Plenty of appeal in ETFs

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It's little wonder exchange traded funds are among the fastest-growing investment products.

HOW'S your money mood? Confident? With markets more steady but still well off their highs, now must be a good time to invest. Ambivalent? Let's just wait and see whether we really are in recovery. Despondent? There's no way, post credit crack-up, that I'm risking my cash again.

Which best describes you will have to do with how you were affected by the downturn, as well as how long you have to make back any money you may have lost.

And it's true for everyone that buying individual stocks, now we have seen so many here and overseas go belly up, can seem a leap of faith. But the fact is you cannot rely on interest-bearing investments alone to secure your future - without growth, too, each year your wealth is eroded by inflation. And we all know that old money-making maxim: buy at the bottom and sell at the top.

Enter ETFs - or exchange traded funds.

Huge in the US and Britain for decades, you buy and sell them just like shares but the investment is not one company but all the companies that make up an index. So with one transaction you can get exposure to, say, the whole S&P/ASX 200 index of leading shares - in other words, rather than it being largely academic, you actually participate in the movement reported on the news each night.

ETFs do this by simply buying the shares that make up an index in exactly the same proportions as the index. So each day your holdings rise and fall in accordance with the stocks' performance and you receive exactly the return of the basket.

As such, there is no active fund management. No one is sitting in a room staring at screens deciding what the fund should buy and sell, so it's far cheaper.

As opposed to paying, say, 1.5 per cent a year for active funds management, these so-called passively managed funds cost more like 0.4 per cent.

There is the additional cost, as with direct shares, of brokerage. However, online brokers charge $30 or less a transaction and there can be a much higher entry fee on active funds, up to 5 per cent.

In a nutshell, ETFs give you cheap and easy access - free of "manager risk" - to a diversified equities portfolio.

What is the potential downside? Without a manager, there is no ability to outperform the market. If the market goes down, so will your investment. But this is balanced by the fact ETFs are listed; you'll know immediately if this happens and have the option to sell then and there. Unlisted funds cannot compete with this transparency (pricing is daily at best) or liquidity (selling out can take weeks).

The only other consideration is that the bigger the ETF, the more active the trading in it, so the more likely you are to get good prices.

Perhaps this is an argument to go with the larger funds. But it's worth knowing that Australia's listing rules mean ETFs must actually buy the underlying stocks and then hold them in custody for you (overseas it is possible to buy synthetic ETFs, that instead replicate performance using derivatives). This means that investments should be safe even if the provider were to go bust.

Is it any wonder, then that ETFs are among our fastest-growing investment products? There are 37 ETFs listed in Australia and the latest Investment Trends research found the number of investors using them doubled in 2009 to 38,000. Seventy-one per cent cited diversification as a key reason, 55 per cent the low cost and 53 per cent the ease of selling.

They are attracting attention from self-directed investors and people with self-managed super funds, in particular. And the high Aussie dollar has increased interest in the many ASX-listed international ETFs as investors seek to cash in.

Regardless of your investment mood, they might be worth a look.

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