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Exchange Traded Funds important notes

Please read the following important notes which explain the specific risk warnings relating to Exchange Traded Funds (ETF's).

As the underlying holdings of an ETF are openly traded securities, they will be vulnerable to market price fluctuations and the value of the investment may rise or fall in value and neither the capital nor any income generated is guaranteed.

Although ETFs have a low tracking error and will generally closely track an index, during times of market volatility, the tracking error of an ETF may increase and it will not always be possible to precisely replicate the performance of an index.

ETFs can have 'counterparty risk' which relates to the way the in which the ETF tracks the relevant index.

There are two tracking methods in general use by ETF; the first method involves holding some or all of the components of the relevant index. For example, if a FTSE100 ETF holds all the underlying securities that make up the FTSE 100 Index this would be a physical ETF with full index replication. In this case there would be no counterparty risk and there is full transparency of the underlying holdings and low tracking difference.

The other method is where an ETF does not physically hold the underlying assets but seeks to replicate index performance 'synthetically' through an over the counter (OTC) index swap transaction with a counterparty such as an investment bank. In this case there is a risk that the counterparty could default which could result in a loss not represented by the underlying index.

How significant is counterparty risk? Most ETF, or any other mutual fund, that is structured under the Europe wide UCITS III (Undertaking for Collective Investments in Transferable Securities) regulations is subject to diversification requirements and limits on counterparty exposure.

Under UCITS III there are specific limits on counterparty exposure for the synthetic replication type of ETFs such that the maximum exposure to an OTC derivative counterparty is 10% of the Net Asset Value (NAV) of the fund. In practice this means that if the counterparty were to default the fund would be liquidated and investors should get at least 90% of the NAV at the time of liquidation. This does not necessarily mean that an investor would receive back 90% of the amount they had invested since the value at the date of liquidation will depend on the performance of the relevant underlying index.

This serves to illustrate how counterparty risk can potentially affect an investment and that where a physical asset is not backing the investment the investor is reliant on the financial strength of a counterparty to meet their obligations.

Counterparty risk on some ETFs is limited to 5% which is below the UCITS III requirements, and some ETF will further mitigate single counterparty risk by using multiple counterparties.

Currency risks - if the underlying investments of the ETF are traded in a different currency to the ETFs denominated currency (i.e. portfolio exposure to dollar but ETF denominated in sterling), there will be additional currency risks to bear in mind. Exchange rate fluctuations may affect the return on the fund.

Volatility – commodity ETFs known as Exchange Traded Commodities or ETCs are generally higher risk investments, which can experience high price volatility, with the possibility of significant intra day price movements. Although this may not be normal on a daily basis it may be an indication of how volatile the fund may be.
Other more mainstream ETFs, such as a FTSE 100 ETF, may also experience volatility but this is likely to be to directly related to market movements; this is known as 'market' or 'systemic' risk.

The following notes relate to specific types of ETF:-

- Short and or leveraged ETFs are more complicated investments which carry greater risks. Leveraged ETFs will exaggerate market movements (up and down) and therefore be very volatile with higher levels of risk to capital and also higher potential reward.

- Short ETFs are intended for investors who think the market is going to fall (the ETF price would rise as the market falls; this is called 'going short') and may also be used as a small part of a portfolio for investors looking to 'hedge' a portfolio against general market falls.

- Leveraged ETFs are intended for sophisticated investors who should read the relevant individual leveraged ETF prospectus to ascertain suitability and understand the risks that are involved.

- Losses with a leveraged ETF can be accumulated at a much quicker rate and there is a greater chance that investors will lose all of their capital.

- Because both short and leveraged ETF price movements are calculated using a daily percentage, for periods of more than one day it is possible that they will ''outperform'' or ''underperform'' the relevant index or commodity. Leveraged or short ETFs are not intended as a buy and hold investment.

- Both short and leveraged ETFs are generally only suited for a small part of an investor's portfolio, experienced investors, and those looking for exposure to a particular type of investment to hold for a specified time period or in certain market conditions.

Tax treatment of the ETF depends on the tax wrapper (ISA, Pension plan etc) that is used and on the individual circumstances of the investor. The levels and bases of taxation and any tax reliefs may change in future.

Any income payable from an ETF is not guaranteed and may fluctuate.