How to approach ETF program design

DEVELOPING AND IMPLEMENTING AN ETF PROGRAM MAY SEEM DAUNTING, BUT THE PROCESS—WHICH MAKES USE OF COMMON INVESTMENT MECHANISMS—IS RELATIVELY STRAIGHTFORWARD. WITH PROPER GUIDANCE, ANY INSTITUTIONAL INVESTOR SHOULD BE ABLE TO FIND AN EFFECTIVE SOLUTION THAT UTILIZES THIS POWERFUL TOOLSET.

WHERE TO START

If they are not currently using ETFs at the strategic level, institutional investors need to ask three important questions:

1) Does the organization's Investment Policy Statement (IPS) allow for direct purchase/ownership of securities?

ETFs trade on exchanges just like stocks, with similar terms for transaction and settlement. So, if an investor's organization is able to buy or sell stocks directly, it should have the ability to buy and sell ETFs.

2) If the IPS does not explicitly allow direct ownership of—and transactions in—securities, does it permit the ownership of mutual funds?

The majority of ETFs are registered under the Investment Company Act of 1940. The primary difference between ETFs and mutual funds is simply that the former are traded intraday on exchanges rather than purchased or redeemed directly through the mutual fund company at a single end of day price referred to as net asset value (NAV). Therefore, investors may be able to utilize the same mutual fund exemption or allowance in their investment policy to trade ETFs.

3) Are there options for implementing an ETF program that do not require direct transactions?

Yes. If the options above are unsuitable, investors could choose another path: to contract with an asset manager to develop an ETF program on the organization's behalf. Many options are available, including using ETFs within an existing mandate or creating a new mandate. An experienced multi-asset advisor, such as J.P. Morgan's Multi-Asset Solutions team, could implement a separate account that holds ETFs in percentages that reflect the organization's overall asset allocation. This approach would provide a diversified liquidity vehicle that could efficiently manage inflows, outflows and risk adjustments.

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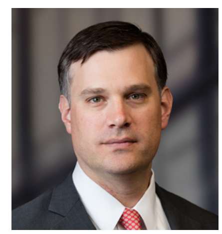

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Once a suitable investment mechanism has been identified, we would suggest taking the steps described below.

HOW TO INVEST

If an institutional investor is set up to trade shares of publicly listed companies, then it already has the structural mechanisms in place to transact in ETFs. If it is not currently set up for equity trading, the first step would be to establish a brokerage account through the institution's custodian or with an external broker dealer(s). Many of the larger custodians have in-house ETF trading expertise and an equity trading desk. The custodian's relationship manager should be able to assist by making internal connections.

If the custodian does not have ETF trading capabilities, the investor will need to set up a trading relationship with a broker dealer. It's important to ensure proper connectivity between the trading firm and the investor's custodian prior to placing an order. Here are three of the most common types of broker dealers that specialize in trading ETFs:

Full Service Broker Dealers: The term chiefly refers to large investment banks that have the capabilities to execute across most types of securities, including ETFs. When selecting a trading counterparty, investors may want to consider the breadth of services it provides such as providing pre- and post-trade analysis and offering access to firm research.

Market Makers: Often referred to as liquidity providers, these firms not only provide liquidity on exchange but commonly execute trades off exchange for investors in a principle capacity. When selecting a market maker, investors should consider which asset classes and regions they specialize in.

Agency Only Brokers: These entities tend to leverage technology to provide liquidity through the use of algorithms, dark pools and request for quote systems which request pricing from various liquidity providers with the aim of obtaining the best possible price. They may also act as outsourced trading desks. They charge a fee for this service, but often are able to achieve better pricing—particularly if the institutional investor does not have multiple trading relationships in place.

ADDITIONAL CONSIDERATIONS

ETF liquidity: Single-stock liquidity is determined solely by exchange volume, while ETF liquidity is based on the liquidity of the fund's underlying holdings. This difference is important to note because investors need to confirm that the chosen trading counterparty has the ability to access an ETF's deep pool of liquidity.

ETF issuer's role: ETF issuers do not trade on behalf of clients. Once an institution is ready to invest, we would recommend reaching out to the appropriate sales representative at the relevant ETF issuer. The representative will be able to provide additional insight specific to the fund and asset class and—together with the issuer's capital markets team—put an implementation plan in place. This process involves providing connectivity with key trading partners, such as the entities noted above.

For questions regarding the creation and implementation of an ETF program, please contact your client advisor.

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