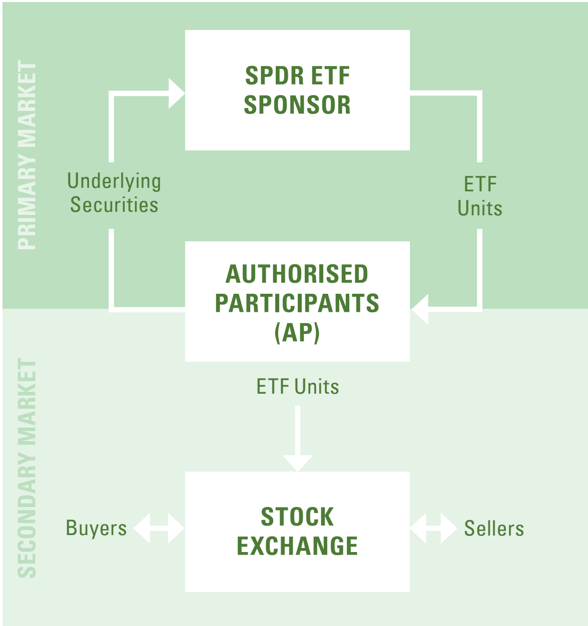
How ETFs Are Created and Redeemed

Exchange traded funds (ETFs) in the global market place today cover a wide variety of asset classes. There are ETFs that track broad market indices, specific sectors, as well as fixed income, commodity and currency. In the simplest terms, ETFs are a collection or "basket" of securities that typically track a specific market index. ETFs have characteristics of managed funds and shares. Similar to a share, they are priced intraday and trade on the exchange.

ETF Creation/Redemption



Like managed funds, ETFs are transparent with their expenses and holdings. While there are some similarities, the main difference between ETFs and other investment vehicles like managed funds and shares is the process through which fund units are created and redeemed. This is called the creation/redemption process, also known as the application/redemption process, and takes place in the primary market between the fund and authorised participants (APs). APs are Australian Securities Exchange (ASX) registered stockbrokers.

Authorised participants create fund units in large increments — known as creation units — by assembling the underlying securities of the fund in their appropriate weightings to reach creation unit size (typically 100,000 fund units) and then delivering those securities to the fund in-kind. In return, the AP receives fund units which are then introduced to the secondary market where they are traded between buyers and sellers through the exchange. As a result of the creation/redemption process, the ETF's portfolio manager typically does not have to buy or sell securities except for rebalancing purposes thus assisting to keep transaction costs low in comparison to traditional managed funds.

APs also have the ability to redeem fund units through the same process in reverse. Large increments of fund units — known as redemption units — are collected in the secondary market and then returned to the issuer for cancellation in exchange for the underlying securities in the appropriate weighting equaling that redemption unit (again, typically 100,000 fund units) which leads to a reduction in the outstanding shares.

To help illustrate this process, let's walk through a specific example (see graphic above). Suppose an authorised participant wants to create units of the SPDR® S&P®/ASX 200 Fund [STW]. First, the AP would reference a list of the exact securities and their weightings within the fund. The list is provided daily by the ETF provider. The AP would gather those same securities in their appropriate weightings in the creation unit. Next, the AP would transfer the securities in-kind to State Street in exchange for fund units of STW. To complete the creation process, the AP would introduce these newly created SPDR S&P/ASX 200 Fund units into the secondary market where they would be traded between buyers and sellers through the exchange. When the authorised participant wants to redeem fund units of STW, they would follow the same process in reverse. In the secondary market, the AP would gather large increments of fund units for redemption. Then in the primary market, the AP would deliver the redemption units to State Street in exchange for the underlying securities in the appropriate weightings equaling that redemption unit. Additionally, fund units can also be redeemed by "Qualifying Australian Residents"[1] who are stockbrokers or have appointed a stockbroker to act for them in redeeming the units.

Understanding the creation/redemption process is key to understanding the unique structure of ETFs, allowing investors to more efficiently buy and sell ETFs. It is this process that sets ETFs apart from other investment vehicles like unit managed funds or shares.

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Index Definition

S&P/ASX 200 INDEX

The S&P/ASX 200 Index is recognised as one of the leading investment benchmarks for the Australian equity market. The index represents the 200 largest and most liquid publicly listed entities in Australia. The S&P/ASX 200 Index provides investors and fund managers with an effective benchmark for Australian equity performance, as it offers a broader representation of the Australian market.

[1] Units in each Fund may only be redeemed by "Qualifying Australian Residents" — broadly Australian residents for tax purposes for the relevant financial year. If a redeeming Unitholder is not a Stockbroker, they must appoint a Stockbroker to act for them in redeeming their Units.

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State Street Global Advisors Australia Services Limited Level 17, 420 George Street, Sydney, NSW 2000. 1300 665 385.

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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.

Diversification does not ensure a profit or guarantee against loss. Sector ETFs products are also subject to sector risk and non-diversification risk, which generally results in greater price fluctuations than the overall market. Brokerage commissions and ETF expenses will reduce returns and transaction costs will also be incurred when buying or selling units of an ETF on ASX markets. ETF units may only be redeemed directly by persons called "Authorised Participants".

SSGA ASL is the issuer of units in the SPDR funds and the Responsible Entity for the managed investment scheme Australian SPDR funds quoted on the ASX or AQUA Product Issuer for those Australian SPDR funds quoted on the AQUA market of the ASX .

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