evercore Pan-Asset or your own professional adviser) and we recommend that they are bought under advice from people who study them daily to seek to understand the variety of funds available.

Massive range of asset classes available

The Exchange Traded Fund Universe

Equities	Bonds	Listed Property (REITs)	Listed Commodities (Physical/ Futures)	Other Listed Alternative Investments	Cash
Single Countries	Government	UK Property	Diversified Commodities	Private Equity	Money Market Indices
Global/Regional	Inflation-Linked	Global Property	Agriculture	Global Water	Currency Strategies
Sectors	Corporate	US Property	Energy	Global Timber & Forestry	
Style Indices – Yield, Growth, Value, Market Cap, Quant	Credit Spreads	European Property	Industrial Metals	Global Clean Energy	
Leveraged/ Inverse		Far East Property	Livestock	Infrastructure	
Option Strategies			Precious Metals	Emerging Markets Infrastructure	
Shariah			Leveraged/ Inverse	Hedge Fund	

COMPLEX ETFs SIMPLE ETFs

ETF providers with UK Listings

iShares
www.uk.ishares.com

Credit Suisse
www.csetf.com

ETF Securities
www.etfsecurities.com

db x- tracker
www.etf.db.com

Source ETFs
www.sourceetf.com

HSBC ETFs
www.etf.hsbc.com

Lyxor
www.lyxoretf.co.uk

Powershares
www invescopowershares.com

Osmosis ETF
www.osmosisim.com

More Information

We hope that this has been a useful quick guide to ETFs, but if you would like a more detailed explanation please download our publication **"Big Picture Investing"** from our website at **www.pan-asset.co.uk** or telephone **Hilary Power** on **020 7398 5840** to request a hard copy.

Evercore Pan-Asset Capital Management Limited
Vestry House
Laurence Pountney Hill
London EC4R 0EH
Tel 020 7398 5840
Fax 020 7398 5849
enquiries@pan-asset.co.uk
www.pan-asset.co.uk