

# understanding exchange traded funds



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## WHAT ARE THEY?

**Exchange Traded Funds (ETFs) are funds that hold a portfolio of securities managed to match the performance of an underlying index.**

Because they are index based, they are generally an efficient, liquid and cost effective way to gain index exposure to various equity markets. Instead of issuing units like a managed fund, ETFs issue shares which trade throughout the day at prevailing market prices, like other securities on the ASX. With the exception of voting arrangements, investors generally have the same rights as investors in shares. All economic benefits such as dividends, bonus issues, rights issues etc flow through to investors.

Like shares, ETFs can also be sold short – a bet that the index value will decline – and also be bought on margin using borrowed money.

## WHAT IS AVAILABLE?

There are five broad categories of ETFs available in Australia. These include global equity funds; global sector funds such as consumer staples stocks, telecoms stocks; physical commodity funds such as gold, silver, platinum or ‘baskets’ of various precious metals; Australian share funds based on indices such as the S&P/ASX 50 or S&P/ASX 200 stocks; and Australian sector funds such as resources, financials, property and industrials indices.

## FEES

Fees can vary substantially, depending on the underlying asset. Typical ETF fees are shown in the table below:

| Asset Class / Sector                      | Fee              |
|---|------------------|
| Broad market US Share Funds               | 0.10%            |
| Other US Share portfolios                 | 0.20%            |
| Regional Funds (Europe, Asia, Japan)      | 0.50%<br>- 0.60% |
| Sector funds (e.g. Health-care, telecoms) | 0.50%            |
| Emerging Market Funds                     | 0.60%<br>- 0.75% |

In addition, an investor will pay normal brokerage commissions as per any transaction on the ASX.

## HOW DOES AN ETF DIFFER FROM AN INDEX MANAGED FUND?

On the face of it, ETFs appear very similar to index managed funds which also track an index. However, there is one important difference. Index managed funds are priced once a day. The market price of a managed fund doesn’t fluctuate during the trading day; investors only ever pay the net asset value struck at the end of each trading session. There is no premium (or a discount) between the price of a unit in a managed fund and its net asset value.

ETFs, on the other hand, trade like shares throughout the day and their prices may fluctuate; but the net asset value at which shares are issued or redeemed is only determined at the end of the day. This can create a problem. The market price of an ETF is supposed to mirror the value of the underlying stocks in the index. But sometimes the two prices can diverge widely. This is because the net asset value of an ETF is set at the end of each local trading day but those ETFs can then trade all over the world, while the local markets are closed. If the price is higher than the net asset value, investors are essentially paying a premium.

## GOOD POINTS

ETFs are low turnover funds relative to many actively managed funds, with turnover reflecting the changes to the underlying indices, usually on a quarterly or semi-annual basis. They are thus more tax efficient than most actively managed funds.

Most managed funds are structured as unit trusts where investors buy unlisted units in a fund. Instead, ETFs offer investors liquidity via the ASX. Dedicated market makers in the ETFs listed on the ASX are required to make two-sided markets within a maximum spread and minimum volume. In deep markets, liquidity is not a problem and ETF shares can be traded easily.

Liquidity is also provided by a share creation / redemption facility, unlike a listed investment company which has a fixed

supply of shares on issue. The number of issued shares for each ETF can be increased or decreased on a daily basis according to investor demand. The creation / redemption feature also means that the ETF share price is usually kept closely in line with the net asset value of the fund. The actions of one investor are quarantined from other investors; a redemption by one investor does not trigger a tax event for other investors.

## RISKS

The 'vanilla' ETFs that are available in Australia are relatively low risk – ignoring normal market-related risks. They all will track the performance of their particular index relatively closely. However, overseas investors can buy ETFs with complex structures which have the potential to be disastrous in the wrong market conditions. The reason for this is that they can be highly leveraged, difficult to implement and illiquid. Five examples are discussed below:

- Commodities ETFs (as opposed to precious metals ETFs which are backed by actual physical metal) usually hold futures contracts because the indexes they track are typically made up of such contracts. But this can lead to problems, as an ETF will lose money in falling markets every time it rolls over from a near-month contract to a further dated contract. Commodities ETFs also suffer because of their transparency – namely their contract roll-over dates are known by the market and are easily 'gamed' by traders. The result of this is significant underperformance compared to any gains in the spot price of the commodity.
- Fixed interest ETFs may seem like a good idea, with low fees giving them a big advantage in the usually low-return bond market. However, keeping fixed interest ETF returns in

line with the indexes has proven to be difficult. For most bonds, there is no centralized exchange matching bond buyers and sellers, and different market players can assign very different prices to the same bonds. Many bonds don't trade for days at a time, and when they do, they can be costly to buy and sell. Currently, many fixed interest ETFs trade at a premium to their net asset value. This may not always remain the case. If investor sentiment changes, large scale selling can turn ETF premiums into discounts, especially in the high-yield bonds which are notoriously difficult to trade in tough times.

- Certain emerging market ETFs can suffer from illiquidity as a result of the relatively 'thin' trade in those countries' stock markets. While returns may be impressive, in bad times it may be difficult to exit these products.
- Geared and Inverse ETF's carry additional risk due to the nature of such securities having multiples of exposure or a "short" exposure to the underlying index. Such ETFs are popular with speculators and those seeking enhanced returns, but are substantially more volatile.
- Swap backed ETFs are securities which pay you a return equivalent to that of the underlying index but without necessarily holding the underlying assets. Such securities have an additional level of credit risk to the third party swap provider, as well as collateral risk - given you may not have visibility over the assets held as collateral.

Promoters of ETFs have made much about the potential use of ETFs in tactical asset allocation, extolling their low cost and flexibility. Unfortunately, ETFs are

just building blocks. There is a risk that ETFs are bought simply on the basis of their recent past performance, with little consideration given to the inherent risks in the indices underpinning these ETFs, or their future prospects. For example, an ETF based on the Resources index may look good now but represents a big bet in just one sector. There is little evidence that investors can effectively 'play the market' between sectors and may be disappointed with the results if they buy high and sell low.

ETFs investing in global shares are typically not hedged. Consequently their returns will be impacted by the relative currency movements between the Australian dollar and the foreign currency of the underlying securities during the investment period. This means returns to Australian investors will increase if the AUD weakens relative to those foreign currencies over the investment term. Likewise, returns to Australian investors will fall if the AUD strengthens relative to the foreign currencies.

## HOW THEY SHOULD BE USED

ETFs are suited to those investors who believe the market provides an efficient long term return or are unwilling to pay the additional fees involved with active investment management. Given the flexibility offered by ETFs, there is scope for investors to use them as core holdings or in conjunction with active strategies, to manage portfolio volatility and reduce the cost of maintaining exposure to an asset class.

ETFs work well when they are based on deep and liquid markets. We strongly caution against investing in the more obscure types of ETFs that invest in niche markets and sectors or which are leveraged. Not only are there serious risks inherent in some ETFs, there is no guarantee that they will always be liquid or that an investor can trade at a market price close to the net asset value.



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