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EXCHANGE TRADED FUNDS

In Melbourne a lively group learned a lot about Exchange Traded Funds, a relatively new form of investment that blends the benefits of both managed funds and shares.

John Jardim, Vice President from iShares, a division of BlackRock, gave a presentation explaining how this form of investment works and answered many questions along the way. The meeting was facilitated by Pauline Taylor, Finance and Economics Consultant.

What is an Exchange Traded Fund?

An Exchange Traded Fund (ETF) is an open ended fund that trades like any other listed share on an exchange. It generally tracks an index, such as the S&P/ASX20 or can track bonds, currencies and commodities. For traditional share indices, weightings are in accordance with market capitalisation. Like shares, ETF prices move throughout the day. An open ended fund means that more supply can come on to the market to meet demand.

Because an ETF simply tracks an index, costs tend to be lower because there is no active management component or research on stock selection. The costs/fees are generally expressed as the Management Expense ratio (MER). For example the iShares MSCI Australia 200 ETF, the MER is 0.19%.

What is the difference between ETFs, managed funds and listed investment companies?

Managed funds are unitised: investors buy units and sell from the manager, i.e. they cannot be traded on the stock market. They generally incur higher costs, particularly if they are actively managed and are usually less tax efficient due to higher levels of portfolio turnover. The MER for a managed fund is generally around 1-2%.

Listed investment companies (LICs), are market listed, closed ended funds. The value of the underlying investment portfolio held in an LIC on a per share basis is referred to as its Net Tangible Assets (NTA). However, on-market prices may differ from the NTA for a variety of reasons including current market sentiment, the past performance of the LIC and the future expectations for the fund. LICs may therefore trade at a discount, premium or at par to its NTA. Managing this process can be challenging, as LICs are only obligated to disclose their NTA at the end of each month.

What is the difference between "synthetic" ETFs and "vanilla" ETFs?

Most ETFs buy and own the shares and other investments that they are trying to match. These are known as standard, physical or vanilla ETFs. Synthetic ETFs may or may not directly own the underlying shares or other assets and use complex products called derivatives. These products are derived from an underlying asset and often involve

counterparties, which add another element of risk. In Australia, there are very few synthetic ETFs and the regulator, ASIC requires that they use the word “synthetic” so that investors are clear that they are buying a different type of product. iShares only deal in the “physical” or “vanilla” ETFs.

What are the main advantages of using an ETF?

- *Diversification* – you can invest in a diversified portfolio of securities via the one iShare thus reducing concentration risk
- *Cost efficient* – ETFs are generally less expensive than investing in actively managed funds and can also be less costly than purchasing a large number of shares as there are less trading costs.
- *Flexible* – ETFs can be traded like a share through any broker, investment adviser or online trading platform and because they trade like shares they can be bought on limit or stop loss orders
- *Transparent* – holdings within the fund are published daily
- *Liquid*- the listed nature of ETFs provides investors with the liquidity to react to changing market conditions quickly and simply
- *Tax efficient* – compared with actively managed funds, ETFs may prove more tax efficient as a result of lower levels of portfolio turnover. Also, trading in and out of ETFs does not increase portfolio turnover within the ETF, which can help keep them tax efficient.
- *Portfolio diversification* – ETFs enable you to invest in an asset class, such as a specific sector, country or region, giving you a broader range of assets.

What risks are associated with ETFs?

- *Tracking errors* - “physical” ETF prices may not exactly follow the price of the index or investments they are designed to track. This 'tracking error' may be caused by fees, taxes, and other factors, such as market timing.
- *Price errors* - sometimes ETF prices quoted by online stockbrokers can differ from the value of the assets that the ETF holds, so you may buy or sell for more or less that ETF's assets are worth. Before placing an ETF order, check that the price you're quoted matches what the ETF issuer says its assets are worth (the 'net asset value', or NAV).
- *Costs* - while ETFs generally have lower costs, management fees vary and there are other costs to consider. Like Shares, ETFs have transaction costs, ' 'buy-sell spread' (the respective prices that you can buy and sell ETF units at) that can vary. Also,

there are brokerage fees to consider each time you buy and sell units whereas brokerage fees do not apply to unlisted securities such as managed funds.

- *Passive investment strategies* - Most ETFs are 'passive' investments that simply seek to follow a market index (up or down), rather than trying to outperform it. This means you have no protection from investment losses when the market falls.

- *Securities lending* can be used by ETF managers whereby they transfer some of their assets (such as shares) to other companies for a fee. Not all ETFs engage in securities lending. The Product Disclosure Statement should tell you whether or not your ETF engages in this practice. The risk is that the borrower will not return the securities as promised.

- *Currency risk* - If the ETF tracks overseas assets, changes in the value of the Australian dollar may also affect the value of your investment. All International ETFs on the ASX are not hedged for currency risk.

What ETFs are offered by iShares?

iShares ETFs comprise Australian shares, International shares – in both developed and emerging markets and have just recently announced three new fixed income funds: IShares UBS composite bond, iShares UBS Treasury and IShares UBS Government inflation.

With a minimum investment size for some bonds being up to $500,000, it can be difficult for small investors to achieve a diversified exposure to fixed income assets. By using a fixed interest ETF, an investor can gain exposure to a diversified portfolio of bonds, with the ability to specifically tailor the trade size to the portfolio allocation required.

In Australia, most individual fixed interest securities can only be bought and sold over the counter, unlike equities which can be readily traded on the stock exchange. iShares fixed income ETFs enable investors to obtain an actionable price on any ASX trading day at which they can buy and sell exposure to a diversified portfolio of fixed income securities. More information is on the iShares website and the Commonwealth Government's Money Smart website: http://au.ishares.com/publish/content/documents/pdfs/etfs_explained.pdf

http://au.ishares.com/publish/content/documents/pdfs/faq.pdf

http://au.ishares.com/about_ishares/ishares_etfs.do

https://www.moneysmart.gov.au/investing/complex-investments/exchange-traded-funds-(etfs)

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