



## EXCHANGE TRADED FUNDS & IA SECTORS – FAQs

### 1. WHY ARE ETFs BECOMING PART OF THE IA SECTORS?

The IA classifies funds into different sectors to help retail investors and financial advisers navigate the fund universe and to compare the funds within it. As a result of our latest changes, there are currently 52 IA sectors and these help investors to find certain types of fund based on their investment goals, such as growth or income. The sectors also narrow down the fund universe by type of asset, such as equities, bonds, or property. You can see how the Sectors fit together in our [Sectors Classification Schematic](#).

From Monday 19 April 2021, Exchange Traded Funds (ETFs) will be included in the IA sectors for the first time, broadening the number of funds in the IA sectors scheme to over 4,100. ETFs are being classified to IA sectors to help investors to find and compare funds across a wider range of investment products that are available to retail investors in the UK. Investors can buy the majority of these products through fund platforms, advisers or directly from investment firms.

### 2. WHAT IS AN EXCHANGE TRADED FUND?

An Exchange Traded Fund or ETF is an investment fund commonly aiming to track an index, much like index tracking funds. One significant difference between an index-tracker fund and an ETF is that shares in the ETF are traded on a stock exchange and can be bought or sold by investors at the current market price throughout trading hours.

There are **three** main ways that ETFs track an index:

#### 1. Full Physical Replication

All securities, for example equities or bonds, within an index are purchased according to their weightings, in order to ensure a minimal index tracking error.

#### 2. Optimised Physical Replication

Optimised physical replication, which can also be called “sampling replication”, is where a more limited number of securities are considered, in order to create an ETF that broadly reflects, but does not fully track, a given index.



### 3. Synthetic Replication

Synthetic replication involves the use of derivatives, such as total return swaps. Under this structure, the ETF uses the investor's cash to buy a "substitute basket" of securities. The fund simultaneously enters into one or several swap agreements with one or several counterparties that commit to deliver the reference index's performance in exchange for the performance of the securities purchased and subsequently held by the fund.

#### Actively managed ETFs

Whilst historically ETFs tracked well-known indices, there are some ETFs in which a portfolio manager will exercise discretion over what to buy or sell, outside of following an index.

#### More information on ETFs

You can find out more information on ETFs [here](#) in the IA & Dechert's ETFs: A Beginners Guide.

### 3. WHAT TYPES OF ETFs WILL BE PART OF IA SECTORS?

Funds in the IA Sectors scheme are FCA-authorized unit trusts, open-ended investment companies, as well as FCA-recognised offshore funds. Recognised funds are funds domiciled outside the UK that can be sold to UK retail investors and are typically EU UCITS funds. ETFs are FCA-recognised offshore funds typically domiciled in Ireland or Luxembourg. Only ETFs that are EU UCITS with HMRC reporting fund status will be admitted to the IA Sectors.

Only ETFs that use **full physical** and **optimised physical replication** are being admitted to the IA Sectors at this time. Although still a minority, the IA has also allowed the admission of **actively managed** ETFs to the sectors. The IA is conducting further work to consider the admission of ETFs that use **synthetic replication** and will provide more information as the work progresses.

### 4. HOW MANY ETFs ARE COMING IN TO THE IA SECTORS?

Around 530 ETFs are being admitted to the IA Sectors in April 2021. Following April, the process for classifying ETFs to the IA sectors will be the same as for other types of offshore funds so we expect this number to increase. Eligible ETF providers can request to classify ETFs to the IA sectors on a dynamic basis throughout the year using the IA Fund Static Form, which can be found [here](#) on the Managing Fund Sectors page of our website. ETFs should be an EU UCITS fund, be registered for sale in the UK and have reporting fund status as a minimum requirement.



## 5. ARE ANY WIDER CHANGES TO THE IA SECTORS BEING MADE?

The inclusion of ETFs in the IA sectors is leading to some wider sector changes. The Global Bonds sector, which would have increased in size by 50% (129 ETFs), will be replaced by 14 new bond sectors. You can find details on the new bond sectors and their definitions [here](#) on the Fund Sectors Definitions website page. The bond sectors have been created using the following criteria: type of bond, credit type and currency focus.

Some additional sectors will also be created later in 2021. These will include:

- New country/regional equity sectors;
- more industry sectors in addition to the existing Technology and Telecommunications sector;
- sectors that include funds with a focus on more alternative asset classes.

New IA sectors are formed where there are logical fund grouping. This is typically where a reasonable sub categorisation of an existing sector can be made. To assess the viability of new sectors, the IA considers the following factors:

- Size of the sector (i.e. the number of funds): there must be ten funds or more.
- Size of FUM within a sector: a new sector should have a reasonable level of funds under management. Whilst there is no set rule that IA sectors apply on a minimum level of FUM, it is a factor in any decision made on creating new sectors.
- Composition of the sector by diversity of firms: for a sector to be viable, there must be a reasonable spread of investment managers represented. This is particularly important for performance and ranking data and so that investors are able to find and compare funds from a suitable range of managers.

## 6. WHICH SECTORS WILL NOW INCLUDE ETFS?

42 of the 52 IA sectors will see at least one ETF classified to them. You can find a full list of the ETFs that are classified to the IA Sectors, including details on the sector that they are classified to, in the [Current List of Funds](#). This list is updated on a monthly basis.

At launch, the Specialist (79) and Global (71) sectors will welcome the largest number of ETFs.

Many ETFs are global bond funds and these ETFs have been classified to the 14 new bond sectors that are also being created on 19th April 2021. The new bond sectors are:

- USD Government Bond; EUR Government Bond; Global Government Bond;
- Global Inflation Linked Bond;
- USD Corporate Bond; EUR Corporate Bond; Global Corporate Bond;
- USD Mixed Bond; EUR Mixed Bond; Global Mixed Bond;
- USD High Yield Bond; EUR High Yield Bond; Global High Yield Bond
- Specialist Bond

The 'old' IA Global Bonds sector will cease to exist.



## 7. WILL YOU INCLUDE DATA ON ETFs IN IA STATISTICS?

Initially, data on ETFs will not be incorporated into our monthly fund statistics. The IA collects and reports FUM and sales data from its members on a UK investor basis, and includes data from funds domiciled in the UK and overseas. It is not possible to collect ETF data on a UK investor basis due to structural issues however, it is our intention to explore how we can start collecting and reporting ETF data in the future.

Data on the net asset value and sales of ETFs is available on a fund domicile basis from Morningstar and the European Fund Management Association (EFAMA). According to Morningstar data, at the end of 2020 the net asset value of EU domiciled ETFs was €923 billion. 71% of the total net asset value (NAV) of EU ETFs was domiciled in Ireland and 21% in Luxembourg, whilst 0% of the total NAV was domiciled in the UK.

## 8. HOW WILL SECTOR AVERAGE PERFORMANCE BE AFFECTED BY ETFs?

Performance data is not collected by the IA, but by data vendors such as Morningstar, Refinitiv Lipper and FE Fundinfo, who use it to create IA sector ranking tables and calculate IA sector averages. We republish Morningstar's latest sector performance data on our [website](#). We do not provide a methodology for the calculation of sector average performance, believing it to be more appropriate for the commercial market to develop this. The entry of ETFs will not affect the methodology that the data vendors use to calculate the sector average performance. Any questions on the methodology for the calculation of the sector average performances should be directed to [FE Fundinfo](#), [Refinitiv Lipper](#) or [Morningstar](#).

### **Sector average performance**

The daily performance of ETFs will start to be included in the sector average performance data calculated by the Data Vendors from 19th April 2021. This will have some impact on the average performance of the IA sectors and on sector fund rankings and investors should consider this when comparing a fund's performance with the sector average.

The IA does not contribute to or analyse IA sector performance data. However, as part of its due diligence ahead of admitting ETFs to the IA sectors, the IA asked the Data Vendors to investigate the effects of the inclusion of ETFs on sector average performance.

The Data Vendors provided sector average performance data from a snapshot in time that incorporated the performance of the ETFs waiting to be classified to the IA sectors as well as the funds already classified. The Data Vendors looked at both sector average performance and ranking data. The results of the impact analysis showed that whilst the inclusion of ETFs had some impact on sector average performance, there was nothing in the data that would have given the IA cause to re-consider its position.



The majority of ETFs track an index and aim to replicate the performance of the index as closely as possible to reduce 'tracking error'. If a number of ETFs that track the same index are classified to a sector, this is likely to affect fund ranking data.

For example, a large number of ETFs/index tracking funds entering a sector that track the same index would all have similar performance outcomes and could push other funds up or down the peer group rankings (depending on the performance of the index). Further information on the ETFs and index trackers classified to each IA sector can be found on the [Current Fund List](#). This list uses an Index Tracker flag to signpost the ETFs and funds that are seeking to replicate the performance of an index. The index can usually be clearly identified from the name of the fund.

### **Historic average performance**

There are occasions when the historic sector average performance can be affected by changes to the sectors. For example, where new sectors are created by splitting up an existing IA sector, the Data Vendors can apply a process called performance track record extension.

From 19 April 2020, the IA Global Bonds sector will cease to exist and will be replaced by 14 new bond sectors. These new bond sectors have been formed from funds originally classified to the Global Bonds sector, ETFs newly classified to the IA sectors and some additional funds that have been put forward for classification. The Data Vendors have created performance track records for these sectors based on each new sector's constituent funds. To find out more about their approach, please contact [FE Fundinfo](#), [Refinitiv Lipper](#) or [Morningstar](#).

The historic sector average performance data of the 'old' IA Global Bonds sector will be available through the Data Vendors' databases but no new sector average performance data will be calculated for this sector going forward.