

Supplementary information about Exchange Traded Funds, Commodities and Investment Trusts

This document should be read in conjunction with the Doing Business with FundsNetwork document and the relevant key information document for your Exchange Traded Fund, Commodity or Investment Trust. More detail will also be available in the Prospectus which is available from the fund manager.

Exchange Traded Funds (ETFs) and Exchange Traded Commodities (ETCs), mostly aim to replicate the performance of an index or commodity like an index-linked fund, but they trade like a stock on a stock exchange, as do Investment Trusts, which are public limited companies. As for any investment, the price of shares can go up and down and there are some unique characteristics and risks associated with each type of investment that you should understand before investing in them.

Physical and synthetic ETFs and ETCs

The underlying assets of ETFs and ETCs can be physical or synthetic. An example of a physical asset would be company shares. Synthetic assets are complex financial instruments, usually issued by investment banks. At the moment FundsNetwork™ only offers access to ETFs and ETCs with underlying assets that are physically held.

More about ETFs

ETFs are a type of open-ended collective investment scheme that are listed on stock exchanges. ETFs are bought and sold like ordinary stocks through brokers or advisers at the prevailing market price. The underlying assets are often held by a custodian.

More about ETCs

ETCs are a type of debt security designed to track a specified commodity such as precious metals and futures. ETCs invest in or track a commodity or basket of commodities.

Stock lending

The managers of ETFs and ETCs may generate extra income by lending some of the holdings in ETFs and ETCs to other institutions. This is known as stock lending. The other institution pays the ETF/ETC manager for the loan. Part of this payment is put in to the ETF/ETC itself and part of it is kept by the ETF/ETC manager.

If the other institution was to fail and the holdings in the ETF/ETC could not be recovered, then investors in the ETF/ETC would suffer a loss.

The managers of ETFs and ETCs have policies in place to reduce the risk of any loss occurring through stock lending, for example by spreading their lending across several institutions.

Tracking errors

ETFs and ETCs aim to mirror the performance of a particular index or commodity, but there are factors that can lead to what is known as a tracking error. That is a difference between the actual performance of the ETF/ETC and the performance of the underlying index or commodity. Tracking errors can work to the advantage or disadvantage of ETF/ETC investors, but usually they work to the disadvantage.

Some of the main factors that lead to tracking errors are:

- **Charges** – the annual charges that you pay for investing in an ETF/ETC reduce the overall return you get and this can lead to underperformance compared to the price of the index or commodity being tracked
- **Cash holdings** – ETF/ETC managers may keep some cash aside within the fund to help smooth its overall management. This cash isn't invested in the underlying index or commodity, so if the value of that index or commodity increases the result can be an underperformance overall. If the value of the underlying index or commodity decreases though, the opposite will be true and an outperformance may result
- **Index changes** – Sometimes index providers (for example FTSE or Dow Jones) make changes to their underlying indexes. ETF/ETC providers tracking those indexes then need to react to make changes to their fund and keep everything in step. The time it takes them to do this can result in a tracking error
- **Optimisation** – Optimisation is a way of broadly tracking an index by investing in just a sub-set of the securities in that index. Optimisation inevitably leads to tracking errors of some degree because the manager is not investing in all of the securities in the index. ETF/ETC managers may use optimisation where there are securities in an index that are difficult to obtain and deal in. This is a problem that more often occurs in emerging markets or markets where there are fewer buyers and sellers overall (less 'liquid' markets)

Daily timing differences

At the moment, all ETFs and ETCs offered through FundsNetwork are traded on the London Stock Exchange. However, the indices they track may be open outside of the London Stock Exchange's trading hours.

Where that is the case it means there will be times when the ETF/ETC is being traded but the index it tracks is closed. This can mean a difference between the daily performance of the ETF/ETC and that of the index itself.

More about Investment Trusts

Investment Trusts are a type of investment fund that provide a ready-made portfolio of investments managed by an expert investment team. They are public limited companies (PLCs) with a fixed number of shares and a board of directors, that invest in other companies and follow a variety of investment policies, usually specialising in a type of investment or particular geographic region.

Gearing

Investment trusts have the ability to borrow additional money to invest, known as gearing. This can enhance potential investment returns but gearing can also increase the investment risk of a trust, so whilst gearing can boost gains, it can also magnify losses.

Investment trusts have the ability to use bank loans, bank overdrafts and derivative instruments such as Contracts for Difference (CFDs) to increase their exposure to stocks. CFDs are used as a way of gaining exposure to the price movements of shares without buying the underlying shares directly.

The use of gearing and derivative instruments by investment trusts may increase the level of volatility in the net asset value and share price.

Discounts and Premiums

Because shares in an investment trust are listed on the London Stock Exchange their price is affected by supply and demand. This means that the share price may be different from the total value of the investments it holds (known as the net asset value or NAV).

If you pay less than the NAV for your shares, you are buying at a "discount". If you pay more, you are buying at a "premium". Changes in the difference between the NAV and the share price can magnify the gains or losses on your investment.

Discounts and premiums can vary for a range of reasons. For example, in rising markets, discounts tend to get smaller because investors generally feel confident and expect prices to rise further.

Demand for an investment trust's shares can push a price discount closer to the net asset value of the trust and, in rarer cases, even result in investors paying a premium above net asset value.

Conversely, in falling markets, investors tend to feel less confident about future prices, so discounts can get larger as markets fall, making investment trust share prices cheaper than an equivalent OEIC or unit trust.

Discounts and premiums can therefore compound the effect of rising and falling markets on an investment trust price and, if there is also gearing within the trust, gains or losses can be magnified still further, which may suit investors with a higher risk appetite.

Of course, it's important to remember that you need to take several factors into account when choosing an investment trust, not just price discounts and premiums. In addition to the risk that the market as a whole will rise or fall, you need to consider how the trust's portfolio will perform against the market, what the current discount or premium is and where it might be heading, whether the manager can successfully manage the fund to provide positive returns in the future and what extra volatility or risk will be created by the trust's gearing.

More information

For more detailed information on an individual ETFs, ETCs or Investment Trusts, please ask the fund manager for a copy of the Fund Prospectus.