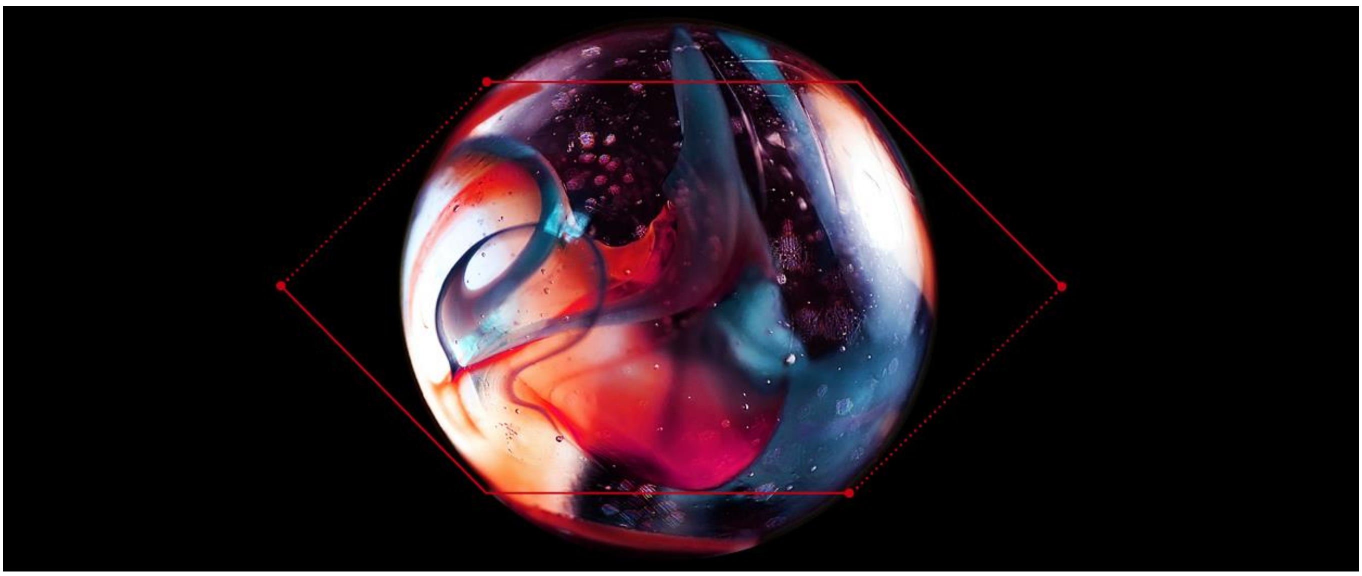
ETFs vs Futures

For Professional Clients only



Introduction

- Investors can choose among several instruments to gain exposure to a given index: among the most common instruments are ETFs and Futures.
- Each of those investment tools has specific characteristics which investors need to take into account in order to make the most efficient investment suited to their needs.
- Investors should be looking at – among others aspects – costs, fees, tax considerations, market frictions, complexity, internal restrictions, counterparty and operational risk, regulatory and legal framework.
- Historically, investors have used futures due to their perceived lower costs. However, that has changed recently due to a number of factors. Among these are increased banking regulations, resulting higher balance sheet funding costs, and the competitive nature of the ETF market, which led to a compression in ETF management fees.
- In addition, easier operational handling of ETF positions and the tried and tested UCITS regulatory framework has led many investors to increasingly use ETFs to replicate index positions.

Comparison

	ETF	Future
Definition	Collective investment scheme which trades on exchange throughout the trading day like listed shares	An obligation for the buyer to purchase the underlying asset at a pre-specified future date and price
Legal structure	Benefits from tried and tested UCITS framework for European-domiciled ETF	Classified as listed derivative contract
Capital requirement	Fully-funded (100% upfront payment)	Partial funding (margin posting requirement)
Availability of exposures	Broad range of exposures available, from standard indices covering broad market segments to niche indices covering only a subset of the markets or specialised investment styles (e.g. "smart beta")	Narrow range of exposures available compared to ETF, covering mostly blue-chip indices (e.g. S&P 500, EuroStoxx 50, etc.)
Trading venue	On-exchange and "over-the-counter" (OTC)	On-exchange and OTC
Liquidity	Multiple layers of liquidity available ◆ Secondary market liquidity ◆ Primary market liquidity of underlying securities	Deep liquidity available for major indices only
Trading costs	◆ Bid/ask spread at the point of trading ◆ Brokerage commissions at the point of trading	◆ Bid/ask spread on each roll ◆ Brokerage commissions on each roll ◆ Futures roll commissions on each roll
Holding costs	Transparent and predictable cost structure ◆ Tracking difference between the index and the ETF	They can be unpredictable and are made of explicit and implicit costs ◆ Explicit cost: uncertain "roll costs" (rich/cheap) upon expiry of contracts, driven by market conditions, bank regulation and resulting balance sheet funding costs ◆ Implicit cost: reference funding rate vs return on cash
Position management	◆ Open-ended structure of ETF (minimal operational effort needed) ◆ Professional portfolio management ◆ Distributing ETF: need to re-invest dividends	◆ Monthly or quarterly expiry of contracts ◆ Investors need to "roll" expiring contracts in order to stay invested ◆ Daily margin posting / cash flow management
Leverage	None (except leveraged ETF)	High, given low margin requirements

Source: HSBC Asset Management. For illustrative purposes only.

Key risks

The value of an investment in the portfolios and any income from them can go down as well as up and as with any investment you may not receive back the amount originally invested.

- **Concentration Risk:** The Fund may be concentrated in a limited number of securities, economic sectors and/or countries. As a result, it may be more volatile and have a greater risk of loss than more broadly diversified funds
- **Counterparty Risk:** The possibility that the counterparty to a transaction may be unwilling or unable to meet its obligations
- **Derivatives Risk:** Derivatives can behave unexpectedly. The pricing and volatility of many derivatives may diverge from strictly reflecting the pricing or volatility of their underlying reference(s), instrument or asset
- **Emerging Markets Risk**: Emerging markets are less established, and often more volatile, than developed markets and involve higher risks, particularly market, liquidity and currency risks
- **Exchange Rate Risk**: Changes in currency exchange rates could reduce or increase investment gains or investment losses, in some cases significantly
- **Index Tracking Risk**: To the extent that the Fund seeks to replicate index performance by holding individual securities, there is no guarantee that its composition or performance will exactly match that of the target index at any given time ("tracking error")
- **Investment Fund Risk**: Investing in other funds involves certain risks an investor would not face if investing in markets directly. Governance of underlying assets can be the responsibility of third-party managers
- **Investment Leverage Risk**: Investment Leverage occurs when the economic exposure is greater than the amount invested, such as when derivatives are used. A Fund that employs leverage may experience greater gains and/or losses due to the amplification effect from a movement in the price of the reference source
- **Liquidity Risk**: Liquidity Risk is the risk that a Fund may encounter difficulties meeting its obligations in respect of financial liabilities that are settled by delivering cash or other financial assets, thereby compromising existing or remaining investors
- **Operational Risk**: Operational risks may subject the Fund to errors affecting transactions, valuation, accounting, and financial reporting, among other things
- **Real Estate Investments Risk**: Real estate and related investments can be negatively impacted by any factor that makes an area or individual property less valuable

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