An ETF Due Diligence Checklist

The rapid increase in the number of exchange traded funds (ETFs) in the global marketplace in recent years has made the task of navigating the landscape more onerous. Selecting an ETF from the sizeable universe of more than 130 listed on the Australian Securities Exchange (ASX) and 6,000 global funds can be time consuming and overwhelming. However, knowing what you own is an important investment principle regardless of whether you are buying a security, managed 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?
☐ 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.
☐ 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.
☐ What is the index weighting methodology (market-capitalisation, price-weighted, fundamentally weighted rules-based or equal-weighted)?	Disparate index weighting methodologies can lead to differences in performance and risk/return characteristics among seemingly similar indexes.
☐ 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.
☐ 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. It can increase realised taxes which may need to be distributed to investors.

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?
☐ How many companies 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.
☐ Is the index concentrated in particular sectors, companies, or countries?	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.
☐ 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.
☐ 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.
☐ Does the ETF hold derivatives/synthetics?	There are a number of ETFs that use derivatives to help achieve its investment objective. It is important to understand the types of derivatives used (for example futures or swaps), how they are used, the risks involved and how these risk are managed.
☐ 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 the majority of today's ETFs. Greater assets under management can also enhance a fund's liquidity.
☐ 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.
☐ What's the difference over time between the fund's return and the index's return?	An ETF's 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.

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Consider the Total Cost

Does the ETF minimise expenses?

Questions to ask	Why is this important?
☐ What are the fund's total fees?	The total fees for an ETF often compare favourably to the total fees for a managed fund. If ETFs are similar in product structure with the same index, some investors prefer to choose the one with the lower cost, while taking into consideration the transaction costs associated with trading the ETF.
☐ Are there guidelines to minimise the fund's rebalancing costs?	Frequent rebalancing can increase your costs.
☐ What are the trading costs (commissions and transaction costs) associated with buying the ETF?	While ETFs' fees are known to be low, trading ETFs may incur additional costs that are important to quantify and compare such as brokerage.
☐ What is the average bid-ask spread?	A narrow bid-ask spread indicates a ready market that may facilitate trading.
☐ 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?
☐ What is the ETF's average daily volume?	High trading activity can mean greater liquidity and more efficient trading.
☐ 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.
☐ Has liquidity been impacted due to market volatility?	Due to their unique 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.
☐ 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.

Examine the Fund Provider

Does the company have a solid reputation in the ETF marketplace?

Questions to ask	Why is this important?
☐ How experienced is the ETF provider in developing and managing ETFs?	Large, well-established company with a long ETF history may have an advantage in this evolving marketplace.
☐ What are the company's total assets under management (AUM) and total ETF AUM?	Total assets may indicate stability while high ETF assets further illustrate a commitment to the ETF marketplace.
☐ Does the company enjoy good relationships with index providers and the adviser community?	Solid industry relationships indicate that the ETF provider will not only support current funds, but continue to develop new products.
☐ How does the company manage risk?	A disciplined investment process, broad market expertise and a powerful global investment platform can help manage risk in today's uncertain market.
☐ Does the company 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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