The lowdown on ETFs

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Exchange traded funds (ETFs) are becoming increasingly popular with investors looking for affordable portfolio diversification. Alex Cain talks to the experts about their risks and benefits.

An ETF is a managed fund which can be bought and sold on an exchange like a share and, with the focus on fees hotting up since the GFC, price is a key reason why they have boomed in recent years.

"Management fees of ETFs are typically lower than a managed fund," says Tom Keenan, director of intermediary at Blackrock's ETF business, iShares.

"You can also save on brokerage – if for example you buy an ETF based on the ASX 20, you are getting twenty stocks for the price of one trade, instead of having to pay brokerage on all twenty shares."

Active versus passive

The trade-off is you are getting a passive investment, in other words ETFs follow market indices rather than trying to outperform the market in the way an actively managed fund might.

"Investors do run the chance that they may underperform more concentrated or actively managed portfolios. Though they will usually pay lower management fees than with active managers, investors must also be aware that they forego opportunities to outperform an index," says Michael Elsworth, general manager - specialised research at Lonsec.

ETFs are also subject to 'tracking error' risks which may cause a fund's return to deviate from its underlying index.

"You can avoid paying too much 'spread', which means the difference between the buy and sell price, by putting in 'market orders,'" says Tim Murphy, co-head of fund research at Morningstar.

For example, if you're interested in an ETF with a net asset value, or NAV (the value of the underlying assets such as shares) of $10 then the sell price might be $9.95 and the buy price $10.05.

In order to avoid this, Murphy recommends putting in a market order to buy at $10, which will likely be picked up by a broker or brokerage service which can reduce this spread.

A market order is effectively a request to buy or sell an investment immediately at the best available price. Market orders should not be used for shares that are traded infrequently though, as the asking price can be a lot higher than the current market price so you'll pay over the odds.

"Investors should also buy ETFs between 10.30am and 3.30pm, avoiding the first and last half hours of trading," Murphy says.

"This is because not all the underlying stocks will be open for trading for the first half hour and there could be some volatility in price for the last."

ETF access and diversification

Finding a way to balance out your portfolio, protecting it from risk when markets are volatile, can be a complicated process.

ETFs provide instant exposure to a diversified portfolio of securities, such as the S&P/ASX 200, through a single trade. And it doesn't mean you have to give up your own stock picks.

"If investors want diversity in their portfolio, an ETF based on the ASX 200 for example can complement their own share picks," says i-Shares' Keenan.

"Also, investors can use ETFs to access assets which might be difficult to get hold of, such as gold and US dollars."

ETF liquidity

Many investors have questions around the liquidity of ETFs, which really means how easy it is to cash them in.

You might have even logged onto a trading screen and noticed that the volume of ETFs traded on the ASX each day is much lower than that of the individual shares that might be held by the ETF.

This often leads to fears that investors won't be able to sell their ETF holdings when they want to.

An ETF has a special structure, with a market maker who is contractually obliged to buy your shares if there is no buyer. So if you want to sell your ETF and there is no other investor who wants to buy it from you, there is always someone who will step in to buy it.

"It's like a mirror," says Drew Corbett, head of product strategy and distribution at ETF provider BetaShares. "The ETF will reflect the underlying market.

"So if you have an ETF that holds the largest companies on the ASX, with names like Wesfarmers and BHP Billiton for example, you will be able to sell that ETF as easily as you would be able to sell BHP Billiton or Wesfarmers shares."

If an ETF provider were to go out of business, the shares you owned through them would legally be held in trust for you.

Physical versus synthetic

Many ETFs publish their holdings every day, meaning investors can download a list of all the ETFs' assets that has been updated the day before, which is helpful if you like to know what you're holding.

Most ETFs in Australia are physically backed by the underlying assets – so an equity ETF buys the underlying shares, or a bond ETF buys the bonds it represents. These are referred to as 'physical' ETFs.

A term you might have heard is 'synthetic ETFs'. This type of ETF isn't backed by the underlying assets but instead aims to replicate the index with derivatives such as swaps or contracts in the futures market. Until now in Australia, these ETFs have mainly been commodity related ETFs.

The reason synthetics can be a concern is counterparty risk or default risk, in other words the possibility that the party providing the swap will fail to deliver the performance of the assets being tracked.

The regulator, Australian Securities & Investments Commission (ASIC), has fixed rules around ETFs which mean that in Australia anything designated as an ETF is obliged to hold at least 90% physical assets or cash.

"In practice, all ETFs in Australia hold at least 95%," Betashares' Corbett says.

In Betashares' case the only time they use synthetics is when they can't get the actual asset – for example, with their commodity ETF it would be difficult to gather actual barrels of oil, so they use the futures market for that. But, in most other cases, such as their gold ETF, it is backed by actual gold bullion.

ASIC requires other exchange traded products based on synthetics such as futures to use the word 'synthetic', 'structured' or 'collateralised product' in their titles so investors can identify them.

"Investors who are still concerned have plenty of options when they're starting out," says Amanda Skelly, director of ETFs at State Street. "All the equity based ETFs are purely 'physical'."

The key is to do your research so you know what you're getting.

Stock markets rally: cautious optimism

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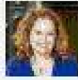

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Last Friday, February 1, stock markets around the world surged to levels not seen for years, but the question is, will it last?

Australia's stock market moved to a 21 month high. At market close on Friday, the S&P/ASX200 index had risen 42.3 points, or 0.87%, to 4,921.1 points. The broader All Ordinaries index was up 40.9 points, or 0.83%, at 4,941.9 points.

The rally echoed those around the world, with the Dow index, the major index in the US, closing above 14,000 on Friday, the first time it has closed above 14,000 since October 2007, before the GFC. European markets also rose on Friday after positive economic data.

For the last year at least, stock markets have been very much impacted by global macro factors. This included the economic situation in the US and the 'fiscal cliff', Europe's debt crisis and China's economy, all of which caused volatility.

Gains late last week, particularly in the US and Australia, were largely in response to positive US economic data and a good company earnings season.

US non-farm payrolls (employment) rose by 157,000 in January, in line with forecasts. Job gains in the two previous months were solidly upgraded by 127,000 while the jobless rate rose from 7.8pct to 7.9pct.

However the fragility of the situation was highlighted by Europe on Monday, where European stock markets fell sharply. This was due to fears of instability in the Eurozone which reared up again on negative news from Spain and Italy.

Australia's All Ordinaries Index was trading at 4,908 on Tuesday afternoon.

Will the market keep gaining?

Short term gains are fine, but for the average investor it is important to take a long term view of the market rather than reacting to sudden rallies.

Despite many ups and downs in the Australian share market during the last year, it is important to note overall returns were around 20% including dividends.

Concerns about the US, Europe and China seem to have abated for now. Term deposit rates, which have until recently been very attractive, are falling, which could encourage some investors to take some of their money out of term deposits and put it into shares.

Does this all point to a sustained lift in the stock market?

"We are cautiously optimistic," said Johan Carlberg, principal and portfolio manager at Alphinity Investment Management.

However seeing companies grow their earnings will be the key.

"The reason the Australian market has lagged is we haven't had the earnings growth since the GFC. What we need to see some evidence of at least during the course of this year is earnings growth," Carlberg said.

Company earnings season, where companies announce how they have performed for the first half of the year, has kicked off in Australia, but no-one is expecting any surprise standout results just yet.

However, they are also not expecting too many nasty surprises, believing most companies who have slashed their profits have already made their announcements.

A positive year ahead could also be driven by the Reserve Bank of Australia cutting interest rates late last year, with further cuts, although not realised yesterday, expected this year as the mining industry slows down and the non-mining economy lags.

This should have a twofold impact. It will reduce the attractiveness of holding cash and stimulate the economy and also corporate earnings.

"We have yet to see the maximum impact of rate cuts," said Carlberg.

In January, chief investment officer of Australian equities manager Platypus, Donald Williams, said that additional cuts from the RBA would help support recoveries being seen in the construction and retail sectors while providing additional value support to the local share market.

Finally, the Australian dollar has steadied which should also help companies who were hit by the strengthening dollar last year.

Companies are now accepting that the high Australian dollar is here to stay, so those that have been impacted are coming up with longer term solutions rather than viewing it as a temporary situation, said Bob Van Munster, head of Australian equities for Tyndall Asset Management.

This includes reducing their cost bases, as evidenced by the likes of Boral which recently cut 700 jobs in an effort to trim its overheads.