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## News

### ETF EVOLUTION

By [Caroline Munro](#) on 19 November 2010 [0 comments](#)

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The exchange-traded fund (ETF) market in Australia is currently the poorer cousin of its US counterpart. According to the November 2010 Bell Potter ETF report, ETFs in North America reached US\$1.173 trillion in global funds under management (FUM) at the end of May 2010, and as at July 2010 ETFs accounted for 28 per cent of the value of all US equities turnover. Bell Potter noted that the funds have grown at a compound rate of 38.8 per cent since 1999, "largely at the expense of fund flow into active mutual funds". As at September 2010, the Australia ETF and exchange-traded commodities (ETC) market, however, had what Bell Potter research analysts William Spraggett and Anthony Mahony described as "a comparatively immaterial" \$4.6 billion in FUM — and there are only 33 ETFs listed on the Australian Securities Exchange (ASX). Yet an earlier report by the pair noted that domestic assets under management tripled in the three years to 30 June 2010, and according to the latest Investment Trends ETF report, the number of Australian investors using ETFs doubled between December 2008 and the end of 2009 to 38,000. Local issuers say they have seen an increase in inflows recently after interest petered out through the year, with inflows into unhedged international ETFs increasing dramatically last month due to the strength of the Australian dollar.

#### Take-up of ETFs

According to the Blackrock ETF Q3 2010 handbook, iShares sits at the top in terms of global ETF providers by assets under management as at the end of August, 2010, with \$US492.7 billion. It is followed by State Street Global Advisors with \$US139.6 billion and Vanguard with \$US113.3 billion.

iShares director Tom Keenan says his company experienced a record trading month in October as advisers and investors took advantage of the strong buying power of the Australian dollar. He adds that a week after the Australian dollar hit parity with the US dollar trading flows were up 33 per cent.

Speaking from a global equity perspective, Keenan agrees that there was some petering off of interest in ETFs over the last year.

"Inflows into global equities have been down across the board, whether you are an active fund manager or an ETF provider," he says. "But certainly we've seen quite a large uptick in inflows over the course of October. Global equities are starting to look cheap relative to Australian equities, and with the purchasing power of the dollar at the moment it now looks like a good time to diversify internationally, although with all the obvious risks associated with that."

State Street Global Advisors' manager of business development, Graham Smith, says the SPDR 200 had \$1 billion worth of applications for new units, and about \$250 million of redemptions.

"The uptake of those units means we have a net increase \$750 million situation going on, which is very sticky, enduring money," he says.

Smith expects to see an acceleration of interest in ETFs due to a larger group of issuers in the market providing more choice and more education around ETFs. He believes that by the end of 2011 Australia is likely to see two or three more ETF issuers coming to market, bringing another 15 to 20 products.

Vanguard ETF product manager Robyn Laidlaw says it is 17 months since Vanguard launched its initial range of ETF products in Australia — one Australian and two international — and in response to investor demand it recently launched the Vanguard Australian Property Securities Index Fund. Vanguard manages almost \$80 billion in Australia, and Laidlaw expects increased interest in ETFs and their practical uses.

Australian Index Investments (AII) is a much smaller player, but chief executive Annmaree Varelas says that considering it is a new fund manager the uptake of its ETFs has been good. It has listed six sector ETFs seeded with \$6 million in May 2010, which is now up to \$18 million.

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## Adviser interest

ETFs have traditionally been the domain of the self-directed investor and self-managed super funds (SMSFs), and advisers have been slow to take them up. The Investment Trends ETF report found that 60 per cent of ETF investors did not use professional financial advice, with 7 per cent of those having stopped using advisers in 2009. Investment Trends found that this trend became more pronounced for recent ETF investors, since 82 per cent of investors said their most recent decision to invest in ETFs was not supported by professional advice. However, Investment Trends principal Mark Johnston says the number of planners advising on ETFs is “growing very rapidly”, from 15 per cent to 30 per cent over 2009.

“Planners have initially been experimenting and gaining familiarity with ETFs, but expect usage to grow strongly,” he says, adding that according to the Investment Trends May 2010 Planner Direct Equities Report, planners indicated that ETFs would grow from 1 per cent of new client inflows in 2010 to 6 per cent in 2013.

Much of the planner interest in ETFs comes out of the industry transition towards an asset-based fee-for-service model, says Johnston.

Keenan says that the demand for ETFs comes from investors wanting simpler, more transparent and cost-effective products.

“Clients don’t want any surprises or unintended risks in portfolios, and therefore they want more transparency around the vehicles that they’re investing in,” he says. “Costs are also a major concern to clients, so ETFs will provide advisers with a tool to deliver all of those things.”

Keenan says that iShares has experienced a good take-up of its ETFs from the independent financial adviser market because they tended to have larger books of SMSF clients. However, he agrees that changing remuneration structures in the financial planning sector have also resulted in increased adviser interest.

“Advisers are looking at ways that they may operate under the new regime, and certainly ETFs are increasingly being seen as a very useful tool for advisers to use when operating under the new rules,” he says.

Laidlaw says that while planners are more tentative, they are interested and the shift over the last year has been away from asking what ETFs are to how they can be used to achieve their clients’ goals.

Keenan says the increasing interest is resulting in headway for the Australian ETF market, in that research houses are upping their knowledge and capabilities while wrap platforms are making ETFs widely available.

“All the wrap platforms, having seen the trends in direct equities, are starting to upgrade their direct equity trading functionality to try and capture more SMSF money, and so that will mean you will probably see more direct share trading on wraps by advisers as they continue to use the wrap platform but are looking to ease the administration and reduce the overall costs to clients,” he says.

Smith says State Street is receiving more enquires from platforms and dealer groups to add its ETFs to their platform choice.

“The mainstream nature of ETFs is really starting to move,” he adds.

## Knowing the risks

ETFs in their current form in Australia are relatively easy to understand, transparent and low-cost, and can generally be split between Australian ETFs and cross-listed international ETFs.

Morningstar Research co-head of fund research Tim Murphy says that aside from the commodities kind, ETFs are generally long-only and “invest in physical underlying equities tracking largely well-known indices that are broadly diversified for most part”.

“Upfront it is relatively easy to understand what they are, what they are invested in and therefore what kind of exposure you’re going to get,” he says.

Varelas explains ETFs have dedicated market makers that provide continuous liquidity to the market as part of the operating rules to issue an ETF.

“The ASX requires that a dedicated market maker is on board 95 per cent of the time that the market is open,” she says. “So there’s always a buy and a sell spread — there is never a time when an investor is

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stuck or can't get out of the units."

She adds that most ETFs distribute a daily net asset value (NAV) of the fund that allows the market maker to price the units against the fund, and AII also publishes an indicative NAV every 30 seconds.

"So at any one time, if an investor wants to buy the units they can actually look at our indicative NAV and what the market maker is offering on the market," she explains. This means that the investors will be buying the ETF at the true value of the assets held in the underlying basket of securities.

"There is a requirement that a cover arrangement is in place and a custodian holds all the assets for the investors, so that if anything happens to the issuer of the ETF, the investor has recourse and ownership of the actual stocks that the ETF is tracking."

Smith agreed that if the unthinkable occurs the assets are available for the investors in the scheme.

"But the biggest risk in any investment is misunderstanding the market you're exposing yourself to — market risk definitely becomes a big issue because these products are not designed to protect you from falling markets," he adds.

Murphy says that like any other investment, ETFs have fundamental risks that would impact how they are used within a portfolio. Smith asserts that ETFs that are listed on the ASX as Australian managed investment trusts are exactly the same as any other index fund.

"The risk is the perception that they're different, but they're not different at all," says Smith.

Laidlaw says that market risk is generally well understood by investors, but it is other risks that an adviser would help their clients work through.

Concentration risk could become an issue for those investing in small country indices that can be quite concentrated in specific stocks or sectors, says Murphy. In terms of resources, for example, he says there is a greater likelihood of doubling up on the same stock as Australian investors already tend to be overweight Australian equities.

Investing in international ETFs presents other risks, such as currency risk and even tax liabilities.

Laidlaw says the international ETFs offered on the ASX at the moment are all unhedged.

"So you have a risk that a strengthening Australian dollar would negatively affect your return, and conversely a weakening Australian dollar could positively affect your return. It's another element of the return that people need to think about," she says.

Smith says international ETFs would be subject to a dual regulatory environment of a cross-listed product, adding that because the rules are always changing investors could also be exposed to political risk.

Murphy notes that estate tax could also be a concern.

"Because they are cross listed with some US ETFs, they potentially become subject to US estate tax if you have more than \$60,000 invested and you're the owners of the ETFs when you pass away," he says. "That's something that's not particularly well known across the market."

Laidlaw says that regardless of which type of ETF you're invested in, it is important to pay attention to who the issuer is and what their track record is managing ETFs or delivering index investment returns.

### **The need for advice**

Although ETFs are relatively simple in Australia at the moment, advice will become more important as ETFs become more mainstream, more products come onto market, and investors start to trade them more actively.

Smith says advisers play an important role in helping investors understand the technical aspects of ETFs.

"They need to look at the structural difference between an ETF and an index fund, or the way that ETFs are brought in offshore so that they understand the regulatory environment," he says. "Those are technical things that you need to understand, and that's where advisers are important. We are putting a lot of work into the research houses so that advisers have support from the likes of Lonsec, S&P, Morningstar and Zenith."

Smith says the shift of interest from institutional investors to retail investors begs the question: what does the retail segment really know about ETFs?

"ETFs have been available since 2001 and were initially well supported by large instos and investment banks," says Smith. "Then around 2007 — and probably more through the GFC — we noticed a radical change in our registry from having very large institutional holdings to having a mass market migrate towards ETFs. We ended up with a 1,700 per cent increase in investors in the five-year period up to June, 2009. That massive trend into those products was retail."

Varelas says given the broader range of strategies beyond replicating a whole market and being able to actively use ETFs, sector rotation or tilts will become used to add value to beat the market — an area where there is definitely a role for advisers, she adds.

"If investors are going to trade these proactively, then advice is essential because active management has risks and advisers can work through these with clients."

### **ETFs evolving**

ETFs are in their infancy in Australia, whereas in the US and Europe they have been evolving for some time. However, most agree the more exotic and complex ETFs used overseas will hit Australian shores soon.

Murphy says drawing off what has happened offshore, inverse and leveraged ETFs will become available in Australia. He says the US in the last couple of years has seen a proliferation of ETFs tracking two or three times the S&P 500.

"But then there has also been the inverse of that where ETFs have been tracking the negative performance of the S&P 500. You would invest if you thought the S&P 500 would go down, because then you'd make money on a particular ETF," he explains. "But those ran into a few problems in terms of investor expectation over the last few years.

"In 2008 the iShares Dow Jones Real Estate ETF (IYR) lost 39.82 per cent as US REITs tanked. So you would have thought an ETF tracking two times the inverse of the same index would have achieved a return of approximately plus 80 per cent, right? Wrong. The ProShares UltraShort Real Estate ETF (SRS), which promises just that, achieved a return of minus 50 per cent in 2008," Murphy says.

"The reason is down to daily rebalancing and compounding, which work against long-term holders of these ETFs. They are designed for more institutional investors who want short-term equity exposure."

As a result of poor outcomes for inverse ETF investors over the global financial crisis, the sector is currently undergoing a Government inquiry.

"You can imagine that through the global financial crisis, people who were investing in inverse ETFs thought they were in the right place but then they lost money," Murphy says.

Despite the hard lessons learnt by investors in the US, Murphy anticipates that inverse ETFs will be available in Australia in about a year.

Smith agrees that the next generation of ETFs in Australia will include reasonably exotic exposures.

"In Europe, a lot of the ETFs are based on swaps from investment banks — the reason for that is that it is a very efficient way in Europe to trade across borders," he says. "But then that brings in counter-party risk."

Murphy describes these types of ETF as 'synthetic-based' ETFs, which do not invest directly in the underlying physical shares but rather invest in a swap or futures contract, "or some derivative that promises to pay off the same return as the index delivers over time".

"The argument in favour of that is that it is a more efficient mechanism of purely tracking the return of that index, but the argument against that is that you are taking on counter-party credit risk," he adds.

Varelas says there is a real need for the right labelling of those products, and the right education and disclosure around how they actually work. She agrees that these types of ETFs are just 12 to 18 months away from Australia.

"Which is a big jump for the market whereas these products in the US have developed over time and investors have first become very familiar with the passive style product," she adds.

Smith does not believe these more exotic types of ETFs will hit Australia that soon, although he admits that the ASX is actively engaging in the global market place with ETF issuers and is making adjustments to its listing platform to make it easier for ETFs to come to market.

Although the evolution of ETFs in Australia is a fast one, perhaps there is some level of comfort in the fact that the large issuers already have a great deal of experience in ETFs offshore. But Murphy is concerned that advisers' and investors' knowledge around ETF is still very low.

"That's why research, information and education around these things are crucial," he says. That said, he does not see that advisers will recommend the more esoteric ETFs and will rather embrace the more vanilla ones that currently exist in Australia.

Keenan agreed that as Australian investors are given more choice and as ETFs become more complex, the role of advice will become even more important.

"As more ETFs are listed here and when you start getting variations in the underlying structure, then it will become critically important for the investor to understand the risks associated with that," he says.

But he feels that new products moving into Australia is just part of the evolution of the product and industry.


"As you get a growth industry, you will get an increase in product choice," says Keenan. "It is likely that, like managed funds, some ETFs will be launched and will prove unsuccessful. I think it's a natural evolution of the market and I think choice overall is good for investors. Product proliferation on the main will be a good thing but it will make the due diligence of ETFs all the more important."

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