Deutsche Asset
& Wealth Management

Passive Insights

Every basis point counts - how institutional investors can use ETFs for long-term investment

October 2014
Marketing Material
For Institutional Investors Only
For Discussion Purpose Only.

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Content

1. Introduction

Exchange-traded funds (ETFs) are index tracking mutual funds. The only difference between an index mutual fund and an ETF is the intraday liquidity, via a listing, that the ETF offers. In Europe, the vast majority of ETFs comply with the UCITS (Undertakings for Collective Investment in Transferable Securities) mutual fund regulations, which means they meet high standards in terms of investor protection and fiduciary responsibility.

Institutional investors may consider using ETFs for a number of purposes. Often cited is ETFs' usefulness in implementing short-term strategies relating to transition management and tactical positioning. There is however a good case to be made for institutional investors using ETFs to try to meet their long-term, strategic investment needs. As the ETF market in Europe has developed, the choice of underlying exposures available in ETF form, which may not be available using other types of investments, has increased significantly. Equity exposure can be acquired on global, regional, country and sector levels. Alternatively weighted equity indices – 'strategic beta' – can also be tracked, while exposure to fixed income, commodities, cash, credit and alternatives are also available via ETFs.

Compared with using index funds or futures, ETFs can offer institutional investors a number of advantages when it comes to trying to meet both their tactical and strategic investment needs. Trading futures requires a flexible investment policy and the resources to mark-to-market on a daily basis while managing margining and the rolling process. ETFs by comparison require no such effort. In this sense, even for short-term tactical use, such as cash equitisation, ETFs could be considered the most straightforward tool available to institutional investors.

Importantly, fee compression in the ETF market means ETFs on major benchmarks can now compete with index funds in terms of their total cost of ownership.

2. Competitive Fees & Total Cost of Ownership

It is important to note that a mutual fund or an ETF's All-in fee (Total Expense Ratio) is only one component of the total cost of ownership, and it is the total cost of ownership that should be assessed when working out the costs of investing. For an index tracking fund the total cost of ownership comprises a number of components. In addition to the All-in fee, the following factors should also be considered:

— **Tracking performance**

Examining the tracking difference (the difference between the returns of the index being tracked and the returns of the fund) over time is a key part of assessing the cost of holding the index exposure. The performance of a tracker fund is negatively impacted by management fees and any additional costs associated with operating the fund (for example, financial transaction taxes, and stamp duty incurred when rebalancing the portfolio). Crucially, not all of these costs are incorporated in the TER, which means the tracking difference over time gives a fuller sense of the true costs of holding the exposure. Keep in mind however that revenues from the ETF or the fund engaging in securities lending work in the opposite direction, helping to offset the impact of fees and costs.

Securities lending allows holders of stocks to lend out their holdings in return for a fee from the borrower, with loans collateralised with the aim of hedging counterparty risk.

Tracking difference is also important for comparison with using a futures strategy. The roll costs associated with using futures has a negative impact on tracking performance.

A measure of estimated tracking difference is provided for all db X-trackers ETFs online (www.etf.db.com). This transparency is important when assessing the expected cost of achieving exposure.

— **The importance of country domicile**

ETFs are regulated mutual funds, and depending on which country a fund is domiciled in, there may be differences in the net dividends received by the fund from physical holdings of foreign stocks, depending on tax agreements between different countries. An ETF domiciled in Ireland for example may be subject to 15% withholding tax on dividends, compared with the 30% withholding tax rate for dividends on US stocks that funds domiciled in other European jurisdictions can be subject to. Country domicile can, therefore, have a direct bearing on fund performance versus the underlying index.

— **Costs of buying/selling fund/ETF shares (the "trading spread")**

Index funds may be subject to dilution levies or entry/exit charges when buying or selling units. These charges may take into account any transfer taxes that may apply, e.g SDRT (stamp duty reserve tax) in the UK or FTT (Financial Transaction Tax) in France and Italy. New investors pay these charges when they buy new units so that existing investors are protected and do not bear these costs. Other fund houses may choose to mutualise such costs, meaning existing or remaining investors may bear the costs of others redeeming their holdings or subscribing new shares.

ETFs are also subject to these entry/exit charges when new units/shares are created. As they are traded on exchange, these costs are typically reflected in the bid-offer spread. However, the two-way liquidity in ETFs can help to offset some of these costs (if there is no need to create/redeem shares). It could be the case that the costs of implementing an allocation with ETFs, as reflected in the bid-offer spread, may be lower than the equivalent entry/exit charges that may apply to an index mutual fund.

The ETP Capital Markets Team at Deutsche AWM can assist institutional clients looking to minimise trading costs by using broker relationships, while also analysing potential trades to demonstrate the expected overall holding cost versus other investment types based on investment horizon.

— Lending of ETF shares
As ETFs trade in the same way as listed securities, there is a borrowing/lending market just as there is for equities or bonds. Typically, market makers and brokers may be willing to borrow the ETF shares to facilitate their trading and hedging activities. This provides an opportunity for holders of ETFs to generate some revenues through lending out their holdings, and therefore further reduce their total cost of ownership and improve overall investment performance (note that this is different from securities lending activities described in point 1 above, which relates to the ETF lending the underlying securities it holds). The ETP Capital Markets Team can work with clients and their custodian/securities lending agent to see if their ETF positions could be lent out.

3. Transparency

Although not related to the costs associated with acquiring index exposure, transparency is an important consideration when it comes to selecting investments. The ETF industry in general has set high levels of transparency with regard to the underlying operational aspects of how ETFs achieve their index tracking aims. For example, db X-trackers ETFs publish, on a daily basis, full breakdowns of current holdings, while for those ETFs that use securities lending, full breakdowns of securities held as collateral, the current percentage of securities on loan, and the current collateral value as a percentage of securities on loan are available online and updated daily. A list of approved borrowers is also published online, as well as the revenues received by the ETF and other important details, including calculations for the ETF’s securities lending return, average annual percentage on loan, and the maximum annual percentage on loan.

4. db X-trackers Core ETF range

Deutsche Asset & Wealth Management (Deutsche AWM) aims to be highly competitive in terms of total cost of ownership. Starting with the TER, Deutsche AWM offers a 'Core ETFs[1]' range with low All-in fees. The table below shows the range as at 1 September 2014:

db x-trackers ETFs	ISIN	Replication	Ticker	All-in Fee p.a.
FTSE 100 UCITS ETF (DR)	LU0838780707	physical	XDUK	0.09%
DAX® UCITS ETF (DR)	LU0274211480	physical	XDAX	0.09%
DAX® UCITS ETF (DR) - Income	LU0838782315	physical	XDDX	0.09%
EURO STOXX 50® UCITS ETF (DR)	LU0380865021	physical	XESC	0.09%
EURO STOXX 50® UCITS ETF (DR)	LU0274211217	physical	XESX	0,09%
MSCI USA Index UCITS ETF (DR)[2]	IE00BJ0KDR00	physical	XD9U	0.07%
MSCI World Index UCITS ETF (DR)[3]	IE00BJ0KDQ92	physical	XDWD	0.19%
Nikkei 225 UCITS ETF (DR)	LU0839027447	physical	XDJP	0.09%

With annual All-in fees starting from less than 10 basis points per year, the db X-trackers Core ETFs can compete with index funds on a TER basis.

5. Summary

Institutional investors may be inclined to assume that index trackers or futures strategies must be the most cost effective method to attain passive market exposure. This is no longer the case. With highly competitive All-in fees, but more importantly with highly competitive overall total cost of ownership, ETFs should be considered alongside index mutual funds, especially for long-term strategic investment purposes. If low total cost of ownership can be shown to be achievable, then the ETF may be the more optimal solution.

[1] Low cost, blue chip benchmark trackers that may be considered as long-term holdings in investors' portfolios
[2] Sub-fund of Concept Fund Solutions plc

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Source: Deutsche Bank unless otherwise specified in the document. Opinions included herein are those of Passive Asset Management at the time of publication and may change without notice. There can be no assurance that the future performance of the strategies discussed herein will reflect their simulated past performance.

Risk Factors or ETFs

- ETFs are not capital protected; therefore investors should be prepared and able to sustain losses up to the total loss of the capital invested.
- The value of an investment in ETFs may go down as well as up and past performance is not a reliable indicator of future performance.
- Investment in ETFs involve numerous risks including among others, general market risks relating to the relevant underlying index, credit risks of the counterparties used by ETFs when entering into OTC derivative transactions, including credit risks on the provider of index swaps utilized in the case of swap-based ETFs, exchange rate risks, interest rate risks, inflationary risks, liquidity risks and legal and regulatory risks.
- db X-trackers UCITS ETFs following a direct replication investment policy, may engage in securities lending. In these instances the db X-trackers UCITS ETFs face the risk of the borrower not returning the securities lent by the db X-trackers UCITS ETF due to e.g. a default situation and the risk that collateral received by the db X-trackers UCITS ETFs may be liquidated at a value lower than the value of the securities lent out by the db X-trackers UCITS ETFs.
- ETFs shares may be denominated in a currency different to that of the traded currency on the stock exchange in which case exchange rate fluctuations may have a negative effect on the returns of the ETF. The value of any investment involving exposure to foreign currencies can be affected by exchange rate movements.
- There may be tracking difference between the ETF and the underlying index due to the impact of annual fund management fees. The returns on the ETF may not be directly comparable to the returns achieved by direct investment in the underlying assets of the ETF or the underlying index.
- Shares purchased on the secondary market cannot usually be sold directly back to the ETF. Investors must buy and sell shares on a secondary market with the assistance of an intermediary (e.g. a stockbroker) and may incur fees for doing so. In addition, investors may pay more than the current net asset value when buying shares and may receive less than the current net asset value when selling them.
- The price of ETFs traded on the secondary market will depend, on market supply and demand, movements in the value of the ETFs as well as other factors such as prevailing financial market, corporate, economic and political conditions. However, in certain abnormal market conditions liquidity may be affected.
- Tax treatment ETFs depends on the individual circumstances of each investor. The levels and bases of, and any applicable relief from, taxation can change.
- DB Affiliates significant holdings: Investors should be aware that Deutsche Bank or its affiliates ("DB Affiliates") may from time to time own interests in any individual db X-trackers UCITS ETF which may represent a significant amount or proportion of the overall investor holdings in the relevant db X-trackers UCITS ETF. Investors should consider what possible impact such holdings by DB Affiliates may have on them. For example, DB Affiliates may like any other Shareholder ask for the redemption of all or part of their Shares of any Class of the relevant db X-trackers UCITS ETF in accordance with the provisions of this Prospectus which could result in (a) a reduction in the Net Asset Value of the relevant db X-trackers UCITS ETF to below the Minimum Net Asset Value which might result in the Board of Directors deciding to close the db X-trackers UCITS ETF and compulsorily redeem all the Shares relating to the db X-trackers UCITS ETF or (b) an increase in the holding proportion of the other Shareholders in the db X-trackers UCITS ETF beyond those allowed by laws or internal guidelines applicable to such Shareholder
- For further information regarding risk factors, please refer to the risk factors section of the prospectus, or the Key Investor Information Document of the relevant ETF you are considering investing in.
- Please consult your financial advisor before you invest in an ETF since not all ETFs are suitable for all investors.
- Full disclosure on the composition of the db X-trackers UCITS ETF's portfolio and information on the Index constituents, as well as the indicative Net Asset Value, is available free of charge at www.etf.db.com.

— For further information regarding risk factors, please refer to the risk factors section of the prospectus, or the Key Investor Information Document.

All-in Fee Clarification wording - Direct replication ETFs

— Investors should be aware that in addition to the All-In Fee, other factors may negatively impact the performance of their investment relative to the underlying index
— Examples include: Brokerage and other transaction costs, Financial Transaction Taxes or Stamp Duties as well as potential differences in taxation of either capital gains or dividend assumed in the relevant underlying index, and actual taxation of either capital gains or dividends in the fund.
— The precise impact of these costs cannot be estimated reliably in advance as it depends on a variety of non-static factors. Investors are encouraged to consult the audited annual- and un-audited semi-annual reports for details.