

Simplicity rules

Low-cost index funds take the guesswork out of investing, reports **Barbara Drury**.

You need nerves of steel to wade back into the sharemarket after a crash but that's what investors must do if they want to participate in the market recovery. If you've lost confidence in your ability to pick winning stocks and lost faith in the ability of highly paid fund managers to beat the market, there is another way.

Index funds take the guesswork out of investing by tracking the performance of an entire market sector. Even better, an index approach costs far less than buying the same shares direct or paying

fund managers to pick and choose the best stocks.

According to Morningstar's Phillip Gray, in the year to February about 60 per cent of Australian large equities funds outperformed, or did less worse than, the Australian market.

This is a heartening statistic unless you have money with the 40 per cent that did worse than the market. And even if you backed one of the winning managers, there's no guarantee they won't be one of next year's losers. Over long periods of time very few fund

managers consistently beat the market.

There are two types of index fund: listed exchange-traded funds (ETFs) and unlisted index funds.

There are 1600 ETFs in the US, where five of the most actively traded stocks are ETFs, but they have been much slower to take off here. Due in part to last year's market turmoil, that appears to be changing (see box) and the trend looks likely to continue as investors shift cautiously out of cash and into shares.

One indication ETFs are gaining popularity is Vanguard Investment's



decision to launch a range of ETFs to complement its existing unlisted index funds covering local and international shares, property, fixed-interest and cash.

The head of retail at Vanguard, Robin Bowerman, says the group is looking at launching funds “quite soon” over Australian market indices as well as cross-listing ETFs from the US, where it is a major market player.

One of the lessons people learnt from last year’s market crash is a share portfolio needs to be actively monitored and managed. Ideally, investors should sell in the boom and buy in gloom but that’s easier said than done.

Ian Murdoch of Investstone Wealth Management recommends clients use an index fund as a tactical tool to help them navigate markets highs and lows with a cool head.

“We found it hard to get people to sell out of core stocks at the height of the market because they get emotionally attached but we believe they would sell an index fund,” he says.

Even though an index fund is designed to be held over the medium to long term, Murdoch says it still needs to be actively managed and that investors should consider trimming their holding to lock in profits in a rising market.

HOW THEY WORK

Index funds — both the managed and exchange-traded variety — are designed to replicate and track the performance of a basket of securities that make up a chosen market index.

Say, for example, you buy an index fund based on the ASX 200. The fund will own shares in all 200 Australian

companies that make up the index. So if BHP Billiton represents 14 per cent of the index, as it does at present, then about 14 per cent of the fund will be invested in BHP shares.

The price you pay for a share, or unit, in the fund is based on the net asset value of the underlying stocks.

Index funds typically pay twice yearly distributions but the amount depends on the type of fund. For example, iShares S&P 500, which covers the top 500 US stocks, yielded 2 per cent last year while the SPDR ASX 200 yielded 8.4 per cent in the year to February.

Index funds also have tax advantages. Earnings are distributed untaxed to investors and may include franking credits. And because index funds turn over their underlying portfolio less frequently than actively managed funds, the level of capital gains tax that needs to be paid by the fund is greatly reduced.

A private client broker at Ord Minnett, John Kimber, uses local, overseas and sector specific ETFs for his mostly wealthy clients who want to own the market without the cost of owning a lot of shares. “If clients want extra yield or growth they can then buy direct shares,” he says.

“ETFs give me the flexibility to consistently and reliably implement the asset allocation process that reflects what I want to do [for my clients] and not what a fund manager wants me to do. They’re very low tax, very liquid to deal in and very low cost.”

MANAGED INDEX FUND OR ETF?

Unlisted index funds and ETFs both aim to replicate the performance of a specific index and both are constructed like a managed fund; the main difference is in the way you buy them.

ETFs can be bought and sold on the Australian Securities Exchange (ASX) throughout the trading day like shares, at prices you specify, with three-day settlement. If you want to buy an index fund you need to request a product disclosure statement from the fund manager or your financial adviser and fill in an application form.

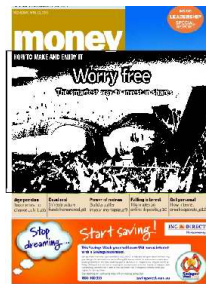
While Vanguard pioneered index funds in the US and in Australia, they are also available from fund managers including Barclays Global Investors, Colonial First State and Dimensional.

When it comes time to sell units in a managed fund you apply to the fund manager who sets the unit price daily. With an ETF, you place a selling order with your broker. But you can only sell when a buyer is willing to pay your price, so it’s important to select an actively traded fund.

While prices of both listed and unlisted funds are based on net asset value, Bowerman says ETF prices can fluctuate around their underlying value. “With [unlisted] funds you know you will get net asset value,” he says.

Bowerman says the buy and sell spread (the difference between the going price to buy and sell units) can also widen out with ETFs if there is not a lot of trading. By comparison, buy-sell spreads on unlisted funds are capped at about 20 basis points.

While it’s easier to buy and sell an ETF, index funds have other advantages. Gray points out many investors like to make regular contributions to a fund. You can do this relatively cheaply with an index fund and not pay brokerage, whereas you pay brokerage every time you buy additional ETF units.



Buy the lot ...
ETFs track the
performance
of an entire
sector.

EXCHANGE TRADED FUNDS COMPARE THEIR FEES

ETF	Fee % pa	Retail index fund	Wholesale index fund	Retail managed fund	Wholesale managed fund
SPDR S&P/ASX200	0.28	1.48	0.23	1.86	0.98
SPDR S&P/ASX50	0.28				
SPDR S&P/ASX200 AREIT	0.40	1.49	0.30	1.69	0.79
iShares S&P500	0.09			2.23	1.07
iShares FTSE/Xinhua China 25	0.74			1.88	1.86
iShares MSCI Emerging Markets	0.72		0.56	2.09	1.24
iShares MSCI Japan	0.52			2.02	1.21
iShares S&P Europe 350	0.60			1.98	1.50
iShares Global 100	0.40	1.39	0.39	1.96	1.10
iShares S&P Asia 50	0.50			1.96	1.32

AVERAGE FEE. % PER ANNUM

SOURCE: MORNINGSTAR

“If you made monthly contributions of \$500 to an ETF for 12 months and paid \$30 brokerage each time you would end up with an investment of \$6000 but it would cost you \$360 in brokerage,” Gray says.

Bowerman says the choice of an index fund or ETF comes down to personal preference. “Some investors only deal with listed securities and may never come to us for a managed fund.”

1.48 per cent while the ASX 200 ETF charges just 0.28 per cent.

The comparison for global funds is even starker. You can buy the iShares S&P 500 and gain exposure to the top 500 US stocks for an annual fee of just 0.09 per cent compared with average fees of 2.23 per cent for an actively managed retail equivalent.

Wholesale fees for actively managed funds, for people who invest via a

WHAT THEY COST

The main attraction of index funds is they give investors exposure to a diversified share portfolio at a very low cost. While investors may tolerate high fees during a boom, they are more discriminating when returns are low or negative as they have been lately.

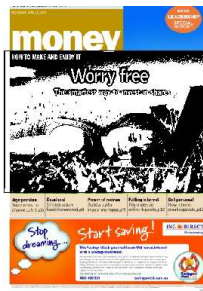
“You don’t have control over markets but you do have control over your cost of exposure to those markets,” Gray says.

As the table shows, the average actively managed Australian share fund available with a mandate to invest in the top 200 stocks charges fees of 1.86 per cent for retail investors. The average comparable index fund charges fees of

An index approach costs far less than buying the same shares direct.

platform such as Macquarie Wrap or ING’s One Answer, are considerably lower than retail fees but still more expensive than index funds.

As well as management fees, investors need to consider adviser fees platform fees and brokerage (for an ETF). Expect to pay about \$30 for an online broker and up to \$100 for a full-service broker, depending on the amount you buy or sell.



While nobody likes to pay high fees, Gray points out some of the money charged by fund managers goes on things such as investor newsletters, an informative website and investor education. "You're not going to get that level of information with an ETF. These features are important to a lot of investors but they are not talked about as often as returns," Gray says.

HOW TO BUY THEM

In theory, you can buy an index fund or an ETF via a broker or financial planner. In practice, you are more likely to walk away with an ETF from your broker or a managed fund from a financial planner for reasons that have little to do with your investment needs.

Kimber says the adviser decision-making process depends on what flashes on their screens when they get to work in the morning. For a financial planner, it's often a wrap account with a selection of managed funds. For a broker like himself, who is rewarded in brokerage, it's more likely to be shares and listed investments. "The tail often wags the dog," he says.

Gray agrees. "Financial planners are more likely to offer funds with a trailing commission," he says, although planners are beginning to recommend them.

A report on ETFs released last month by Investment Trends found that although the market was dominated by direct investors, 16 per cent of financial planners intended to increase their use of ETFs in the coming year.

Ian Murdoch is one of them.

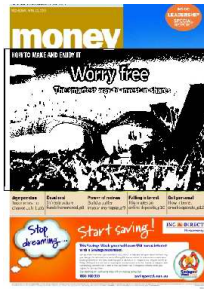
"We're not advising clients into ETFs just yet but we're on the cusp of it," Murdoch says.

Up until now, Investstone has been recommending clients use Vanguard's High Yield Australian Shares Fund to position themselves for the market recovery. In the year to the end of January the fund returned a grossed up yield (including franking credits) of 7.18 per cent against the market yield of 6.02 per cent.

Yields are likely to fall this year as company earnings fall, dividends are cut and share prices (hopefully) rise.

Even so, Murdoch expects yields on index funds will remain significantly higher than returns from bank accounts.





Broad market exposure attracts DIY super funds

There are 22 Exchange Traded Funds listed on the Australian Securities Exchange (ASX) and the number is set to increase when Vanguard enters the market.

The total assets held by Australian ETFs grew by 8 per cent last year to \$1.6 billion, with total turnover of \$5.1 billion. Globally, the shift to ETFs was even more marked. In 2008, \$US204.7 billion flowed out of unlisted managed funds and \$US214.8 billion flowed into ETFs.

Locally available ETFs come in three broad groups – Australian, international and sector funds.

The three Australian funds are provided by State Street Global Advisors and trade under the brand name SPDR, known as spiders. These replicate the performance of the top 50 and top 200 shares and the top 200 listed property trusts (see table).

The head of structured products at State Street, Susan Darroch, says the 200 is the most popular because of its broad market exposure.

The 16 diversified international funds are provided by Barclays Global Investors under the brand name iShares. These cover everything from the top 500 US shares to leading companies in markets such as Europe, China and South Korea.

Last week Barclays announced the sale of its global iShares business to

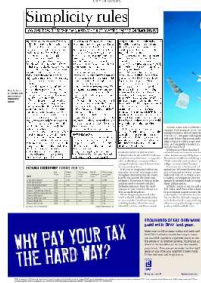
private equity group CVC Capital Partners, which has added some uncertainty to the market.

The co-head of iShares Australia, Tim Bradbury, says the ETF structure means the underlying share assets are quarantined and held by a custodian on behalf of investors, which should give comfort to investors whether iShares is owned by Barclays or another firm.

Bradbury estimates more than half of iShares investors are self-managed super funds that like the control that comes with direct equity investments but tend to be light on for global equity assets.

This year Barclays also added three global sector funds covering leading stocks in the consumer staples, healthcare and telecommunications sectors. These may appeal to Australian investors with a diversified portfolio of Australian shares but little or no exposure to some of the world's biggest household names such as Unilever, Nestle, Johnson & Johnson or Vodafone but they are not recommended as a core investment.

"I certainly wouldn't advise putting all your money in a telco fund, for example," says Morningstar's Phillip Gray. "If there is a prolonged sell-off in that sector then you will lose more than if you were in a broader market fund."



Simplicity rules

**Buy the lot ...
 ETFs track the
 performance
 of an entire
 sector.**

Low-cost index funds take the guesswork out of investing, reports **Barbara Drury.**

You need nerves of steel to wade back into the sharemarket after a crash but that's what investors must do if they want to participate in the market recovery. If you've lost confidence in your ability to pick winning stocks and lost faith in the ability of highly paid fund managers to beat the market, there is another way.

Index funds take the guesswork out of investing by tracking the performance of an entire market sector. Even better, an index approach costs far less than buying the same shares direct or paying fund managers to pick and choose the best stocks.

According to Morningstar's Phillip Gray, in the year to February about 60 per cent of Australian large equities funds outperformed, or did less worse than, the Australian market.

This is a heartening statistic unless you have money with the 40 per cent that did worse than the market. And even if you backed one of the winning managers, there's no guarantee they won't be one of next year's losers. Over long periods of time very few fund managers consistently beat the market.

There are two types of index fund: listed exchange-traded funds (ETFs) and unlisted index funds.

There are 1600 ETFs in the US, where five of the most actively traded stocks are ETFs, but they have been much slower to take off here. Due in part to last year's market turmoil, that appears to be changing (see box) and the trend looks likely to continue as investors shift cautiously out of cash and into shares.

One indication ETFs are gaining popularity is Vanguard Investment's

decision to launch a range of ETFs to complement its existing unlisted index funds covering local and international shares, property, fixed-interest and cash.

The head of retail at Vanguard, Robin Bowerman, says the group is looking at launching funds "quite soon" over Australian market indices as well as cross-listing ETFs from the US, where it is a major market player.

One of the lessons people learnt from last year's market crash is a share portfolio needs to be actively monitored and managed. Ideally, investors should sell in the boom and buy in gloom but that's easier said than done.

Ian Murdoch of Investstone Wealth Management recommends clients use an index fund as a tactical tool to help them navigate markets highs and lows with a cool head.

"We found it hard to get people to sell out of core stocks at the height of the market because they get emotionally attached but we believe they would sell an index fund," he says.

Even though an index fund is designed to be held over the medium to long term, Murdoch says it still needs to be actively managed and that investors should consider trimming their holding to lock in profits in a rising market.

HOW THEY WORK

Index funds — both the managed and exchange-traded variety — are designed to replicate and track the performance of a basket of securities that make up a chosen market index.

Say, for example, you buy an index fund based on the ASX 200. The fund will own shares in all 200 Australian

companies that make up the index. So if BHP Billiton represents 14 per cent of the index, as it does at present, then about 14 per cent of the fund will be invested in BHP shares.

The price you pay for a share, or unit, in the fund is based on the net asset value of the underlying stocks.

Index funds typically pay twice yearly distributions but the amount depends on the type of fund. For example, iShares S&P 500, which covers the top 500 US stocks, yielded 2 per cent last year while the SPDR ASX 200 yielded 8.4 per cent in the year to February.

Index funds also have tax advantages. Earnings are distributed untaxed to investors and may include franking credits. And because index funds turn over their underlying portfolio less frequently than actively managed funds, the level of capital gains tax that needs to be paid by the fund is greatly reduced.

A private client broker at Ord Minnett, John Kimber, uses local, overseas and sector specific ETFs for his mostly wealthy clients who want to own the market without the cost of owning a lot of shares. "If clients want extra yield or growth they can then buy direct shares," he says.

"ETFs give me the flexibility to consistently and reliably implement the asset allocation process that reflects what I want to do [for my clients] and not what a fund manager wants me to do. They're very low tax, very liquid to deal in and very low cost."



MANAGED INDEX FUND OR ETF?

Unlisted index funds and ETFs both aim to replicate the performance of a specific index and both are constructed like a managed fund; the main difference is in the way you buy them.

ETFs can be bought and sold on the Australian Securities Exchange (ASX) throughout the trading day like shares, at prices you specify, with three-day settlement. If you want to buy an index fund you need to request a product disclosure statement from the fund manager or your financial adviser and fill in an application form.

While Vanguard pioneered index funds in the US and in Australia, they are also available from fund managers including Barclays Global Investors, Colonial First State and Dimensional.

When it comes time to sell units in a managed fund you apply to the fund manager who sets the unit price daily. With an ETF, you place a selling order with your broker. But you can only sell when a buyer is willing to pay your price, so it's important to select an actively traded fund.

While prices of both listed and unlisted funds are based on net asset value, Bowerman says ETF prices can fluctuate around their underlying value. "With [unlisted] funds you know you will get net asset value," he says.

Bowerman says the buy and sell spread (the difference between the going price to buy and sell units) can also widen out with ETFs if there is not a lot of trading. By comparison, buy-sell spreads on unlisted funds are capped at about 20 basis points.

While it's easier to buy and sell an ETF, index funds have other advantages. Gray points out many investors like to make regular contributions to a fund. You can do this relatively cheaply with an index fund and not pay brokerage, whereas you pay brokerage every time you buy additional ETF units.

"If you made monthly contributions of \$500 to an ETF for 12 months and paid \$30 brokerage each time you would end up with an investment of \$6000 but it would cost you \$360 in brokerage," Gray says.

Bowerman says the choice of an index

fund or ETF comes down to personal preference. "Some investors only deal with listed securities and may never come to us for a managed fund."

WHAT THEY COST

The main attraction of index funds is they give investors exposure to a diversified share portfolio at a very low cost. While investors may tolerate high fees during a boom, they are more discriminating when returns are low or negative as they have been lately.

"You don't have control over markets but you do have control over your cost of exposure to those markets," Gray says.

As the table shows, the average actively managed Australian share fund available with a mandate to invest in the top 200 stocks charges fees of 1.86 per cent for retail investors. The average comparable index fund charges fees of 1.48 per cent while the ASX 200 ETF charges just 0.28 per cent.

The comparison for global funds is even starker. You can buy the iShares S&P 500 and gain exposure to the top 500 US stocks for an annual fee of just 0.09 per cent compared with average fees of 2.23 per cent for an actively managed retail equivalent.

Wholesale fees for actively managed funds, for people who invest via a platform such as Macquarie Wrap or ING's One Answer, are considerably lower than retail fees but still more expensive than index funds.

As well as management fees, investors need to consider adviser fees platform fees and brokerage (for an ETF). Expect to pay about \$30 for an online broker and up to \$100 for a full-service broker, depending on the amount you buy or sell.

While nobody likes to pay high fees, Gray points out some of the money charged by fund managers goes on things such as investor newsletters, an informative website and investor education. "You're not going to get that level of information with an ETF. These features are important to a lot of investors but they are not talked about as often as returns," Gray says.

HOW TO BUY THEM

In theory, you can buy an index fund or an ETF via a broker or financial planner. In practice, you are more likely to walk away with an ETF from your broker or a managed fund from a financial planner for reasons that have little to do with your investment needs.

Kimber says the adviser decision-making process depends on what flashes on their screens when they get to work in the morning. For a financial planner, it's often a wrap account with a selection of managed funds. For a broker like himself, who is rewarded in brokerage, it's more likely to be shares and listed investments. "The tail often wags the dog," he says.

Gray agrees. "Financial planners are more likely to offer funds with a trailing commission," he says, although planners are beginning to recommend them.

A report on ETFs released last month by Investment Trends found that although the market was dominated by direct investors, 16 per cent of financial planners intended to increase their use of ETFs in the coming year.

Ian Murdoch is one of them.

"We're not advising clients into ETFs just yet but we're on the cusp of it," Murdoch says.

Up until now, Investstone has been recommending clients use Vanguard's High Yield Australian Shares Fund to position themselves for the market recovery. In the year to the end of January the fund returned a grossed up yield (including franking credits) of 7.18 per cent against the market yield of 6.02 per cent.

Yields are likely to fall this year as company earnings fall, dividends are cut and share prices (hopefully) rise.

Even so, Murdoch expects yields on index funds will remain significantly higher than returns from bank accounts.

An index approach costs far less than buying the same shares direct.



Broad market exposure attracts DIY super funds

There are 22 Exchange Traded Funds listed on the Australian Securities Exchange (ASX) and the number is set to increase when Vanguard enters the market.

The total assets held by Australian ETFs grew by 8 per cent last year to \$1.6 billion, with total turnover of \$5.1 billion. Globally, the shift to ETFs was even more marked. In 2008, \$US204.7 billion flowed out of unlisted managed funds and \$US214.8 billion flowed into ETFs.

Locally available ETFs come in three broad groups – Australian, international and sector funds.

The three Australian funds are provided by State Street Global Advisors and trade under the brand name SPDR, known as spiders. These replicate the performance of the top 50 and top 200 shares and the top 200 listed property trusts (see table).

The head of structured products at State Street, Susan Darroch, says the 200 is the most popular because of its broad market exposure.

The 16 diversified international funds are provided by Barclays Global Investors under the brand name iShares. These cover everything from the top 500 US shares to leading companies in markets such as Europe, China and South Korea.

Last week Barclays announced the sale of its global iShares business to

private equity group CVC Capital Partners, which has added some uncertainty to the market.

The co-head of iShares Australia, Tim Bradbury, says the ETF structure means the underlying share assets are quarantined and held by a custodian on behalf of investors, which should give comfort to investors whether iShares is owned by Barclays or another firm.

Bradbury estimates more than half of iShares investors are self-managed super funds that like the control that comes with direct equity investments but tend to be light on for global equity assets.

This year Barclays also added three global sector funds covering leading stocks in the consumer staples, healthcare and telecommunications sectors. These may appeal to Australian investors with a diversified portfolio of Australian shares but little or no exposure to some of the world's biggest household names such as Unilever, Nestle, Johnson & Johnson or Vodafone but they are not recommended as a core investment.

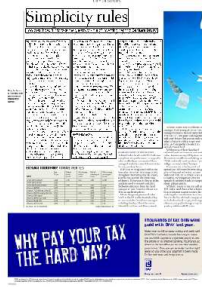
"I certainly wouldn't advise putting all your money in a telco fund, for example," says Morningstar's Phillip Gray. "If there is a prolonged sell-off in that sector then you will lose more than if you were in a broader market fund."

EXCHANGE TRADED FUNDS COMPARE THEIR FEES

ETF	Fee % pa	Retail index fund	Wholesale index fund	Retail managed fund	Wholesale managed fund
SPDR S&P/ASX200	0.28	1.48	0.23	1.86	0.98
SPDR S&P/ASX50	0.28				
SPDR S&P/ASX200 AREIT	0.40	1.49	0.30	1.69	0.79
iShares S&P500	0.09			2.23	1.07
iShares FTSE/Xinhua China 25	0.74			1.88	1.86
iShares MSCI Emerging Markets	0.72		0.56	2.09	1.24
iShares MSCI Japan	0.52			2.02	1.21
iShares S&P Europe 350	0.60			1.98	1.50
iShares Global 100	0.40	1.39	0.39	1.96	1.10
iShares S&P Asia 50	0.50			1.96	1.32

AVERAGE FEE, % PER ANNUM

SOURCE: MORNINGSTAR



Sydney Morning Herald
Wednesday 22/4/2009
Page: 4
Section: Money
Region: Sydney Circulation: 211,370
Type: Capital City Daily
Size: 1,666.38 sq.cms.
Published: MTWTFS-

Brief: TRENDS
Page 4 of 4

