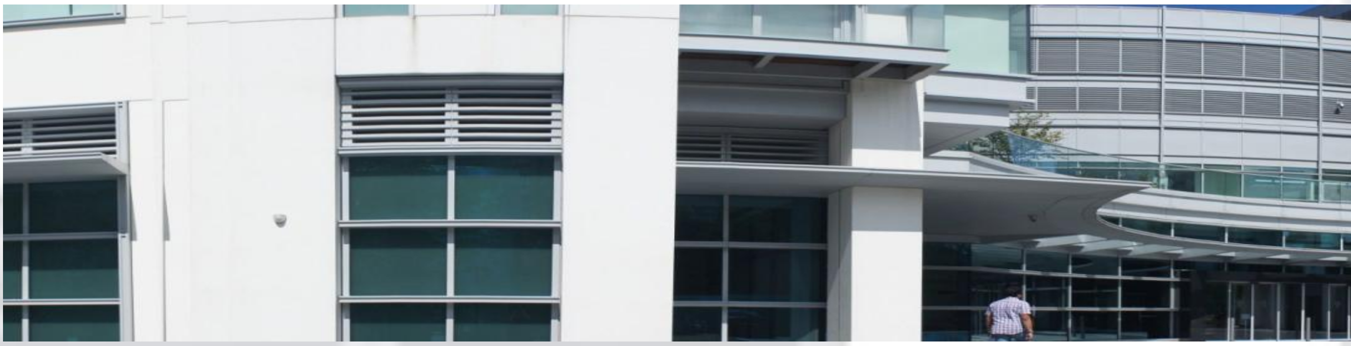


# Week 2: Understanding the differences in real estate fund vs real estate ETF structures

In the previous session we have established that ETFs are in principal open-ended investment companies, whose shares can be traded on the stock exchange.

In general investors are seeking diversified returns when they are looking to invest in a mutual fund such as a real estate securities fund. Investing in a mutual fund provides investors with exposure to a portfolio of assets in a specific sector or region.

Since 2000 a new style of mutual fund has entered the European market, the so-called exchange traded funds (ETF). Compared to a mutual fund they offer the following advantages:

- they have a higher liquidity and can be traded on a stock exchange just like any other share. Thus, they are yet another product that offers real estate exposure on a highly liquid basis for an otherwise illiquid asset class
- Accessible to retail investors, require smaller initial investment amounts
- Lower cost, typically no initial fees

However, in some other aspects they are more similar to Property Unit Trusts (PUTs) than real estate securities funds.

Any investor who has mastered the understanding of Property Unit Trusts, will see the similarities and find the ETF structure easy to understand.

Just like the PUT, the ETF issues or creates units based on the NAV of the underlying portfolio. The difference is that the shares of an ETF can be traded throughout the day on the exchange and the portfolio does not consist of physical properties but shares of property companies or REITs.

This also means that the price of an ETF share on the stock exchange is subject to the forces of supply and demand and the trading price can be different to the fund's NAV.

When the ETF creates new units it issues bundles of shares, which are being bought by the "authorised participant". This participant can be a market maker, broker, large institutional investor etc, who is then trading individual shares on the stock exchange.

Because the trading price does not completely reflect the NAV, ETFs behave more like an individual share than a mutual fund, which is investing in property company/REIT shares. However, ETFs have different liquidity levels themselves and the more liquid ETFs are expected to trade very **close to their NAV.**

Example: Premium/Discounts of ETFs

| closing 25.06.13 | | Trading price | NAV | Premium |
|---|---|---|---|---|
| REZ | iShares NAREIT Residential Plus Capped Index Fund | 50.35 | 50.01 | 0.7% |
| RTL | iShares NAREIT Retail Capped Index Fund | 35.95 | 35.84 | 0.3% |
| IFNA | iShares EPRA/NAREIT North America Index Fund | 48.02 | 47.75 | 0.6% |

Also for mutual funds there are differences in pricing, for example an open-ended fund (i.e. PUT) will trade equal to its NAV while a closed-end fund can trade at a premium or discount.

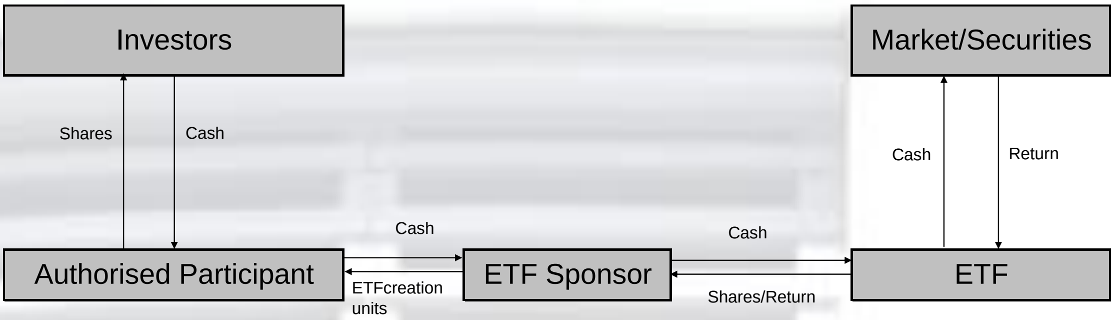
**Portfolio setup and strategies**

The ETF itself originates with a sponsor, meaning the company or financial institution which chooses the investment objective of the ETF. In the case of an index-based ETF, the sponsor chooses both an index and a method of tracking its target index. Index-based ETFs track their target index in one of two ways.

1. A replicate index-based ETF holds every security in the target index and invests its assets proportionately in all the securities in the target index.

2. A sample index-based ETF does not hold every security in the target index; instead, the sponsor chooses a representative sample of securities in the target index in which to invest. Representative sampling is a practical solution for an ETF that has a target index with thousands of securities.

Figure: Physical ETF




*Source: N. Lux, 2013*

Target indices include:

US Indices

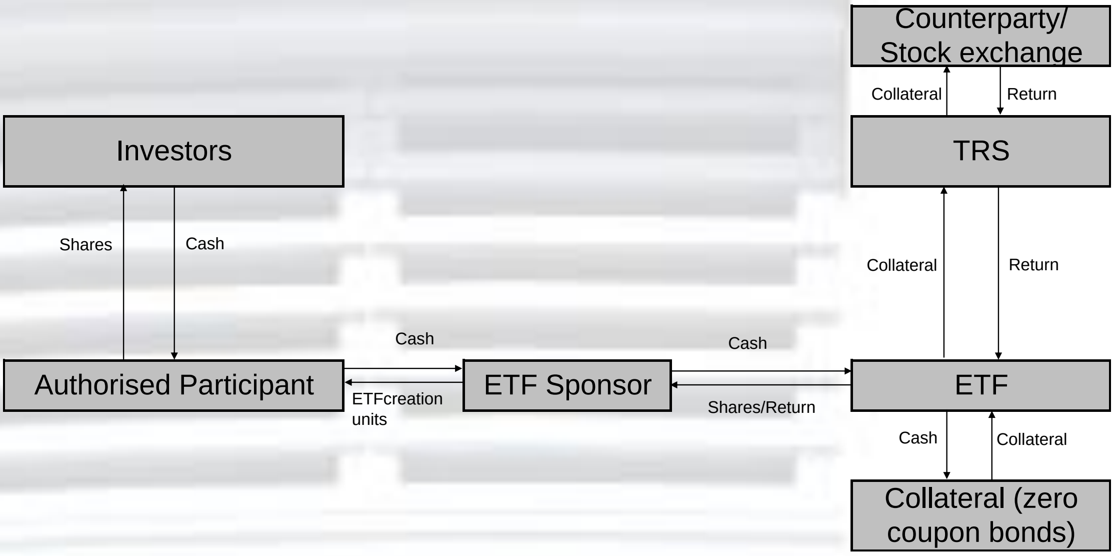
- Cohen & Steers Realty Majors Index
- Dow Jones U.S. Real Estate Index
- Dow Jones U.S. Select REIT Index
- FTSE EPRA/NAREIT North America Index
- FTSE NAREIT All Mortgage Capped Index
- FTSE NAREIT All Residential Capped Index
- FTSE NAREIT Industrial/Office Capped Index
- FTSE NAREIT Real Estate 50 Index
- FTSE NAREIT Retail Capped Index
- IQ US Real Estate Small Cap Index
- KBW Premium Yield Equity REIT Index
- Market Vectors Global Mortgage REITs Index
- MSCI US REIT Index
- S&P United States REIT Index
- Wilshire U.S. Real Estate Investment Trust Index
- Morningstar Real Estate Index

Other Indices

- FTSE EPRA/NAREIT Developed Europe ex UK Dividend+
- FTSE EPRA/NAREIT UK Index
- FTSE EPRA/NAREIT Developed Asia Dividend+ Index

Both of these replication methodologies are called physical ETFs. In addition to the physical ETF there are so-called "synthetic" ETFs, which deliver the index performance via a swap contract. The total return will then be delivered by the swap contract, while the cash in mainly invested in low risk collateral such as zero coupon bonds, which were acquired at a discount or government bonds.

Figure: Synthetic ETF




*Source: N. Lux, 2013*

Real Estate ETFs are currently mostly physical ETFs, meaning they invest in a basket of physical securities. We will analyse the different risks related to these strategies in the next session.

## Next week 3: Understanding the risks of ETF Structures vs real estate REIT funds