EXCHANGE TRADED NOTES (ETNs)

DEFINITION

An Exchange Traded Note (ETN) is a type of unsecured, unsubordinated debt security issued by an underwriting bank. This security is traded on an exchange and typically provides a return linked to a market index or other benchmark. Some ETNs provide exposure to familiar, broad-based indices, while others provide exposure to less familiar, newer, and more complex asset classes or proprietary indices. ETNs are similar to fixed income securities in that they have a maturity date and are backed only by the credit of the issuer. However, they do not pay periodic coupon payments or offer principal protection.

HOW THEY WORK

OVERVIEW

These combine aspects of both bonds and exchange traded funds (ETFs). ETNs, as with ETFs, are traded on major exchanges throughout the day at prices determined by the market. They are unsecured debt obligations of the issuer, such as a bank or other financial institution, which can be held until maturity. However, they are different from traditional bonds since ETNs typically do not pay any interest payments to investors, as the issuer instead promises to pay the ETN holder an amount determined by the performance of the underlying index or benchmark on the ETN's maturity date minus any specified fees.

DIFFERENCE BETWEEN ETNs AND ETFs

Exchange traded notes are commonly confused with ETFs. Unlike ETFs, ETNs don't own anything. Instead, they are products that promise to pay a return, and that promise is only as sound as the financial strength of the issuing bank. Since ETNs do not hold assets to replicate the underlying index, they are vulnerable if the issuer suffers from financial difficulty.

VALUATION

ETNs list on an exchange and can be purchased and sold at market prices, similar to other exchange-traded investments. Market prices of ETNs most commonly fluctuate due to movements in the indexes they track. However, another factor that affects the market prices of ETN is the credit rating of the issuer. If an issuer's credit rating were to be downgraded, the market price of the ETN may drop despite no change in the underlying index. ETNs also have an intrinsic value based on the index or metric the security it follows. Factors that influence supply and demand, such as the credit worthiness of the issuer, may cause the market price to deviate from this intrinsic value. Issuers of ETNs issue and redeem notes as a means to keep the ETN's price in line with that value.

ADVANTAGES

- Tax Efficiency – Unlike mutual funds and ETFs, ETNs are not required to make annual income and capital gains distributions to its shareholders. If held in a taxable account, those distributions are taxable to its investors. For ETN holders, a capital gain or loss is realized when they sell the security, and shares that are held for over a year are subject to favorable capital gains tax rates.
- No Tracking Error – Mutual funds and ETFs attempt to track an index by mimicking the holdings of that index. Funds are often unable to perfectly replicate the index holdings and, therefore, its performance. ETNs are not constrained by mimicking the holdings of the index as returns are not based on underlying securities and are able to perfectly track the index.
- Accessibility to New Markets and Strategies – ETNs provide access to exposures such as certain asset classes and strategies that are not easily accessible to individual investors which may be hard to replicate through an ETF. For example, the use of ETNs allows investors access to futures, MLPs indices, and many other highly specialized investment segments.

DISADVANTAGES

- Credit Risk – ETNs are subject to risk of default by the issuing bank which is the major difference between ETFs and ETNs, and therefore a disadvantage. ETFs are only subject to market risk whereas ETNs are subject to both market risk and the risk of default by the issuing bank.
- Illiquidity – With the relatively recent emergence of ETNs, some of them are relatively illiquid. Additionally, the effectiveness of ETNs at tracking indices is dependent on gaining adequate support in the market.
- Dependence on Credit Ratings – A corollary to ETNs exposure to credit risk is the effect that exposure has on its price. Because of that exposure, ETNs have their value decided by two factors: performance of the index they are set to track, and credit ratings of the issuer. In the case of an issuing bank experiencing financial difficulty, the index of an ETN could be experiencing growth while the security itself loses value.