Review of index trackers in 2012

Findings and recommendations

The Netherlands Authority for the Financial Markets

The AFM promotes fairness and transparency within financial markets. We are the independent supervisory authority for the savings, lending, investment and insurance markets. The AFM promotes the conscientious provision of financial services to consumers and supervises the honest and efficient operation of the capital markets. Our aim is to improve consumers' and the business sector's confidence in the financial markets, both in the Netherlands and abroad. In performing this task the AFM contributes to the prosperity and economic reputation of the Netherlands.

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1 Introduction

The AFM conducted a review of index trackers in the period from September 2011 until the end of May 2012. This report is intended to inform market participants regarding the AFM's findings and recommendations as a result of its review.

The review is a follow-up to the review conducted by the AFM in 2010 regarding the quality of the information provided on index trackers. It also provides further information in the context of the 'Guidelines on Active and Passive Investing in the Customer's Interest' published by the AFM in October 2011. One of the points made in these Guidelines is that the customer's interest should be given the highest priority, also in the offering of passively managed products. In other words, investment products should only be offered to private investors if they add value for these investors.

In this report, the term 'index tracker' is to be understood as an open-end listed collective investment scheme whose objective is to follow an index. Index trackers are often referred to as 'Exchange Traded Funds', or 'ETFs'. Funds with an objective other than that of following an index can also be referred to as an ETF. In this report however, reference is made exclusively to ETFs whose objective is to replicate the return of an index. To avoid confusion therefore, this report will refer only to 'index trackers', or simply 'trackers'. Other Exchange Traded Products (ETPs), such as Exchange Traded Notes (ETNs), are left out of consideration.

The main test in the review was to determine the extent of which index trackers are comprehensible for consumers. The term 'consumer' in this report, is to be understood as an average private investor. In the opinion of the AFM, providers should not offer products to consumers that they cannot understand. If consumers purchase products that they do not understand, there is a high chance that this will lead to disappointment at a later date, for instance if the returns or costs involved are not as expected. If consumers are not able to properly estimate the risks associated with a product or its structure in advance, this can lead to unexpected losses if one of these risks occurs.

The most important conclusion of the review is that some types of index trackers are so complex, that they are – for the average consumer – extremely difficult, if not impossible, to understand. The AFM's opinion is that these products should not be offered to consumers, or should only be offered to consumers through the intermediation of an advisor or an asset manager. This intermediation should take place under the stipulation that the advisor is an expert in these products, and is able to assess the suitability of a product for his clients on the basis of the available product information. In this context, the AFM notes that the information provided on index trackers is not always sufficient or clear enough to provide a good understanding of the operation and risks of the product concerned – not even for advisors and asset managers. If such products are to be offered to average private investors without the intermediation of an advisor or asset manager, an effort will first have to be made to ensure that the products are sufficiently comprehensible.

Firstly, this report consists of an explanation of the review, followed by the findings. The report concludes with the recommendations of the AFM.

2 The review

The review started with a theoretical study, followed by the assessment of a number of products. Since the report is intended to provide information on the findings and recommendations arising from the review, the theoretical study will be described only in general terms. For this reason, no description of the operation of the various products and product features is included.

2.1 The theoretical study

The theoretical study focused on the operation of the various product structures. A distinction was made between physical and synthetic trackers.

A *physical tracker* is a tracker which purchases the securities in the index to be replicated in order to generate a return that is equal to that of the index. If the composition of the tracker replicates the underlying index one for one, this is known as *full replication*. If the composition of the index tracker does not fully correspond to the underlying index, this is known as *sampling*.

A *synthetic tracker* is a tracker that replicates the return of the underlying index by means of a swap agreement. The swap agreement can be concluded by one or several counterparties. An agreement is made with the counterparty that the counterparty will pay the return of the relevant index. This construction guarantees that the index will be replicated without having to purchase the underlying securities in the index. The counterparty naturally requires a fee for this, which can take two forms. If the fee is in the form of a financial payment, this is known as a *funded swap structure.* The feature of this structure is that the counterparty not only provides the return of the replicated index, it also provides collateral for the funds it receives for the index tracker. The fee can also be a payment in the form of the return on the securities that are owned by the index tracker. This return is as it were exchanged for the return of the replicated index that is provided by the counterparty. This construction is known as an *unfunded swap structure*. It should be noted that the above description of swap structures is highly simplified.

In addition to the above product structures, the review also considered *trackers with leverage*, and trackers designed to realise a return that is the opposite of that of the index, known as *inverse tracker*s. These types of index trackers can be constructed in both physical and synthetic form.

After the identification of the operation of the various product structures, the theoretical study concerned an inventory of the product risks and various types of costs involved in index trackers. Moreover, the potential reasons why a tracker can deviate from the index it is intended to replicate were established, and an analysis was made of the various methods used to construct an index. Following this, the possible needs of consumers that could be met by trackers were listed and an evaluation was made of the current state of the market.

2.2 The product tests

After establishing the theoretical framework, a number of products were assessed in order to identify how they work and the risks involved. A testing framework was formulated for the identification of a product's operation and risks consisting of questions regarding the potential and actual relevant features of index trackers. This was based on the theoretical framework and also designed to consider the criteria of 'cost-effectiveness', 'usefulness', 'safety' and 'comprehensibility' (in Dutch, '*kostenefficiëntie*', '*nut*', '*veiligheid*' and '*begrijpelijkheid*', hereinafter 'the KNVB criteria'). In order to assess a product on the basis of the testing framework, the prospectus, KIID (Key Investor Information Document, or the simplified prospectus), most recent fact sheet, semi-annual report and annual report, the information on the provider's website and the product brochure (if available) for each tracker were consulted. The input therefore comprised the entirety of the information actually publicly available and comprised both mandatory and voluntary pre-contractual information.

The KNVB criteria

The AFM uses the KNVB criteria as a frame of reference to assess whether providers are putting their customers' interests first when developing products. The findings can assist advisers and asset managers in the selection of suitable products for their customers. Providers of execution-only services can use these criteria in the selection of products suitable for offering via this channel. Products in the customers' interests must offer value for money, meet the needs of consumers, do what they are intended to do and be understandable. The resulting key questions are:

Cost-effectiveness	*Does the proposition offer good value for money?*
Usefulness	*Does the proposition meet a genuine need of a target group?*
Safety	*Does the proposition do what it is intended to do in all kinds of situations, and are the results acceptable to the target group?*
Comprehensibility	*Is the proposition not unnecessarily complicated, and can consumers properly assess its quality and suitability?*

The review specifically focused on the comprehensibility of index trackers. The other criteria are indirectly involved in the review. In future, the AFM may conduct a more detailed review to establish the degree of which index trackers fulfil the other criteria.

2.3 Content of the testing framework

The testing framework is designed to establish how the index trackers operate and consists of approximately 100 questions on various subjects. The AFM has assessed the comprehensibility of index trackers on this basis. The assessment was made on the basis of the complexity of the product's structure, the effort needed to understand how it works, and the accessibility of the product information. The questions are grouped per subject, and a few examples are given below:

How is the tracker structured?
The assessment is based on the complexity of the structure of a tracker and the effort needed to understand how it works. The way in which the underlying index is composed is also considered. In the case of synthetic trackers, the relevant features of the swap agreement are identified.

How effectively is the index tracked?
The tracking difference and the tracking error are established for the trackers under consideration. These are measures of performance that demonstrate how successfully an index tracker replicates the performance of an index.

To what extent does the investment policy of a tracker correspond to the policy of the index?
Differences in respect of matters such as rebalancing policy and dividend policy are identified.

How high are the costs?

The costs are identified on the basis of the costs of maintaining a tracker: known as the total expense ratio, or TER. The costs of buying and selling a tracker are also taken into consideration, namely the bid/offer spread.

Are the underlying securities held by the tracker lent out?

The underlying securities held by a tracker are lent out for a fee in order to generate additional income. Collateral is received in exchange for this. These transactions are known as securities lending. We consider the policy applied, the counterparty or counterparties with whom the transactions are effected and the way in which the income from securities lending is distributed.

3 The findings

In its review, the AFM has formed opinions with regard to the comprehensibility of index trackers. The AFM has not assessed the quality of the products themselves. For instance, it may be the case that a product offers value for money or meets a genuine need, but does not score well enough on the standard for comprehensibility. The principal findings are given below, however the account given is not exhaustive.

3.1 Comprehensibility of the product structures

A simple index tracker is an example of a comprehensible product. This is a fully physical index tracker that follows a known index and does not lend out the securities it holds or use other optimisation strategies. A simple tracker can be understood by every consumer on the basis of clear provision of information.

An important finding that arises from both the product testing and the theoretical framework is that the structure of several types of trackers is extremely complex, so complex in fact that these products are incomprehensible to consumers, or are only comprehensible with difficulty. The AFM does not consider these products suitable for offering to consumers, and at any rate that they should only be offered to consumers through the intermediation of an adviser or an asset manager. This presupposes that the adviser must have sufficient expertise to be able to assess the suitability of a product for his clients on the basis of the available product information. In this context, the AFM notes that the information provided on index trackers is not always sufficient in order to understand the operation and risks of the product concerned, even for advisers and asset managers. If such products are to be offered to average private investors without the intermediation of an adviser or asset manager, an effort will first have to be made to ensure that the products are sufficiently understandable.

The findings of the AFM with respect to complex product structures are described below.

Synthetic index trackers

The AFM has assessed one or more synthetic trackers from all providers involved in the review, with the main consideration being the structure of these trackers. The conclusion in all the cases assessed was that the construction of the product was exceptionally complicated, and that the risk profile was substantially different from that of physical index trackers. The reasons for this different risk profile lies mainly in the increased counterparty risk and the dependence on the quality of the collateral placed under the swap agreement. A simplified representation of the structure is already so complicated that a consumer could not be expected to understand the operation and potential risks involved.

Particularly when one considers that index trackers are frequently presented as a simple and cheap alternative to active investment funds, this creates a substantial risk of mis-selling.

Synthetic index trackers are also used specifically to create a certain exposure to less liquid markets. If providers wish to continue to offer investors the possibility to obtain exposure to certain illiquid markets, the AFM takes the view that a provider should also check whether more suitable alternative products are available that do not fall under the term 'index tracker'. The same applies to advisers, asset managers and providers of execution-only services in the selection of index trackers that are suitable for their customers, or which meet their customers' needs.

Leveraged trackers and/or inverse trackers

A number of the synthetic index trackers reviewed follow an index in which leverage, an inverse structure or an active strategy is embedded. The leverage or inverse effect may not only be embedded in the index, it may also be in the physical or synthetic tracker concerned. How exactly this kind of tracker works is often very difficult for investors to understand. Since these trackers work differently from 'normal' trackers, it is also difficult for consumers to estimate their price development.

The information provided on these types of trackers does not adequately distinguish the product features of these trackers from those of simple index trackers. This distinction is important to enable consumers to properly estimate risk in advance. One important purpose here is to make consumers aware that in this case they are investing in highly speculative products, whereby it should be clear that trackers using leverage and/or inverse trackers are usually not intended as long-term investments. It is therefore also important that the product is not presented in a way that could confuse investors using index trackers as a diversified long-term investment.

Physical index trackers with optimisation or sampling

When replicating an index, some providers use optimisation or sampling. These techniques may for instance be used in order to follow a specific strategy to replicate the index. These techniques may involve risks, such as an increase in concentration risk. Securities lending may also significantly increase the complexity and the risk of a physical tracker, since this creates counterparty risk. This means that physical trackers using optimisation, sampling and/or securities lending can be more difficult (or impossible) to understand for consumers. The AFM therefore takes the view that if these techniques are used, the provider or adviser has an additional responsibility to ensure that consumers are clearly informed regarding the risks.

3.2 Comprehensibility of the information provided

The information available on an index tracker must be clear enough to enable a consumer to sufficiently understand a product's operation and risks in order to be able to assess its quality and suitability. The findings relating the quality of the information provided are described in this section.

Information is incomplete or difficult to find

In order to assess a product on the basis of the testing framework, the prospectus, KIID (or the simplified prospectus), most recent fact sheet, semi-annual report and annual report, the information on the provider's website and the product brochure (if available) for each tracker were consulted. The input therefore comprised the entirety of the information available to the public and comprised both mandatory and voluntary pre-contractual information. An important finding is that tests of several products revealed that not all questions which were posed in the testing framework could be answered using the available information. This is because the information was not always complete and/or comprehensive and therefore did not give a clear representation of the tracker's operation and associated risks. For instance, the information on a number of trackers did not state the counterparty with which the swap agreement had been concluded. It was also not clear in several cases whether the performance of the index tracker was shown on the basis of the fund's net asset value (NAV) or the market price of its units.

The information offered on a number of products did not give an adequate description of the underlying index. This is important in order to make a proper estimate of the risk, for example to estimate the concentration risk. The methodology of the index was often not explained, or there was only a reference made to the general website of (for instance) NYSE Euronext. There was frequently no mention of the exact place where information could be found regarding the applicable benchmark.

The investment policy and the associated risks, such as the risks arising from the swap construction and securities lending, were often only explained in the full prospectus and were missing in more prominent places in the information provided, such as in the fact sheets or in the product page on the website.

The costs are not clear
The tests revealed that the costs charged for holding a tracker were not clear in all cases. The review also showed that not all costs of holding a tracker are included in the total expense ratio (TER). In addition to the product assessments, several trackers which on paper follow exactly the same index and have equal TERs are compared. The price development of these products varies. This means that in all probability other costs are charged that do not appear in the product information.

Moreover, the effect of dividend tax on the costs and the return is not clear in all cases. The amount of the tax and the degree to which dividend tax can be reclaimed depends on various factors, such as the tax regime applying in the tracker's country of domicile. In some cases, the product information did not explain the effect of the tax due and (possibly) reclaimable tax on the total costs for Dutch consumers.

The type of index tracker is unclear
Not in all of the cases reviewed it was clear from the separate information sources what type of tracker was involved. From experience, we see that various types of products are sold under the name of 'index tracker' or 'ETF'. In some cases investment products with completely different structures and risk profiles were referred to as index trackers. Therefore there is a risk that consumers will have false expectations with regard to products which have different objectives but are sold as index trackers or ETFs. The fact that in most cases the product's name does not tell one whether it is a synthetic or a physical tracker could also contribute to an inaccurate perception of risk.

3.3 Performance indicators

The tracking error shows the degree of volatility of the difference between the return of the index tracker and the return of the index, and is calculated using standard deviation. The higher the tracking error, the greater the risk that the return of the tracker will deviate from that of the index. The tracking difference is the absolute difference between the return of the index and that of the index tracker.

The information provided on the products reviewed usually did not (or did not adequately) explain the terms 'tracking error' and 'tracking difference' and no target with regard to these two performance indicators was stated. Furthermore, the causes of tracking error and tracking difference (other than costs), such as a different policy regarding dividends, were often not mentioned in the product information.

The AFM takes the view that tracking error is difficult for consumers to interpret. In addition, the tracking errors of various index trackers are not always directly comparable due to the different calculation methods that are used. Tracking error is thus not a clear indicator of performance for every consumer. Tracking difference on the other hand is a performance indicator that is simple to calculate and therefore easier for consumers to understand. The review however showed that tracking difference is almost never mentioned in the product information. Product providers state the tracking error more frequently, but even so, the tests showed that a tracking error is not reported in all cases. If the tracking error was stated, it was difficult to find in the product information since it is usually only to be found in the annual report and not in the more prominent places in the information provided, such as the fact sheet and the website. Moreover, information on the period over which the tracking error was calculated was missing in many cases.

There is no method for calculating tracking error and tracking difference prescribed by regulation. This means that these performance indicators can be calculated in different ways. For investors, it is relevant to know the period over which the tracking error or tracking difference was calculated. A calculation on a daily basis usually gives a higher value than a calculation on a monthly basis, for example. For investors with a short-term investment horizon of a few days to a few weeks, the tracking error is a relevant performance indicator, since it is more focused on short-term volatility. For investors with a longer investment horizon of one to several years, the tracking difference is the more useful measure.

3.4 A different and/or not clearly explained investment policy

It may also be difficult or impossible to understand how an index tracker works if the investment policy used is not clearly explained.

The policy of the tracker is different from that of the index

If an index tracker applies a different investment policy than the policy used for the underlying index, this means that the return of the tracker can be different from that of the index. The same applies if a different rebalancing or dividend policy is applied. If the policy of the tracker is not the same as the underlying index, this also means that consumers cannot make a direct comparison between the operation of the tracker and the underlying index. The assessments reveal that differences in policy are difficult to identify, and that the product information is not clear in this respect. In a number of the product tests it was not at all clear on the basis of the available information whether there were in fact differences in policies.

Investment policy is too broadly formulated

In many cases, the description of the investment policy in the prospectus is so broadly formulated that it leaves all options open. This means that consumers have no basis for forming a realistic estimate of the operation and risks associated with the product. A broadly formulated policy allows for wide variation in a product's operation and risk, which can also have consequences for existing investors. A too broadly formulated policy is therefore undesirable. The policy of one of the physical trackers assessed for instance stated that derivatives may be used. In another case, the policy of a synthetic tracker stated that the swap agreement was usually concluded with the fund's own investment bank, but that it may also be concluded with other parties. The actual counterparty was not mentioned in the information provided, therefore it was not clear who the counterparty was. In addition, the policy of several trackers stated that all securities were eligible for lending and all types of securities were acceptable for the purpose of collateral, however the current information did not make it clear what happened in practice. One could therefore not establish how much was lent, or what collateral was obtained for this.

No policy formulated regarding counterparty selection and collateral

In most cases the information assessed did not state whether a policy had been formulated for counterparty selection. It was therefore not clear how the counterparties to the swap agreement were selected, or whether, for instance, requirements had been established regarding a minimum credit rating for counterparties. There was no information on whether negotiations had been conducted with various parties regarding the price of the swap. The same applied to the selection of counterparties for securities lending. In most cases there was no information available on this either.

Both the product assessments and the theoretical study revealed that the collateral obtained in relation to securities lending usually did not correspond to the composition of the underlying index. The information on the tested products only referred to the type of securities that were acceptable as collateral. No policy was found concerning the composition, the minimum rating of the issuer or the liquidity of the securities concerned. This means that in a default scenario investors would be exposed to an investment that could be significantly different from the replicated index.

3.5 Securities lending

The review made an assessment of securities lending conducted by physical trackers. Among other things, this revealed that a large proportion of the income from securities lending did not flow back to the unit holders in the collective investment scheme, but went to the fund manager. The AFM has stated on previous occasions that it is not, under any circumstances, appropriate that the risk of securities lending is borne by the investor while a disproportionate part of the income goes to the fund manager. The information provided on the assessed products did not state how these proportions were established. The AFM understands that the parties involved in securities lending need to receive a reimbursement for the costs that they incur. The AFM cannot currently give an indication of the amount that the fund manager would be entitled to. The guiding principle, however, is that if the risk is chiefly borne by the investor, most of the compensation for bearing this risk must go to the investor.

The AFM’s view with regard to securities lending does not only apply to index trackers. The same stance has been communicated to other providers of collective investment schemes (that do not qualify as index trackers) in previous reviews.

4 What does the AFM expect of the market?

The AFM expects providers to assess both their current product offering and the product information that they make available in light of the findings and recommendations in this report, and to make adjustments where necessary. The AFM’s intention is that providers should adopt the recommendations of the AFM when developing products for, or offering products to, consumers in the Netherlands. The recommendations with regard to the provision of information are not in addition to the existing legislation and regulation, however the relevant legislation and regulation does of course apply to all of the information provided or made available by the provider, such as the requirement that the information is correct, clear and not misleading (Section 4:19 of the Financial Supervision Act). This applies to both information that has to be provided to consumers by law and information that is provided on a voluntary basis.

The recommendations can assist advisers and asset managers in the selection of suitable products for their clients. Providers of execution-only services can use the recommendations in the selection of products suitable for offering via this channel. The recommendations are not an addition to legislation and regulation with regard to the provision of services with due care. The AFM has formulated the following recommendations on the basis of its findings. The recommendations are intended for providers, advisers, asset managers and providers of execution-only services, collectively referred to here as ‘financial enterprises’.

- The AFM considers index trackers which are incomprehensible are unsuitable for offering directly to consumers, and believes that these products should only be offered to consumers through the intermediation of an adviser or an asset manager. If index trackers are to be offered to consumers without the intermediation of an adviser or asset manager, an effort will first have to be made to ensure that the products are sufficiently comprehensible. The AFM therefore expects providers to only offer index trackers to consumers that can be understood by the relevant target group. In the case of advisers and asset managers, the AFM expects these parties to only recommend products to consumers or include products in consumers’ investment portfolios that they sufficiently understand in order to be able to assess the suitability of the product for their customers. Lastly, the AFM expects the providers of execution-only services to only select products that are suitable for offering via this channel.

- The AFM appeals to financial enterprises to compile the information they provide on index trackers in such a way that enables both consumers and professionals to understand the operation of an index tracker and its associated risks. The AFM wishes to stress that this does not mean that every technical product detail has to be explained. The product information should include a clear description of the principal risks and costs, the counterparties with which agreements are concluded and the composition of the underlying index. Any differences between the investment policy or other policy of the tracker and the index should also be clearly explained in the information provided.

- If an index tracker’s risk profile is different from that of a simple tracker, this should be clearly mentioned in the information. This particularly applies to synthetic trackers, leveraged trackers and inverse trackers.

- If synthetic index trackers are offered or recommended to consumers or are used as part of asset management in order to obtain exposure to certain illiquid markets, the AFM expects a study to be conducted to establish whether any alternative investment products are available that might be more suitable.

- Both the theoretical study and the product tests give reason to recommend that the tracking difference should be used as well as the tracking error as a performance indicator in the information provided to consumers.

- The AFM considers that the type of tracker should be made clear to consumers, for example by indicating in its product name whether its composition is physical or synthetic. In order to avoid confusion among consumers, the AFM considers it desirable that products whose objective is anything other than that of replicating an index, such as certain inverse or leveraged trackers, should not be described as index trackers.

- The AFM expects financial enterprises to properly inform consumers regarding relevant product features such as costs, counterparty risk, concentration risk and currency risk, for example by placing this information in (several) prominent places in the information provided.

The AFM is aware that some of its findings and recommendations apply to other collective investment schemes as well as index trackers. The AFM therefore advises financial enterprises to also strive to follow these recommendations in relation to other collective investment schemes in order to provide the best possible service to consumers.

For the record, the AFM wishes to inform market participants that ESMA is working at European level on guidelines that will apply to index trackers. [1] At the time of publication of this report, these guidelines were still in the consultation phase. On publication of this report, account has been taken of the contents of the consultation document.

[1] *http://www.afm.nl/nl/nieuws/2012/jan/cons-esma.aspx*

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