

An ETF Due Diligence Checklist

The rapid increase in the number of exchange traded funds (ETFs) in the marketplace in recent years has made the task of navigating the landscape more onerous. Selecting an ETF from the sizeable universe of more than 125 funds, in Australia alone, can be time consuming and overwhelming.¹ However, knowing what you own is an important investment principle regardless of whether you are buying a security, mutual fund or ETF. Using this worksheet to create a thorough framework for your analysis can help ensure the ETFs you choose best meet your clients' needs.

Evaluate the Index/Fund Does the index and/or fund objectives align with a client's portfolio?

Questions to ask	Why is this important?
<input type="checkbox"/> How long has the index existed?	Even as new indexes are constructed, the index provider's tenure in the marketplace can indicate a measure of stability.
<input type="checkbox"/> Is the index concentrated in particular sectors, companies, or countries?	Understanding an index's focus allows you to pinpoint the exact exposure you need for a client's portfolio.
<input type="checkbox"/> What is the index weighting methodology (market-capitalisation, price-weighted, fundamentally weighted, or equal-weighted)?	Disparate index weighting methodologies can lead to differences in performance and risk/return characteristics among seemingly similar indexes.
<input type="checkbox"/> Does the index report holdings on a daily basis?	The more frequently the index reports holdings, the greater the transparency, and the easier it is to determine how closely the ETF tracks its index.
<input type="checkbox"/> How often is the index rebalanced?	If the index frequently adds and removes holdings, those decisions can impact funds that tightly track the index by changing market exposure and increasing trading costs, which reduces investors' returns.

Examine the Fund Provider Does the firm have a solid reputation in the ETF marketplace?

Questions to ask	Why is this important?
<input type="checkbox"/> How experienced is the ETF provider in developing and managing ETFs?	Large, well-established firms with a long ETF history may have an advantage in this evolving marketplace.
<input type="checkbox"/> What are the firm's total assets under management (AUM) and total ETF AUM?	Total assets indicate stability while high ETF assets further illustrate a commitment to the ETF marketplace.
<input type="checkbox"/> Does the firm enjoy good relationships with index providers and the advisor community?	Solid industry relationships indicate that the ETF provider will not only support current funds, but continue to develop new products.
<input type="checkbox"/> How does the firm manage risk?	A disciplined investment process, broad market expertise and a powerful global investment platform can help manage risk in today's uncertain market.
<input type="checkbox"/> Does the firm provide valuable trading support and ongoing education?	In today's dynamic ETF marketplace, expert trading support and actionable investment strategies can positively impact your bottom line.

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Examine the ETF's Product Structure Does the fund's structure help mitigate portfolio risks and promote liquidity?

Questions to ask	Why is this important?
<input type="checkbox"/> How many stocks or bonds are in the index and what are the fund's diversification guidelines?	A greater number of holdings means increased diversification benefits for the portfolio.
<input type="checkbox"/> What is the investment approach? Does the ETF hold everything in the index?	Not all ETFs are created equal. ETFs can employ a full replication, optimisation-based, synthetic replication, or an active management approach to govern portfolio construction and trading decisions. These different approaches dictate how closely a fund tracks its index — and how well the fund suits a given portfolio.
<input type="checkbox"/> What are the fund's top holdings?	Having a large portion of the fund invested in a handful of holdings can lead to concentration risk.
<input type="checkbox"/> Do the ETF's holdings make sense in terms of the objectives of the fund?	Unlike the straightforwardly named SPDR® S&P®/ASX 200 Fund (STW), many ETFs belie their name. Therefore, it's necessary to look beyond the fund's name or the index it tracks and examine the underlying holdings to understand the fund's risk/return profile and judge whether it adheres to its stated objective.
<input type="checkbox"/> Do the index's holdings overlap significantly with existing strategies in the client's portfolio?	Significant portfolio overlap can leave your clients over-exposed to various sectors, companies, or issuers.
<input type="checkbox"/> Does the ETF follow a traditional market capitalisation weighting scheme or is it alternatively weighted?	A market capitalisation weighting method is ideal for a broad market, energy or financial services sector fund while an alternatively weighting might be better suited if particular characteristics are being targeted.
<input type="checkbox"/> What are the ETF's assets under management?	Significant assets illustrate investor interest and, although products' break-even points vary, a commonly recognised asset level at which an ETF becomes sustainable is \$50 million, a level not matched by almost half of today's ETFs. Greater assets under management can also enhance a fund's liquidity.
<input type="checkbox"/> What is the regulatory designation?	There are investment products that may 'look and feel' like an ETF, but they are not ETFs. These include products such as 'exchange traded notes', 'exchange traded certificates', 'exchange traded commodities' and 'exchange traded securities'. Alongside these are exchange traded managed funds, also commonly referred to as active ETFs that are actively managed, i.e. they do not track an index and typically seek to outperform a selected benchmark.
<input type="checkbox"/> How well does the ETF track its benchmark?	With an ETF that seeks to track the performance of an index, ideally, the fund should tightly track its index.
<input type="checkbox"/> What's the difference over time between the fund's return and the index's return?	An ETFs historical performance does not necessarily indicate future results, but it is still a factor to consider in choosing between similar ETFs. Similarly, comparing tracking errors can help you decide among funds.

Consider the Total Cost Does the ETF minimise expenses?

Questions to ask	Why is this important?
<input type="checkbox"/> What is the fund's total expense ratio	An ETF's expense ratio often compares favourably to a mutual fund's expense ratio. If ETFs are similar in product structure, choose the one with the lower cost, while taking into consideration the transaction costs associated with trading the fund.
<input type="checkbox"/> Are there guidelines to minimise the fund's rebalancing costs?	Frequent rebalancing can increase your costs.
<input type="checkbox"/> What are the trading costs (commissions and transaction costs) associated with buying the ETF shares?	While ETFs' expense ratios are known to be low, trading ETFs may incur additional costs that are important to quantify and compare.
<input type="checkbox"/> What is the average bid-ask spread?	A narrow bid-ask spread indicates a ready market that may facilitate trading.
<input type="checkbox"/> What is the tracking error of the fund?	Returns can deviate some from the index, but profound differences may be a red flag of poor management or excessive trading costs.

Gauge Liquidity Can you trade when you want to?

Questions to ask	Why is this important?
<input type="checkbox"/> What is the ETF's average daily volume?	High trading activity can mean greater liquidity and more efficient trading.
<input type="checkbox"/> How does the ETF maintain liquidity?	Due to their unique creation/redemption process whereby authorised participants (APs) create and provide liquidity when it is needed, ETFs have potential liquidity that may not be evident from assessing trading volume.
<input type="checkbox"/> Has liquidity been impacted due to market volatility?	Due to their unique in-kind creation/redemption process, an ETF's liquidity actually reflects the liquidity of the underlying securities. Therefore, if the ETF holds thinly traded securities, APs may have trouble sourcing liquidity during times of market stress. Additionally, less liquid ETFs can result in increased trading costs or limited ability to trade in volatile markets.
<input type="checkbox"/> Does trading activity cause dramatic price swings?	Large spreads between the bid and ask price often indicate an illiquid ETF, so you'll want to study the spreads and market movements over time.

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Learn More

For more information on ETFs, please visit spdrs.com.au for comprehensive product information and for a wide range of educational resources including up-to-date market analysis, actionable investment ideas and best practices for managing your business.

¹ ASX Monthly Investment Products Report, as of 31 March 2018.

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ETFs trade like stocks, are subject to investment risk, fluctuate in market value and may trade at prices above or below the ETF's net asset value. ETFs typically invest by sampling an index, holding a range of securities that, in the aggregate, approximates

the full index in terms of key risk factors and other characteristics. This may cause the fund to experience tracking errors relative to performance of the index.

Investing involves risk including the risk of loss of principal. Diversification does not ensure a profit or guarantee against loss. Sector ETF products are also subject to sector risk and non-diversification risk, which generally results in greater price fluctuations than the overall market.

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