



ETFs in EM local debt: Do they work?

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In recent years we've seen a surge of interest in exchange traded funds (ETFs) as a cost efficient and effective way to try and replicate market index performance. But are ETFs as effective as investors think? As part of our regular competitor analysis, we took a look at how leading ETFs in our asset class—emerging markets local currency sovereign bonds—had performed over the Covid crisis, and over the longer term.

Replicating index performance in highly efficient markets, (e.g. US equities), is less challenging than it is in more complex asset classes. For example, emerging market ETFs may not be able to invest in all the securities that their benchmark does and some securities are subject to local market taxes that are not reflected in benchmark performance. ETF providers may need to rely more on derivatives to synthesise index performance. Derivative contracts cost money, and they don't always perfectly track the underlying index components, especially at times of market volatility when trading conditions become difficult.

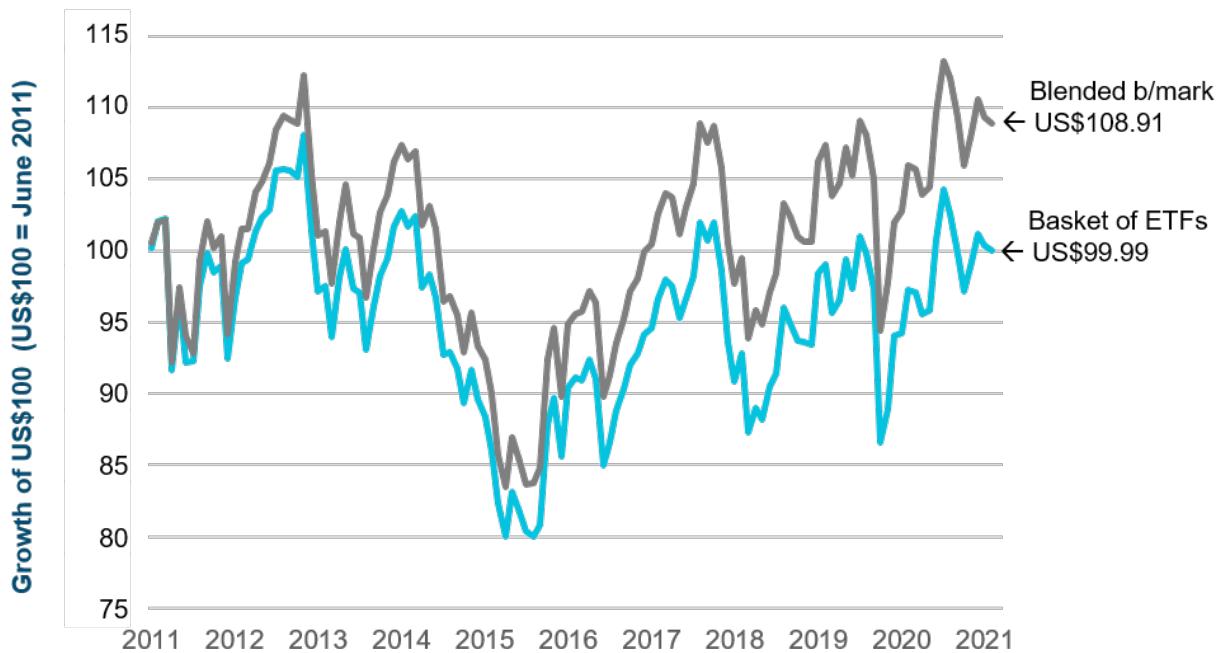
We looked at the five largest EM local ETFs available to European investors. Since inception, their tracking errors versus their respective benchmarks ranged from 1.5% to 3% a year (0% would be a perfect replication). We also found that, without exception, all five ETFs' price performance lagged the benchmark return.

In the chart below, we blended the five ETFs into a single composite, equally weighted at 20%. The ETFs don't all track the same index, so we also created a composite benchmark. The chart shows cumulative performance over the past decade and illustrates that, while the blended benchmark stood 8.9% higher by the end of July 2021, US\$100 invested in the composite of ETFs in 2011 would have shrunk to US\$99.99 – underperforming by roughly 9% over the decade.

This is not to argue that ETFs in EM local currency space are always a bad idea. For example, investors can achieve better results by buying when the ETF is trading at a significant discount to net asset value (NAV). Nevertheless, this requires careful timing, and can be difficult to do in volatile markets. Investors often cite inconsistent performance by active managers as a reason to choose ETFs, but active funds offer the potential to beat the benchmark. There is a risk that an ETF, by locking in inefficiencies and costs, may consistently fail to deliver over time.

Cumulative returns of a basket of ETFs versus benchmark

From June 2011 to July 2021



Past performance is not a reliable indicator of future performance

Source: T. Rowe Price, Bloomberg Finance L.P.

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