

Funds branch out

A new style of investment fund is grabbing attention from both novice and long-time investors, as Jason Bryce reports

FOR a low-key, low-fee investment, exchange traded funds are attracting a lot of attention.

ETFs are passively managed index funds that track the performance of a stock market by owning shares in most, if not all, the stocks listed in the index.

Just a few years since their introduction to Australia there are 27 ETFs listed on the Australian Securities Exchange, including six funds listed in the past three months.

While ETFs are listed on the Australian share market, they typically offer an investment exposure to particular regions or countries, such as Europe, the US, Asia, China and the "BRIC" economies of Brazil, Russia, India and China.

There are ETFs that hold stocks only in the world's top listed companies and ETFs that hold stocks only in smaller companies.

These funds provide instant diversification through one transaction. One share in an ETF may give exposure to hundreds of individual

stocks in the chosen market or index.

ETFs are also relatively cheap because they are not actively managed, so the management fee is smaller.

In Australia, they have "fallen through the gap" between financial advisers and stockbrokers but have managed to make inroads on their own with investors.

"They've actually been offered in Australia since 2001," says Phillip Gray, a researcher for investment product ratings agency Morning-Star. "It's not altogether clear why ETFs haven't been more popular so far but there are several likely reasons.

"First, ETFs appear to have fallen between financial advisers most familiar with managed funds but not fully geared up to dealing with share markets, and stockbrokers still getting to grips with an investment that picks stocks for them."

ETFs also don't pay upfront or continuing commissions to financial planners and advisory groups, so you probably won't be hearing too many advisers recommending them.

"However, now it seems to be brokers recommending them that is driving a bit of interest in exchange traded funds," Mr Gray says.

One financial adviser who has been recommending ETFs to his clients is John Hewison. He has had two ETFs on his list of recommended investments for two years.

"The two biggest advantages that an ETF has is that if there is a market correction and a rush on redemptions, the investors simply sell their ETF shares on the market," Mr Hewison says.

"An unlisted fund can be faced with having to find the money to repay the investors and may have to sell assets for a low price to do so.

"The other big advantage of an ETF is the dramatically lower cost."

COST ADVANTAGE

Fees tend to be less than those charged by an actively managed fund and this is an advantage for many investors.

Some ETFs charge fees as low as 0.09 per cent a year, although most charge in the 0.4-0.7 per cent range.

Their structure is generally much more transparent: you know what the fund is investing in all the time.

"Basically they are an index fund that you can buy and sell on the exchange," says iShares Australia spokesman Tim Bradbury.

iShares is the dominant player in the ETF market in Australia.

"They price throughout the day, so

you are getting the latest buy and sell prices, not just once a day like you do for an unlisted managed fund," Mr Bradbury says.

As recently as 2005, there were just a few hundred ETF trades on the Australian stock exchange monthly. Now there are thousands.

"ETFs have been going gangbusters on all the major exchanges globally," Mr Bradbury says.

"Institutional investors, advisers and brokers are all investing in ETFs, as well as self-directed investors."

CASE STUDY

investor Geoff Hardy, from Melton, says: "You don't need a broker or an adviser to tell you that one share in an ETF gives you instant diversification."

Mr Hardy, a plasterer by day, had been hearing and reading about the great long-term investment prospects offered in the high-growth BRIC economies of Brazil, Russia, India and China.

"So I looked around and decided to buy a few shares in a BRIC ETF.

"That one little shareholding gives me a little foothold in those high growth economies," he says.

Mr Hardy has since bought into an ETF that holds the top listed stocks in the United States.

"I don't have many shareholdings or many investments but with an ETF I feel I have some diversification, which is what they all tell you to strive for.

"I wanted to have a bit of money invested offshore and the ETFs allow me to do that pretty easily and cheaply."

ETFs also have good liquidity: they are listed entities in their own right, so can be bought and sold easily.

Liquidity in ETF shares is provided by two "market makers" which are appointed by the ASX.

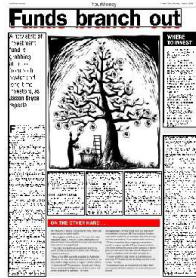
These market makers agree to buy and sell ETF shares within a prescribed maximum spread based on the the current ETF share price.

Citigroup and Susquehanna are the stock exchange's designated market makers.

iShares' Mr Bradbury says: "You can trade an ETF intra-day, unlike a managed fund where you only get one opportunity to trade in a day and you may not even know for sure what price you are coming in at.

"An ETF share price goes up and down like the market and is totally transparent.

"The other major differentiating factor with an ETF is the choice. There is a great range of different ETFs offering exposure to a whole



range of different markets.”
 Research firm Investment Trends recently reported that ETFs were growing in Australia.

“We are finding very, very rapid growth at the moment in ETFs off a very low base and the accelerating growth is being driven by high-net-worth investors,” Investment Trends principal Mark Johnston says, adding that the total number of ETF investors is likely to double this year to 33,000.

“Competition is expected given the phenomenal growth trend overseas,” Mr Johnston says.

“The number of ETF providers entering the market this year confirms our view that Australia’s ETF sector will continue to grow to a significant level as investors and intermediaries become more familiar with the ETF product and the con-

siderable benefits it has over managed funds.”

WHERE TO INVEST

THERE are three major groups of exchange-traded funds available to local investors.

The first group tracks segments of the Australian share market such as the 50 biggest listed companies, the S&P/ASX200 index or the Listed Property index.

The second group invests

in developed-world market indices, such as the S&P 500 index of the biggest US companies, or the Russell 2000 index of the smallest companies.

The third group provides exposure to a number of developed and developing Asian markets, such as the top 25 companies on Chinese share markets.

But this year new funds investing in the defensive sectors of health care, telecommunications and consumer goods have been launched for Australian investors.

ON THE OTHER HAND . . .

ALTHOUGH ETFs have a lot going for them, there are some issues to watch out for.

Morningstar’s Mr Gray says: “First up, like index managed funds, ETFs don’t offer the potential for above-market value-add which comes with investing in an actively-managed fund.

“Tracking a market index also means that ETFs don’t have the potential to minimise the effects of market downturns.

“Most of the ETFs currently available to Australian investors are also relatively narrow in their focus, as they track a single country or region’s share market.

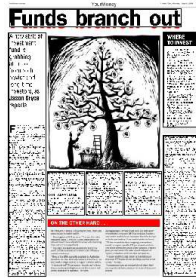
“If demand for ETFs increases, though, we’re likely to see a corresponding increase in the number and variety available in Australia,” he says.

Buying a single ETF now could leave you with a very concentrated exposure, Mr Gray explains. Having a very narrow market focus increases the risks to your portfolio, particularly if that market underperforms.

“All this means that if you’re going to invest in a country or region-specific ETF you should combine this with a diversified global share fund or ETF which gives you exposure to a wider opportunity set of regions, industries and individual companies.

“It’s also worth looking closely at the individual stocks an ETF tracks before deciding whether or not to buy,” he says.

“If you already have an unlisted global share fund, you may already have exposure to many of the same stocks.”



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