

2 ETF, TTT and TSEC Taiwan 50 Index constituents

Exchange-traded funds (ETFs) are passively managed index funds which give investors a vehicle to trade a portfolio of securities in one transaction. They are innovative products of securitized index and traded on an exchange like an individual stock. The ETF consists of the same constituents as the stocks in the benchmark index and is divided into smaller trading units which are traded in the secondary market. Investors indirectly invest in a portfolio by holding ETFs shares which represent the index funds. Therefore, by investing in ETFs, investors are able to track the performance of the benchmark index and profit from the movement of the index.

In addition to trading in the secondary market, creation and redemption can be conducted in the primary market. An index ETF is created when an institutional investor deposits a basket of the index components into the fund. The institutional investor receives an amount of shares during the process of creation units. Some or all of the shares may be traded and priced throughout market hours on a stock exchange. Retail investors cannot purchase or redeem directly from the fund. Instead, they buy or sell fund shares in the secondary market (i.e. the stock exchange) in a same process of buying or selling other listed securities. As for redemption, institutional investors holding ETF shares can redeem ETF and obtain a basket of underlying securities in exchange for ETF shares. This creation and redemption process keeps ETF's market price close to its net asset value (NAV).

After the first launch of exchange-traded fund in 1993, this innovative product has been highly popular because of its various advantages. We briefly summarize them as follows. First, investors can realize portfolio diversification at low transaction costs relative to trading a portfolio of underlying stock. Second, short selling of ETFs

is permitted on a downtick. Also, the expense ratios for ETFs are lower than those for many traditional mutual funds because of passive management.² Other advantages include intraday trading and continuous pricing, tax efficiency, low premium/discount and transparency.³

All the merits mentioned above lead to the popularity of the ETFs, and subsequently, numerous stock exchanges have made efforts to develop the index-tracking funds. Taiwan Stock Exchange Corporation (TSEC) launched its first ETF— Taiwan Top 50 Tracker Fund (TTT) — on June 30, 2003. TTT is the index-tracking security constructed to track the performance of the TSEC Taiwan 50 Index. It had been popular and experienced rapid growth after it was introduced to the market. The fund assets have grown tenfold since its launch. As of the third quarter of 2005, the fund assets of TTT totals US \$1.24 billion and ranks 66th among the 400 listed ETFs in global markets.⁴ To give a more detailed description, Table 2.1 contains specification of TTT. The benchmark index of TTT, the TSEC Taiwan 50 Index, consists of the 50 largest stocks by market value coming from electronics, financial, plastics, textile, and other sectors. 50 of the most highly capitalized blue-chip stocks are selected according to the Ground Rules including exchange-listing, market capitalization, free float restrictions, and liquidity

² Expense ratio means the percentage of total fund assets that is used to cover expenses associated with the operation of a mutual fund. This amount is taken out of the fund's assets and lowers the return that fund holders receive. These expenses include management fees and operating expenses. The management fee is the fee that is charged to the fund by the portfolio manager, and it is often a fixed percentage. The operating expenses are the expenses that the fund incurs through operation and this can include brokerage fees, taxes, investor services, and interest expenses.

³ For detailed information about ETF, please refer to the official website of the American Stock Exchange.

⁴ Source: the official website of Polaris International Securities Investment Trust Co., Ltd.

examination.⁵ Those 50 constituents represent nearly 70% of the values of Taiwan stock market. The responsible committee reviews the index and approves changes to constituents on a quarterly basis to make sure the eligibility of constituent stocks and the transparency of the Taiwan 50 index.⁶

⁵ For more specific information about the Ground Rules, please refer to official websites of TSEC and FTSE.

⁶ A constituent will also be reviewed if necessary following a corporate event.

Table 2.1: Product specification of TTT

Panel A: Fund Characteristics	
Name of Fund	Taiwan Top50 Tracker Fund (TTT)
Fund Type	Exchange Traded Fund (ETF)
Benchmark Index	Taiwan 50 Index
Listing	Taiwan Stock Exchange
Issuer/Manager	Polaris International Securities and Investment Trust Company Ltd.
Management Style	Passive
Investment Objective	Closely track the performance of Taiwan 50 Index (before fees and expenses)
Net Asset Value (NAV)	NAV will be calculated based on the market value of the assets of the Fund after income and expenses accrual. It will be announced after 4 pm on each dealing day.

Panel B: Trading in the Secondary Market	
Board Lot	1,000 units, no odd lot trading
Trading Time	Trading hours of the Taiwan stock Exchange: 9:00 – 13:30
Securities Transaction Tax	0.1% levied on the sale of the units, lower than 0.3% levied on the sale of stocks
Price Relationship with Index	the 100th of the index level
Tick Size	NTD 0.01 if the price of the unit is below NTD 50;
Price Limit	7%, same as that for stocks
Margin Trading	Margin Trading is available on listing; short selling under margin trading is permitted on a downtick.

Panel C: Creation and Redemption in the Primary Market	
Order Input Time	9:00 – 15:30 on each dealing day
Creation Unit / Redemption Unit	500,000 units
Issue Price / Redemption Price	NAV per unit on the day of creation or redemption

Source: Taiwan Security Exchange Corporation