

Exchange Traded Funds (ETFs)

The first ETF was launched in 1993. By the start of 2012 over 3,000 ETFs were in issue around the world worth US\$1.4 trillion. The vast majority of these ETFs are passive funds designed to track an index. In 2012 there were just 38 active ETFs in the U.S. managing under \$5bn. The majority of ETFs are common stock funds, but there are also bond, commodity, and currency ETFs.

ETFs are securities certificates that provide ownership over a basket of individual stock certificates. Like closed-end funds, ETFs can be bought and sold on the stock exchange. However, in contrast to closed-end funds, the supply of ETFs can expand or contract to meet changes in investor demand.

Most ETFs are promoted by a large fund manager such as Vanguard or Black Rock. In addition to marketing the ETF, the fund manager arranges for large financial institutions to lend the stocks that are needed to form the ETF.

The fund manager does not actually create the ETFs. They are created by *authorized participants* (APs) who assemble the designated stocks (termed *creation* units), and then send them to a custodial bank for safekeeping. The custodial bank checks that the basket of stocks represents the requested ETF, and then forwards the ETF shares to the market maker. The market maker can then sell the ETF shares to investors on the open market.

To reverse the process, the authorized participant can buy a large block of ETFs on the open market. The AP can then send the ETFs to the custodial bank and receive back the equivalent basket of individual stocks.

If investor demand pushes the value of the ETF above that of the basket of stocks, APs have an incentive to send a block of stocks to the custodial bank and receive the ETFs in exchange. If investor demand weakens and the value of the ETF falls below that of the basket, APs will return their ETFs to the custodial bank and receive the stocks in exchange. Thus arbitrage by the authorized participants ensures that the price of the ETF stays close to that of the basket of stocks.