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"Exchange Traded Funds in the Capital Market: A Review"

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Abstract:

Exchange Traded Funds (ETFs) are the most popular financial vehicle for investors. An ETF is a combination financial product that combines the benefits of mutual funds and equity. The same as stock it may be traded intraday on a stock exchange and has NAV similar to a mutual fund, and consists of a portfolio that is well-diversified. This article offers a comprehensive method to analyze the challenges and evaluate the existing information, revealing that ETFs have provided investors and market functioning with numerous advantages that significantly exceed any perceived or actual limitations.

Keywords: *ETFs, Benchmark Index, NAV*

Introduction

Capital markets have undergone continual improvement over the years, offering investors the opportunity to invest in a wide range of securities that include, for instance, various types of risk (volatility), valuations, and security composition. The Exchange Traded Funds are one illustration of the such invention (ETFs). A constantly tradeable index-following fund that is open-ended and openly traded is characterized as an exchange-traded fund (ETF). An ETF's major aim is to mimic an underlying index's performance. As a result, ETFs can offer investors a different type of investment that has a risk-return profile similar to the combination of underlying securities. To put it simply, ETFs are passive investment vehicles that offer market (Beta) instead of attempting to surpass (Alpha) of the investment. Broadly speaking, ETFs are special because they integrate the benefits of traditional mutual funds with those of equities and have remarkably low-cost structures. When looking at the features of liquidity, variety, transparency, and expense, ETFs can be a substantial investment. The introduction of this financial instrument enhanced investor interest, which in result in improving the massive development of numerous ETF types (Agapova, 2011).

Since its introduction, the demand for ETFs has expanded, and the range of ETFs worldwide has vastly expanded. When S&P 500 Depository Receipt (SPDR or "Spider") got approval from the Securities and Exchange Commission to construct securities with a structure involving multiple types of securities and then offer it to the market, the concept of exchange-traded funds (ETFs) was developed (Investment Company Institute, 2011). Other unique products, such as commodities ETFs, sector-based ETFs, sustainability ETFs, and country/region-specific ETFs, were launched as a result of the SEC's authorization of the designing and trading of ETFs.

India's first equity ETF, the "Nifty Benchmark Exchange Traded Scheme" (NIFTYBEES), which mimics the performance of the Nifty 50 Index, was listed on the National Stock Exchange (NSE) in 2002. ETFs typically use one of three replication

processes to replicate benchmark indices. These include synthetic or swap-based replication techniques, sample replication, and full replication. However, ETFs use complete replication tactics in India. When ETFs invest in all the securities that make up the underlying index, this is referred to as a full replication strategy. In sample replication, ETFs invest in a subset of the underlying index's holdings rather than the entire portfolio. An agreement between an ETF provider and an outsider in which the outsider offers to provide returns comparable to those of the similar return for the profits earned on the portfolio held by the ETF is known as a swap-based or synthetic replication.

Literature Review

ETFs have been the subject of an expanding body of literature in recent years. In the 1990s, ETFs were initially made available. Exchange-traded funds are passive investment instruments that have gained popularity rapidly. ETFs' ability to be purchased and sold at any time during the trading day, like individual equities, is a significant distinction from traditional index funds.

Haslem (2003) studied the history and characteristics of ETFs. The number of ETFs has increased over the previous 20 years from 0 to over 2000 funds, with a total of more than $1 trillion in assets under management (Blackrock, 2010).

Wong and Shum (2010) looked into the performance of 15 global ETFs that encompassed the entire bullish and bearish sector from 8 years of data. They found that as compared to the bear period, ETFs consistently produced superior returns in the bull period.

Gerasimos (2011) said that ETF's performance is anticipatory and more enduring over the short term. The efficiency of Indian market ETFs was examined by Prasanna (2012), who concluded that they offer statistically higher Sharpe ratios. It was also said that there is no association between the profitability of ETFs and fund size.

THE RESEARCH DIALOGUE Manifestation Of Perfection

Rompotis (2012), who analyzed 43 German ETFs trading came to the conclusion that the ETFs' performance was remarkably identical to the benchmark index, providing more justification for it.

Mariani et al. (2009) examined the yield dispersion of three ETFs and their associated benchmark indexes by using the Levy model in addition to the aforementioned research, and they reached the conclusion that these ETFs revealed the same behavior as their benchmarks.

ETF performance is highly accurate and predictable, according to studies that have looked at the performance of ETFs that track U.S. equity indexes. ETFs typically maintain low levels of tracking error while maintaining strong connections to their benchmark index, and there looks to be a one-to-one inverse relationship between fund returns and expenses (Agapova, 2011; Elton et al., 2004; Gastineau, 2004; Poterba and Shoven, 2002).

Fleming et al. (1996) attributed the informational efficiency of derivative markets to the lower costs associated with executing orders at futures or options markets than those associated with doing so at the spot market when trading a basket of individual securities when observing the lead-lag relationships between S&P 500 futures, options, and the underlying benchmark index

From January 1992 to March 1994, Booth, So, and Tse (1999) looked at the lead-lag relationship between the German DAX index, DAX futures, and DAX options. They discovered that due to the futures market's lower transaction costs, it dominated both the cash and options markets.

Conclusion

The concept of ETFs is new to the stock market but it exhibited tremendous growth in this area. Investors, public officials, and scholars have attempted to examine and explain

the consequences of the recent significant growth of ETFs. The research that has been done up to this point is summarized. The unified structure presented here is also used to examine a variety of components of pricing and trading, such as their function in price discovery, the attributes of premiums and discounts, performance monitoring in relation to benchmark, as well as transaction costs and liquidity sourcing in primary and secondary markets. The methodology is also used to explain some of the problems with active funds that aim to outperform a benchmark index and so-called alternative beta, which is based on model-driven, quantitative portfolio creation methodologies. In my concluding part, I examine a number of current policy concerns, such as how passive flows affect underlying assets, the use of leveraged and inverse ETFs, concerns such as excessive shorting and settlement failures. In conclusion, ETFs have provided substantial benefits to both market participants and market functioning that significantly overcome any perceived or actual limitations.

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