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Trading UCITS ETFs in Mexico



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Background

Institutional and retail investors have benefitted from the availability of UCITS ETFs in Mexico. The products have provided local investors with broader access to markets around the world and added greater diversification to their portfolios.

Given investors use these products in Mexico, it is important to understand how an array of underlying market participants cooperate to provide access to these products locally. Asset managers, market-makers, local brokers, exchanges and custodians all come together to create the modern UCITS ETF market in Mexico.

UCITS Foundation in Europe

The UCITS (Undertaking for the Collective Investment in Transferable Securities) market in Europe began in the late 1980s, when European policymakers set out to create a unified, regulated investment fund framework across Europe. The goal was to facilitate cross-border distribution of investment funds, allowing retail and institutional investors to access a broader range of investment options across EU member states, while at the same time, ensuring high levels of regulatory oversight and investor protections. This ambition led to the 1985 UCITS directive, which brought the framework to life and created the foundation of the modern UCITS platform we know today.

The Evolution Continues: Enter ETFs

UCITS ETFs (exchange-traded funds) have become a commonly used investment vehicle in Europe – as in many other parts of the world. The European ETF market currently has approximately \$1.6 trillion of assets, across some 3,380 unique UCITS share classes. The global ETF market, meanwhile, totals approximately \$9.6 trillion.

Retail and institutional investors alike have found many use cases for ETFs, as the vehicle combines the flexibility and liquidity of a traditional exchange-traded security with the regulatory framework and investor protection provided by UCITS. Index-tracking ETFs have become known for their transparency, relatively low costs and diverse set of investment strategies. The product type has played an important role in providing investors better access to global markets.

Benefits of UCITS ETFs Within Mexico

1. Access to diverse global markets and asset-classes.
2. Access to global asset-managers.
3. Access to aggregated global secondary market liquidity.
4. Access to Accumulating Share Classes.

Rise of UCITS ETFs: A Preferred Choice for Mexican Investors

U.S ETFs are deemed 40 Act funds and are regulated by the U.S Securities and Exchange Commission (SEC). This regulatory framework requires ETFs to distribute income and capital gains to shareholders; and any income or profits earned by the ETF must be distributed to shareholders. European ETFs regulated under the UCITS directive in the European Union have the ability to either distribute or reinvest/accumulate income and gains.

Mexican investors have shown a preference for UCITS ETFs, particularly those with accumulating share classes. This preference has led to an increase in the adoption of UCITS ETFs in the Mexican market.

It is important for investors to review fund documentation, including the prospectus, for details on share classes and tax treatment. Consulting with financial professionals or tax advisors is advised for personalized advice based on individual investment objectives.

Mexico Exchanges and International Quotation System (SIC)

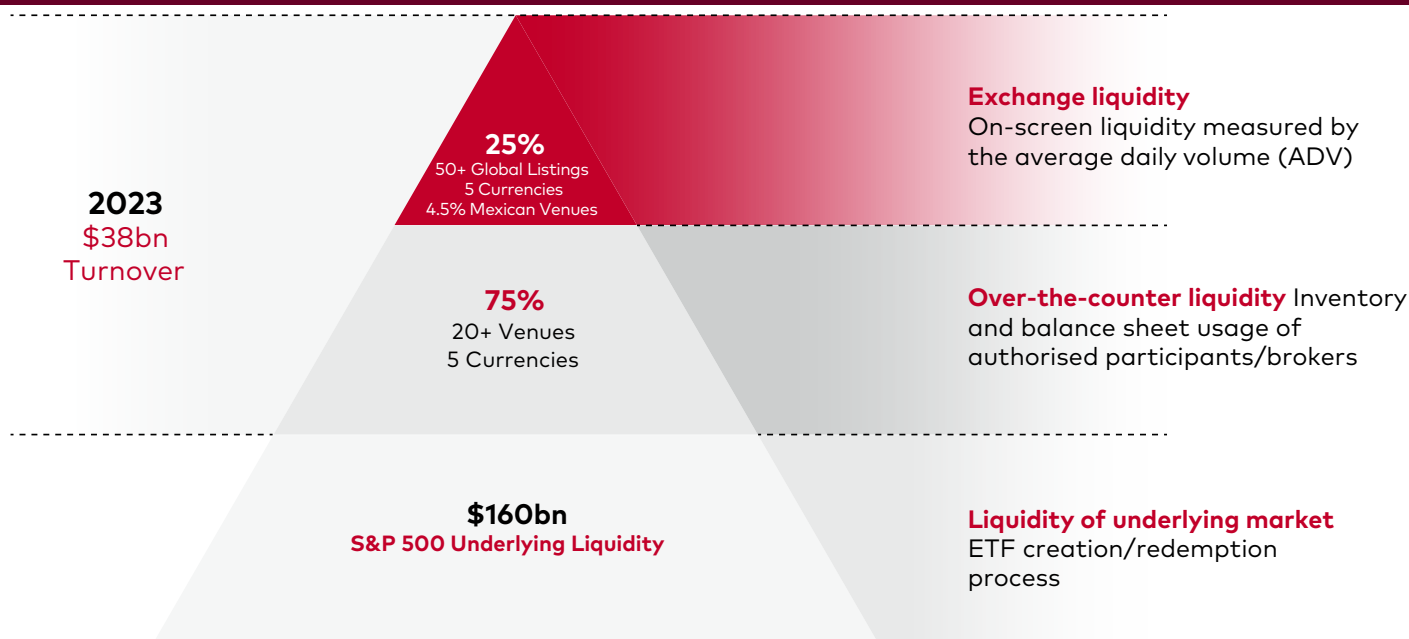
Mexico has two exchanges, which together provide local and international asset managers with the ability to offer a wide range of ETFs to investors. The Bolsa Mexicana de Valores (BMV) and The Bolsa Institucional de Valores (BIVA) exchanges offer access to an international quotation system. The SIC, or Sistema Internacional de Cotizaciones, is an important and well-functioning platform where investors gain access to foreign securities including stocks, bonds and more than 1,600 global ETFs. The securities trade and settle in Mexican pesos, which reduces the complexity and impact of security-by-security currency and foreign exchange management.

Accessing UCITS Liquidity in Mexico

There are approximately 740 UCITS ETFs available to be traded on the SIC. Given that ETFs are open-ended funds where shares are created or redeemed based on an underlying basket of securities, they have multiple layers of liquidity supporting them. These layers range from on-exchange 'visible' liquidity to the liquidity of the underlying market the ETF is tracking. Our [ETF Trading Guidance and Best Practices](#) report details an ETF's multiple layers of liquidity in more detail.

UCITS ETFs are unique in that they combine secondary market liquidity from multiple trading venues globally. This is particularly important to Mexican investors, where the trading volume in the local market often makes up a small percentage of a UCITS ETF's average daily volumes (ADV). In 2023, Mexico-based trading of the Vanguard S&P 500 UCITS ETF made up only 1.2% of the ETF's annual trading volume. Given that local Mexican brokers and trading desks engage regularly with both on exchange and off exchange liquidity in Europe, investors should take an aggregated view of global liquidity.

Figure 1 - Vanguard S&P 500 UCITS ETF

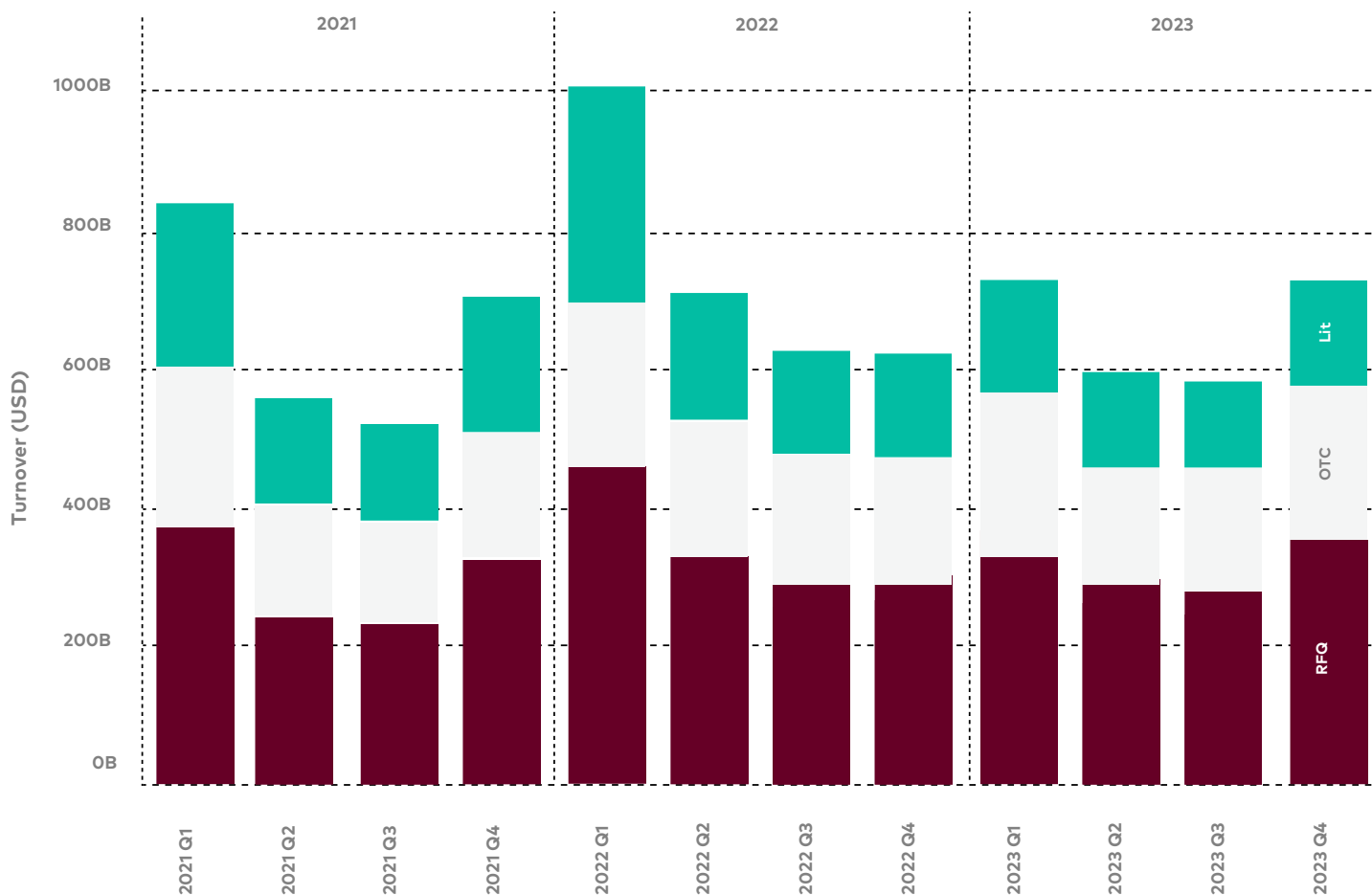


Sources: Vanguard, Big XYT

ETFs are also supported by the liquidity of the underlying securities they track. This liquidity functions through Authorized Participants (AP) and their ability to create and redeem in the primary market. When trading at large multiples of aggregate global volume, an AP is likely to interact with the primary market to source or redeem ETF shares. On top of aggregate global volume, Mexican investors should assess underlying security liquidity while seeking to trade with a counterparty that is active in the primary market and/or European secondary market. There are several international brokers offering global custody in Mexico that can help in aggregating this liquidity across Europe, the U.S and Latam.

Request for quote (RFQ) platforms have become a popular way to trade, allowing investors to transact directly with such counterparties and to avoid unnecessary intermediation and increased trading costs. Also known as a multilateral trading facility (MTF), as much as 50% of UCITS ETFs' volumes is believed to trade on these electronic venues (see Figure 2).

Figure 2 - UCITS ETF - European Trading Venues



Source: Vanguard, Big XYT

Consider Time and Day

Due to the dominance of European trading, it can serve Mexican investors well to place trades before the European market closes, as execution desks in Mexico can utilise increased liquidity at times of market overlap.

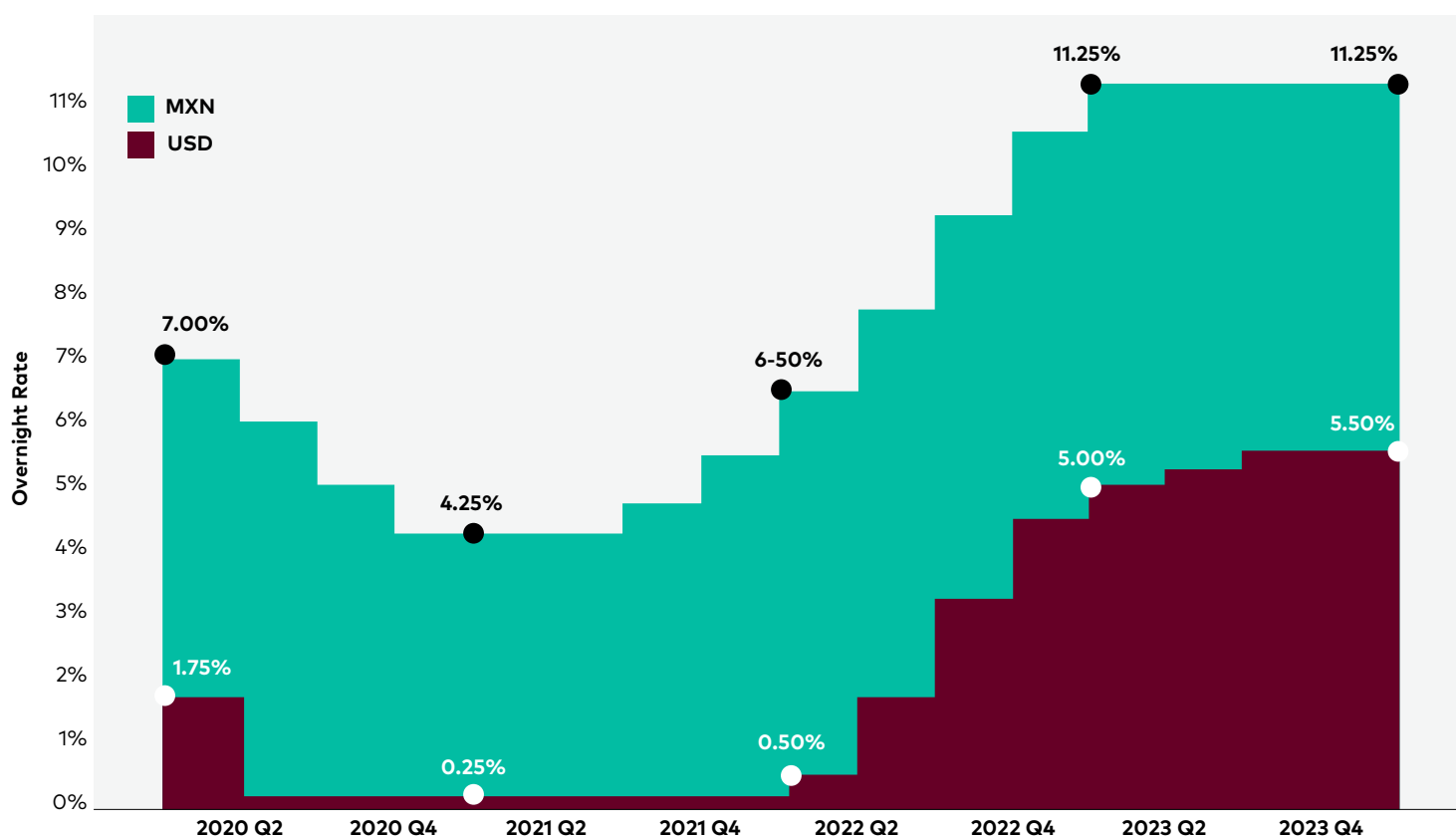
This scenario is particularly important for Mexican ETF investors trading at larger multiples of aggregate global volume, with subsequent primary market activity becoming likely. Understanding the key characteristics of an individual ETF's primary market dynamics can lead to better trading outcomes for investors.

One important primary market consideration is when APs can create and redeem. Vanguard UCITS ETFs have primary market cut-offs for APs throughout the trading day and are shut for entire days when a large portion of securities in the underlying ETF benchmark is closed for trading, for country specific holidays or unscheduled market closures (UMC). For optimal trading outcomes, when making larger trades investors should consider if an AP has enough time to offset the trade with creation and redemption activity following their trade.

When a market maker is unable to offset activity, trading costs increase due to elevated hedging and funding costs. These costs are passed on to investors. This is a particularly important consideration in higher interest rate environments (see Figure 3).

For Mexican UCITS ETFs trading at large multiples of aggregated volume, it can often be beneficial to trade while there is European and Mexican market overlap, such as in the morning after natural price discovery occurs following the US open but before Europe closes.

Figure 3: Overnight Funding Costs

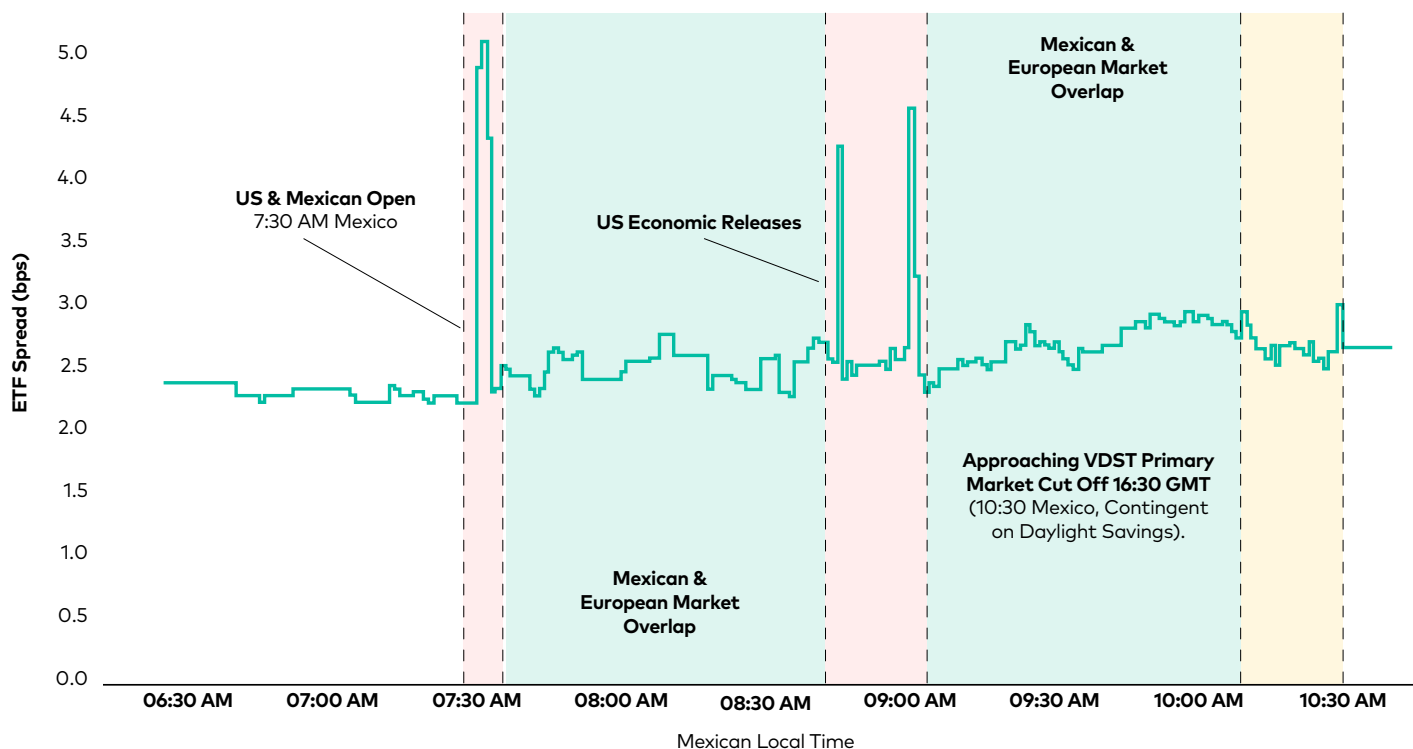


Source: Vanguard

As an example, Figure 4 below shows the spread for the Vanguard 0-1 Year US Treasury UCITS ETF Accumulating (Ticker VDST) through a typical trading day. In the figure, we have highlighted:

- **Green:** Times in the Mexican trading day when European market liquidity will typically be at its highest.
- **Red:** Periods when natural volatility occurs (i.e. underlying market open and economic announcements).
- **Yellow:** Times when cut-offs begin to approach for APs on the primary market.

Figure 4: Intraday Order Book: US Treasury 0-1 Year UCITS ETF (VDST LN)



For investors that benchmark execution to later in the trading day, RFQ venues and target benchmark algorithm trades still offer the functionality to place trades at a variety of execution benchmarks while placing the order during these optimal timeframes.

Speak With an Expert

Vanguard has four ETF Capital Markets teams around the world to assist investors with trading ETFs. Two teams have specific expertise in the local Mexican ETF market and the trading of UCITS ETFs in Europe.

A representative from the ETF Capital Markets team is on hand to provide support on:

- Understanding the multiple layers of liquidity;
- Providing information on active counterparties;
- Sharing guidance on primary market dynamics; and
- Advising on how to achieve best execution experiences.

To speak with a member of our Capital Markets team, please speak to your local sales representative.

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