

Amundi ETF



Mitigating risk through the use of ETFs

Representatives from Amundi ETF and UniCredit put forward their views recently to Risk on the use of exchange-traded funds and exchanges, their role and potential in bringing liquidity and mitigating risk. Among the other topics for discussion was the role and influence of the market-makers, and the advantages they bring to ETF trading.

Risk: Explain how liquidity can be added to an investment portfolio by incorporating the use of exchange-traded funds (ETFs)?

Valérie Baudson (VB), Managing director, Amundi ETF: Since ETFs are traded on an exchange on a daily basis, investors can enter or exit at any time. Market-makers are committed to offering purchase and sale prices (bid/ask) during market hours and are organised to handle very large volumes of trades guaranteeing investors the possibility of buying and selling their ETFs whenever required.

This flexibility is undoubtedly one of the core benefits of ETFs, as it enables investors to increase the liquidity of their portfolio by taking or adjusting their positions instantaneously.

Paolo Giulianini (PG), Director, Head of ETF Trading and Advisory, UniCredit Corporate & Investment Banking: With regard to making ETFs work, a market-maker is quite simply a firm that makes ETFs happen. The creation of an ETF starts with a regulated market-maker, known as the 'authorised participant', which allows the issuer of the ETF to list the fund officially on exchange. The role of the market-maker is to provide real-time pricing, as well as to keep the spread tight, so bringing volume to the product.

Unlike a traditional mutual fund, which provides a unique net asset value (NAV) at the end of the day, ETFs are tradable anytime during the opening hours of the exchange where they are listed. For institutions that invest large amounts in ETFs, there is also the possibility to trade them off the order book (over-the-counter (OTC)) directly with the official market-maker. In this case the price of the ETF is negotiated between the two counterparties and only the market-maker, being a member of the exchange, is entitled to report the trade.

The Panel

Valérie Baudson

Managing director, Exchange-traded Funds, Amundi ETF

Paolo Giulianini Director, Head of ETF Trading and Advisory,

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As an expert view, assets under management in European-listed ETFs have continued to rise steadily since their introduction 10 years ago in April 2000. In this context, it is worth noting the strong trends in their liquidity. One of the most substantial shifts over the past years has been the dramatic increase in ETF turnover, including OTC-reported trades. Every day, more than 10% of total trading on European exchanges is done in ETFs, closing the gap with the US, where this figure is higher than 30%.

One of the reasons is the competition among market-makers that keep bid/ask spreads tight and deep-depth. The on-screen spread of ETFs written on the main European indexes is now always narrower than the spread of the underlying securities of the index (5–12bp on ETFs versus 10–24bp on the same index).

For investors who want to track an index, ETFs are an efficient and convenient investment vehicle. Instead of buying the shares of all index members (which can be very costly if you consider a broad index like the MSCI World or MSCI Emerging Markets), investors only need to trade one security. Furthermore, they do not need to monitor and implement the index adjustments on a constant basis, as the ETF manager is doing this job for them. Compared to other linear index derivatives, ETF investors have neither to face an issuer risk (as it happens for index certificates) nor to handle with daily margining or rolling costs (as it is for futures).

Risk: What impact have ETFs made on traditional funds and portfolio asset allocation for investors?

VB: We believe that ETFs are ideal tools enabling investors to implement various investment strategies. ETFs cover almost all the asset classes available and, compared to traditional funds, they usually have a more efficient cost structure and possess a high level of liquidity and transparency.

Amundi ETF has collaborated in a survey conducted by the Asset Management Research Center of the EDHEC-Risk Institute in order to provide research insights into ETFs and the ways they are used in core/satellite asset management. This survey shows clearly that ETFs are increasingly used by investors, mainly in the core segment, but also in the satellite component of their portfolios.

Risk: Counterparty risk has emerged as a key issue for investors, what steps has the ETF industry taken to mitigate this risk?

VB: Indeed, counterparty risk is a key issue for investors, especially after the 2008 turmoil. The Amundi ETF range is managed according to a swap-based replication method (except for the three historical ETFs) and, as Amundi ETFs are UCITS III-compliant, this risk is limited to 10% of the fund's assets and is clearly stated in the prospectus.

Moreover, the quality of the counterpart is also important. At Amundi ETF we can especially rely on the good quality ratings of both Crédit Agricole, which is the counterpart of our equity, commodity and money market range, and Société Générale, which is the counterpart of our fixed-income range. In addition, we carefully look at the quality of the substitute basket, i.e., the remaining 90% of each fund, which is invested in blue-chip European securities.

Risk: Can incorporating the use of ETFs be an active way to mitigate risk in an investment portfolio?

VB: ETFs are definitely effective tools to optimise a portfolio's risk/return profile. They can be easily implemented in the main investments strategies: core/satellite management, cash equitisation, concentration risk reduction, tactical exposure, etc.

For example, within a core/satellite strategy, the use of ETFs in the core segment in order to passively replicate a specific benchmark (pure Beta exposure) enables investors to monitor and lower the portfolio's overall tracking error.

For sure, investors may also use ETFs for hedging purposes, using, for example, short ETFs. At Amundi ETF, we recently completed our range of short ETFs by launching an innovative range of short fixed-income ETFs covering various maturities.

Risk: In the current economic environment, price has become a critical factor in the investment decision-making process. What are the factors that need to be considered when pricing an ETF and are ETFs currently fairly priced? What is a market-maker and what is its activity?

VB: Cost-efficiency is one of the main advantages of ETFs. Contrary to traditional investment funds, no entry or exit fees are charged for ETFs. Only brokerage fees apply and the yearly management fees are deducted directly from the NAV. Investors should also consider the level of spreads that are applied.

At Amundi ETF, we consider pricing as a very important issue. That's why we decided to enter the market two years ago with a competitive pricing strategy. On average, the management fees of our products at launch date are 20% lower than those of our European competitors. We also work carefully on spreads, which can vary considerably depending on whether an ETF is traded on an exchange or OTC.

PG: A market-maker is a broker-dealer firm (usually an investment bank) that holds its ETF inventory secured in several central securities depository houses (CSDHs) across the world (there are different CSDHs in the UK, France, Germany, Italy, Switzerland, the Netherlands, Spain, etc.) in order to avoid operational failures during the settlement of trades on ETFs.

This inventory is crucial to bringing liquidity to the market. The market-maker has the role of maintaining continuously quotes on ETFs during the entire trading session (usually from 8:45am to 17:45pm CET); the interaction between market-maker quotes and customer orders ensures a high degree of liquidity.

True market-makers are looking for the fastest and cheapest way to hedge trades done on their quotes posted on exchange, create ETF units and maximise ETF trading capabilities.

The market-maker has the unique responsibility of dealing in ETFs and making liquidity available in the market. Moreover, lead market-makers are also authorised participants within the ETF issuer conducting the creation/redemption process in the primary market (meaning that only the market-maker is able to create and redeem the ETF units with the issuer for the number of lots much higher than the average trading size available on exchange).

This creation/redemption process helps facilitate efficient trading by preventing sustained premiums or discounts. If there is a sufficient number of market participants trading an ETF, arbitrageurs and market-makers will ensure that ETFs are always fairly priced. If a premium or discount to the NAV shows up (i.e., the price of the ETF exceeds the NAV by an amount higher than the costs involved in the exploitation of the arbitrage opportunity, such as ticket fees and/or stamp duties), then the market-maker can immediately create or redeem the ETF, forcing its price to move back towards its corresponding NAV. This is something unique to ETFs that differentiates them from mutual funds, which can trade at a discount or premium to their NAV over a long period of time.

Risk: Active ETFs have been heralded by some as a new frontier for the industry and have grown significantly in the US markets. Discuss the potential advantages and drawbacks in using active ETFs and what differentiates them from traditional funds?

VB: Our product strategy at Amundi ETF was, up to now, focused on providing investors with both a large and innovative toolbox for their asset allocation covering the main asset classes (money market, fixed-income, equities and commodities) without deriving from what we consider as the core objective of ETFs: offering passively tracked indexes while remaining simple, transparent and liquid.

Risk: How do you compete against exchange-traded notes (ETNs) and what are the key differences?

VB: Even if ETFs and ETNs can be easily confused because of their denomination and similar way of trading, they do not have the same structures and risk/return profile at all, and most of the investors are not fully aware of the difference between the two vehicles.

ETFs are regulated funds, which respect clear diversification rules and have a limited counterparty risk, as well as liquidity obligations. On the other hand, ETNs, which are issued by a bank, can be compared to a bond and may imply a full credit risk for investors.

These are complementary products as they offer different types of exposures, which would not be accessible by both. For example, pure exposure to a single commodity such as gold would only be accessible through an ETN, whereas investors should favour ETFs for a diversified portfolio, tracking various commodity exposures.

Risk: Elaborate on the role and influence of the market-makers.

How can a market-maker make it easier to trade an ETF?

VB: Behind the denomination of market-makers, we need to distinguish liquidity providers and authorised participants. The former have signed an agreement to have physical access to the stock exchange and are committed to offering purchase and sale prices (bid/ask) throughout the trading day on the stock exchange.

On the other hand, authorised participants intervene mostly OTC; they have signed an agreement with an ETF sponsor allowing them to transact directly with the fund by creating or redeeming units to meet investors' demand.

Both have a very important role as they enable retail and institutional investors to benefit from optimised costs, while ensuring the possibility of buying and selling their ETFs whenever required.

PG: Only official market-makers are given a 'bona fide' hedging and shorting exemption in order to keep the market moving in a fair and orderly way. This active role of the market-maker allows investors to get in and out quickly even in times of extreme volatility and when underlying markets are closed.

The official market-maker is obliged to sign and fulfil binding legal agreements with exchanges in order to fulfil requirements in terms of the following:

- maximum spreads;
- minimum quantity;
- presence in the markets; and
- deviation from indicative NAV (iNAV) and/or fair value.

Under the supervision of the Exchange Market Authorities, the market-maker instantly locks in profits through arbitrage and hedging, rather than betting on the market direction. Doing so, the relationship between the underlying market and the ETF is always kept in line with the fair value and the number of mistrades is kept at a very low level.

Risk: How has the liquidity crisis impacted your ability to trade ETFs?

PG: The ETF market behaves as a quote-driven market more than an order-driven market. This means that quotes coming from official market-makers are mainly responsible for ensuring liquidity to ETFs, rather than buy-and-sell orders entered by investors. As a perfect tracker of an index, the liquidity of an ETF is a direct function of the liquidity of the securities that are included in the basket of the underlying index. The higher the liquidity of those components, the more effectively the market-maker can hedge his position and hence provide better and tighter quotes in the market.

Risk: What's next for ETFs – new products, asset classes and the influence of technological trading advances?

VB: The European market is still under tremendous growth as there is still room for innovative products. New exposures will depend on the evolution of regulation in Europe as well as the providers' capacity to accompany this evolution, bearing in mind that ETFs need to remain simple and easy to use.

We believe at Amundi ETF that there will be a higher use of ETFs in the coming years for many reasons, among them is the fact that the benefits of these vehicles are becoming well-known by investors and that the offering is getting broader.

Market participants (stock exchanges, market-makers, etc.) tend to perfect their technological trading tools and capacities to make the most of ETFs.



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Valérie Baudson has been Managing Director, Exchange-traded Funds, at Amundi Investment Solutions (previously Crédit Agricole Structured Asset Management) since December 2007.

From 2004 to 2007, she was marketing director and member of the European Management Committee of Crédit Agricole Cheuvreux, the European Stockbroking subsidiary of Crédit Agricole Group. From 2001 to 2004, Ms Baudson held the position of corporate secretary and was a member of the management committee. She joined Crédit Agricole Cheuvreux in 1999 as project manager for the senior management team.

Ms Baudson began her career at Banque Indosuez, where she managed international audit missions from 1995 to 1999.

She is a graduate of École des Hautes Études Commerciales de Paris (HEC) where she majored in finance.

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Since the end of 2007, Paolo Giulianini has been Director and Head of ETF Trading and Advisory at UniCredit Corporate & Investment Banking. He runs a well-established and successful ETF trading, advisory and sales team based in London,

Munich and in Milan. They are authorised participants for all ETFs issued by all ETF issuers and official market-maker on all asset classes listed on eight different European exchanges. For seven consecutive years UniCredit has been ranked number one ETF house by *Deutsches Risk* and best market-maker in the ETF Awards 2009 from *Portfolio International*.

During his 14 years as head of delta 1 products at Banca IMI, Mr Giulianini was responsible for building the activity from scratch into one of the leading market-makers for ETFs in Germany, France and Italy in terms of official market-making roles and trades. He helped to strengthen his former bank's ETF sales trading activities throughout Europe, covering all ETF issuers and delta 1 certificates. In the process Mr Giulianini took Banca IMI to the position of being a leading issuer of benchmark certificates in Italy for what has now been the last four years. He worked for IMI Bank in Luxemburg and in Frankfurt between 1994 and 1996. Mr Giulianini graduated from Bocconi University in Milan in 1994.

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