ETFs – an idea whose time has come

- Notable improvements in market liquidity furthered by a slew of macro/structural developments (drastic easing, limit on investments in savings schemes, Roshan digital account) have brought market mechanics back in focus, with the launch of Exchange Traded Funds (two already operational with another two launched today) the latest arrow in the quiver of PSX investment vehicles on offer for investors seeking equity exposure.

- Amongst the two operational ETFs, NIT ETF (NITG-ETF) provides exposure across all major sectors with Banks and E&Ps occupying c. 60.6% weight while UBL ETF (UBL-ETF) does not include Oil companies and have greater representation of Banks and Fertilizers.

- With heavy weight sectors remaining largely ignored in the current rally, capital upside remains on the horizon which should translate into performance of NITG-ETF, in our view (W. Upside: 27.2%/ W.DY: 7.1%). The diversification benefit in an ETF further eliminates the systematic risks prevalent in individual stock investments.

- While ETFs are still in nascent stages in Pakistan, attracting low trading activity with avg. volumes since inception of 41K and 18K in case of NITPG and UBLP respectively, we believe it offers an appealing solution to expatriates/local individual investors willing to take exposure on Pakistan Market with benefits of liquidity and costs.

PSX venturing into ETFs: Aiming to increase market depth and addressing a long-standing investor demand for product diversity, PSX in Mar’20 launched two ETFs namely, NIT Pakistan Gateway ETF (NITG-ETF) and UBL Pakistan Enterprise ETF (UBLP-ETF) where AUMs of these ETFs currently stand at PKR57.5mn and PKR42.1mn respectively (well below half of prevailing AUMs for smallest equity only mutual fund). Two more ETFs are launched today, namely Meezan Pakistan ETF and NBP Pakistan Growth ETF. These ETFs offer passive investment opportunities compared to active investing by mutual funds but at a relatively lower cost (NITPG/UBLP management fees: 0.4/0.65% pa. of net assets) and real time trading option, to individuals in blue scrip companies in the Pakistan’s listed space. Of the two currently available ETFs, NIT ETF provides exposure across all major sectors with Banks and E&Ps occupying c. 60.6% weight vs. 34.6% weight in broader KSE-100 index. UBL ETF on the other hand does not include Oil companies and has more representation of banks and fertilizers. These sector tilts are largely a function of individual management companies, where broader diversification is likely to continue, allowing the formation of a differentiated Exchange Traded Products marketplace for equity investors.

Not just another open-ended mutual fund: Key aspects of ETF offerings, differing from their more prominent open-ended mutual fund cousins (PKR139.1bn in AUMs over 27 funds) are in the form of active redemption/creation of ETF units with segmented secondary market (PSX where investors can buy/sell units during trading hours through TREC holder brokerage trading accounts) and primary market (authorized participant fund managers buying and selling underlying securities) with prices determined every 15 seconds (on total return basis). Moreover, i) fixed periodic rebalancing (bi-annual in case of NITG-ETF), with index constituents added or removed based on prescribed criteria (inclusion in index, free float, liquidity filters including Avg. Daily turnover in addition to which the PSX notifies a list of ETF constituents stocks (currently at twenty after inclusion of six stocks in Sept’20) where marketable lot sizes are set at one share, to smoothen the instantaneous process of ETF Creation and Redemptions, and ii) curtailed management fee and expense ratios (total hovering near 2.5% p.a. of net assets of the fund vs. total expense ratios averaging 3.77% with high of 7.63%, median of 4.11% for equity mutual funds) pulls weight towards ETFs.

KSE-100 Index vs. ETFs performance

Source: PSX, Investing.com & AKD Research

NITG-ETF stock weightages

Source: Offering Documents & AKD Research
Global trends and impact on markets: Based on the Blackrock Global Exchange Traded Products Landscape report for 1QCY20, total global ETF AUMs amount to US$5.3trn with equity based ETFs constituting US$3.8trn. In terms of regional segregations, Emerging market ETFs make up US$360bn in equity ETF AUMs, with CYTD outflows of US$3.5bn, paltry in comparison to Developed market ETF AUMs of US$3.5trn with CYTD inflows if US$80.2bn (US$42.2bn in US ETF inflows alone). Amongst fund manager surveys three major emerging trends in ETF investing include: 1) low cost passive ETFs, which are increasingly favored by millennial investors as they seek to diversify exposures to equity markets, 2) rise in use of smart beta and active ETFs where specific outcomes and criteria are factored into constituents and 3) rise in sustainable investing based ETFs where companies ranking high on environmental, social and governance criteria are favored. Although these trends are far-off in terms of domestic ETF offerings the case of ETF adoption in the Indian market provides some encouragement, where 61 ETFs are offered to domestic investors with cumulative AUMs of US$10.7mn. As the prevalence of ETFs rise, individual stocks may experience increased investor participation in anticipation of inclusion in ETF and expected buying stemming from the same.

Launch of ETFs to help attracting expatriate investments: Pakistan’s ETFs are still in nascent stages attracting low trading activity with avg. volumes of 41K and 18K in case of NITG-ETF and UBLP-ETF respectively. Low volumes in our view are a function of, i) lack of awareness amongst current/potential market participants, ii) general individual participant behavior targeting mid to small cap stocks and preferring stock picking as opposed to basket picking, and iii) heavy weight sectors falling out of favor in current market rally which was driven by valuation mean reversion/growth story in other sectors. ETFs do offer an attractive opportunity for subset of investors preferring to take exposure on Pakistan Market particularly as Govt. eases investment procedure for foreign participants. In this regard, we believe NITG-ETF offers an attractive capital upside of 27.1% and a dividend yield of 7.1% being more tilted towards heavy weight sectors that are a candidate for valuation catchup. That said, for appealing foreign participation in ETFs one of the requisites could be to enhance local participation in these ETFs. As of now, one US-listed ETF exists for Pakistan, tracking the MSCI Pakistan Index (launched April’15, 32 constituents, expense ratio of 0.87%, third highest amongst 52 jurisdictions) with AUM of US$36.8mn, ranked at 46 out of 52 country-specific ETFs on etfdb.com. Constituents for the ETF are dictated by MSCI Pakistan index adjustments, where any inclusion or removal may drive performance based on inflows to the ETF.
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