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ETF's Nuts & Bolts (Part 2)
Understanding Tracking Error

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How much do you know about tracking error? Let's understand what is tracking error and importance to invest in ETF with low tracking error.

What is tracking error?
Tracking error is the standard deviation or volatility of the difference between the **returns** of the fund and its benchmark index.

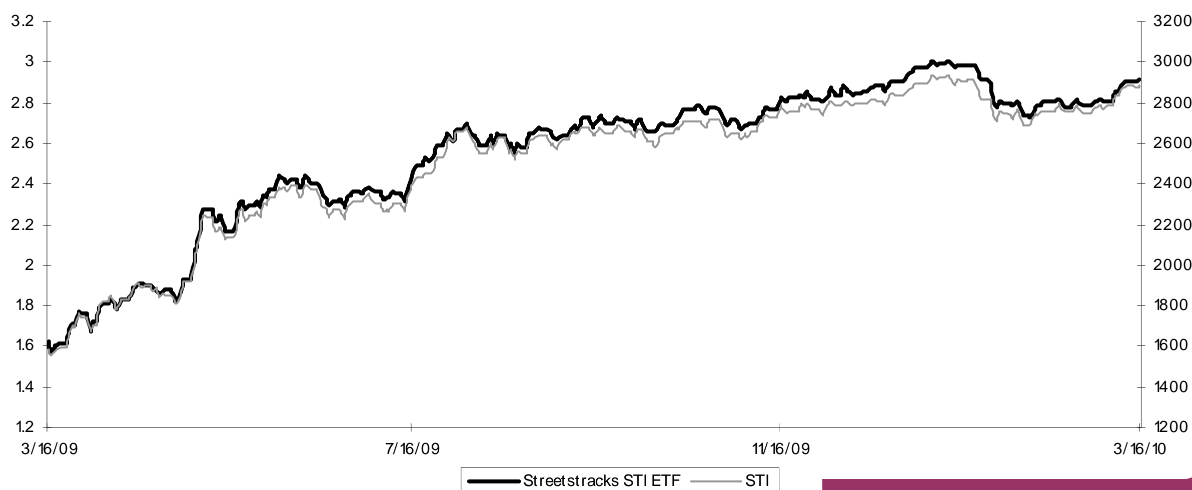
Reasons for tracking error

- Fees
    - ETFs with higher total expense ratio (TER) tend to have higher tracking errors as these fees come out of the fund.
- Index Optimization
    - Index optimization is done when full replication of the index is not possible. Index constituent is either too big or expensive to construct. Typically those constituents with high correlation will be selected to closely represent the index movement.
- Dividends
    - Index does not take into consideration of the dividends from underlying stocks. However, ETF accumulated these dividends into the fund which increase its NAV hence causes the tracking error. To minimize the tracking error, ETFs may choose to redistribute the dividends to the end investors.

Why do we need to be aware of the ETF's tracking error?
Low tracking error signifies that the ETF returns is close it's benchmark. The aim of ETF is its passive managed and closely track to its benchmark index. The lower the tracking error, the more consistent the ETF delivers its performance. Henceforth when there are two similar ETFs tracking the same benchmark, tracking error can be used as a good way for comparison.

Chart illustration

This diagram illustrates the STI ETF's NAV and Strait times index.



Next Article> ETF's Nuts & Bolts (Part 3)
Market Maker & Liquidity

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