

# How to choose the right ETF

## Outline

An ETF (Exchange Traded Fund) is an important tool for building a diversified, cost-effective investment portfolio, as it tracks the performance of a specific index and is traded on the stock exchange like an individual share. But with so many options to choose from, selecting the most suitable ETFs for your investment goals is crucial. This factsheet explains

what ETFs are, how to choose the right index, how to compare costs, and the usefulness of different replication methods. It also highlights key sources of ETF information and the importance of ongoing monitoring. By understanding how to select and monitor ETFs effectively, investors can build a robust, long-term portfolio aligned with their financial goals.

## What are ETFs?

In recent years, ETFs (Exchange Traded Funds) have increasingly established themselves in financial markets. ETFs are becoming ever more popular among investors due to their high transparency and low fees and are very suitable for those wanting to accumulate wealth through regular deposits over the years. Cur-

rently, over 2,300 different exchanged traded products are listed on the London Stock Exchange. While the steadily increasing product offering is an advantage for investors, it leads to greater diversity and complexity in the market. This makes it increasingly challenging to select the right ETFs.

## Select a suitable index

Before product selection can begin, several key decisions must be made. The first step is to determine your individual risk tolerance and risk capacity. This will define the percentage allocation of your investment capital across different asset classes and sub-asset classes (for example, UK stocks). Subsequently, the most suitable indices for each asset class must be identified. The selection of indices is extremely important, as ETFs aim to replicate the corresponding index as closely as possible. If the index rises, the value of the ETF tracking it will also increase. Conversely, if the index falls, the ETF also loses value. Depending on the asset class, there can be many different indices to choose from. For example, those who wish to invest in UK stocks may consider indices such as the FTSE 100, FTSE 250, or FTSE All Share.

These indices can vary significantly in composition, even though they represent the same sub-asset class. As a result, they can also differ in terms of return and risk characteristics. The FTSE 100, for example, includes the 100 largest UK stocks and weighs the top three stocks, (AstraZeneca, HSBC and Shell),

at a total of around 22%. The FTSE All Share, on the other hand, accounts for 97% of UK market capitalization. The FTSE 250 accounts for only medium-sized companies.

To avoid potential concentration risks, it is advisable to select indices that differ in their composition. Additionally, when choosing an index, the currency should always be taken into consideration. Indices based on securities that are not issued in pound sterling are always subject to currency risk. An exception is currency-hedged indices. Here, the currency fluctuations of the foreign currency are “hedged” against the British pound. Currency-hedged indices carry the suffix “hedged”. The index currency is also relevant for the later selection of the trading currency of the replicating ETF. When investing in regional or global stock indices, it is important to consider the allocation across sectors and countries. Bond indices, on the other hand, differ in terms of the issuers, the interest currency, the credit quality, and the time to maturity.

## Compare fees

A key reason for the growth of ETFs is their low fees. These should be compared as part of the product selection. One must distinguish between one-time costs and ongoing costs. Investors with a long investment horizon should pay more attention to ongoing costs, while for a short investment horizon, one-time costs play a bigger role. One-time costs include the difference (also known as the spread) between the buying and selling price - like when trading individual stocks.

This spread represents the price difference between purchasing and then immediately selling the security and should be kept as low as possible. The spread can vary, being lower or higher depending on the comparison index, time of day, and market environment. It is important to note that a low spread is always an indicator of good liquidity of the ETF.

An indication of ongoing costs is given by the Total Expense Ratio (TER). This includes not only the

management fees but also the costs for the marketing and distribution of the product. The TER is expressed as a percentage that is deducted from the investment each year. However, the TER should not be considered in isolation. Other cost factors not inclu-

ded in the TER can also affect the returns of an ETF. These include transaction costs for the ETF when buying and selling securities within its portfolio, possible taxes due to the fund's domicile, as well as the replication quality of the ETF.

#### Differences in the type and quality of replication

Replication refers to the way an ETF mirrors an index. Essentially, there are two types: physical and synthetic replication. In physical replication, the ETF exclusively invests in the securities included in the index, taking into account their respective weighting in the benchmark index. For example, a physically replicated ETF of the FTSE 100 would purchase all 100 largest stocks listed in the UK and allocate to them at the same weighting as the index. However, not all securities included in the index need to be part of the ETF during physical replication. Especially with indices that have a large number of securities, such as the MSCI World stock index with around 1,400 securities, a sampling method can also be employed. In this case, the ETF aims to replicate the index as accurately as possible by using a selected sample of securities from the index. On the other hand, synthetic replication works through the application of financial derivatives. It is more complicated and partially less transparent than physical index replication. However, certain asset classes can be represented much more efficiently through synthetic replication, especially when the components of the index are not easily tradable. The

risks associated with physically replicating ETFs are generally considered lower. The replication method can also affect the quality of replication. This refers to how well the ETF tracks the index. There are always deviations between the ETF return and the return of the index because an exact 1:1 replication is not possible. To measure the replication quality, it is worth comparing the difference between the ETF return and the index return. If the ETF return significantly differs from the index return, caution is advised. When making this comparison, it is important to consider how the fund handles income, such as dividends or interest payments. Here, a distinction is made between distributing and reinvesting (accumulation) products. Both the ETF and its benchmark index should either reinvest the income or pay it out to investors. Otherwise, significant performance deviations can occur. When comparing the returns of several ETFs tracking the same index, it becomes clear that reviewing only the ongoing costs (TER) is not sufficient. It can be determined that ETFs with lower ongoing costs do not necessarily result in higher returns.

#### Difference in returns with ETFs

Example: ETF tracking the FTSE 100 Total Return Index

ETF Name	Replication Method	Management Fee p.a.	Annual Return		
			2022	2023	2024
ETF 1	Physical	0.09%	4.62%	7.77%	9.50%
ETF 2	Physical	0.07%	4.66%	7.75%	9.51%
ETF 3	Physical	0.20%	5.04%	7.08%	9.31%
<b>Benchmark: FTSE 100 Total Return Index</b>			<b>4.70%</b>	<b>7.93%</b>	<b>9.66%</b>

Source: FE Analytics, information from ETF providers

#### Obtaining information on ETFs

When comparing different ETFs with one another, listing the characteristics of all available products - for the respective selected index - is useful. Different sources can be used for this. A central source of information for investors is the monthly reports or factsheets for the respective ETF. As the name suggests, these are updated on a monthly basis for each fund. The monthly reports provide brief information about the fund and present the most important data clearly on 1 to 2 pages. There are no regulatory requirements for the presentation. Each provider can present the same data in a different way. All ETF providers note that their monthly reports also serve as promotional materials. In addition to the monthly reports, investors

also have the prospectus and the key investor information documents available. These are required by the regulator and contain further information about the fund structure and risks. However, the information available in these documents is usually quite general and is only partially suitable for selecting ETFs. If the monthly reports of different ETFs being compared have different creation dates or if information is required that goes beyond the fund documents, this can also be accessed on the websites of the fund providers. Typically, fund providers offer comprehensive information about each fund in a separate section. For example, the observation periods for returns can also be individually entered.

Ongoing investment monitoring

Due to the dynamic market environment, there can always be changes in the ETF universe. For example, new products may be cheaper than a currently selected ETF. A selected ETF may also change its replication method or begin to track a new index. Therefore, it is advisable to regularly monitor the

products used. Monitoring should be conducted at least twice a year. During this process, the characteristics of the ETFs in your portfolio should be reviewed. In this context, it may also be worthwhile looking into new comparable products.

The security selection process at Lumin

Do you want to build wealth effectively but unsure which investment products to choose? Lumin selects the best ETFs and index funds for you, all of which are approved in the UK. With Lumin as your partner, you have the assurance that all securities are analyzed and evaluated independently and objecti-

vely. Lumin offers a range of investment strategies tailored to your individual risk capacity and tolerance. Based on your financial situation, investment experience, and personal risk profile, Lumin can help you identify and implement the strategy best suited to your needs.

In expert hands with Lumin

Lumin is a leading independent financial adviser headquartered in St Albans, with particular reach across London and the South East. We offer trusted and professional advice on pensions and retirement, investments, inheritance and tax planning, financial protection for individuals and businesses, and mortgages. Lumin's financial plans are geared toward growing, or protecting, wealth by optimising our

clients' income, assets, tax burden and financial security. Whatever your financial ambitions, you can count on our expertise to provide peace of mind. We are backed by VZ Group, the leading independent financial services provider in Switzerland.



**Financial advice made easy: Scan the QR code to arrange a complimentary meeting over a coffee.**

London | St Albans  
info@luminwealth.co.uk  
www.luminwealth.co.uk  
03300 564 446

Cornwell House  
21 Clerkenwell Green  
London  
EC1R 0DX

5 Sandridge Park  
Porters Wood  
St Albans  
AL3 6PH

This document is for general information only. It does not constitute advice or (by itself), a basis for any financial decision. You should only make such decisions based on your individual circumstances and, we recommend, with advice from a suitably qualified and regulated financial adviser. Whilst we endeavour to be accurate, Lumin Wealth does not accept responsibility for any inaccuracies in this document or for any loss that may result from reliance on it, but this disclaimer does not affect our responsibilities or your rights under the Financial Services and Markets Act 2000. Any financial projections in this document are provided for illustrative purposes only and should not be regarded as predictions. Past performance is not a guide to future returns. The value of investments may fall as well as rise and you may get back less than you invested. Tax treatment depends on your individual circumstances and rules may change. Lumin Wealth Limited is authorised and regulated by the Financial Conduct Authority, or FCA, (under registration number 775068). It is a limited company registered in England and Wales under company number 03381115. Copyright: No part of this publication may be reproduced or transmitted in any form without the prior permission of Lumin Wealth. The FCA does not regulate tax and estate planning.