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News

ETFS: PLAYING WITH FIRE

By Benjamin Levy on 14 April 2011 0 comments

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Exchange-traded funds have been the success story of recent years, with growth levels continuing to soar. But could the sector's success also lead to its undoing? Benjamin Levy reports.

The last two years have been boom times for exchange-traded funds (ETFs). The total value of funds under management in the sector is expected to skyrocket by more than $1.5 billion by the end of the year, and new products are coming out as fast as you can stick a label on them.

However, the explosive surge in popularity may also be creating some teething problems. As the sector begins to burst around the edges with competition, product providers will be pushed to develop more niche ETFs: ones that are riskier, more expensive, and narrowly defined.

That expansion could begin to threaten the original attraction of low-cost, transparent ETFs — and advisers and investors could easily get into trouble with products that are no longer so easy to manage. If the industry is going to fend off that scenario, then more education and advertising is needed to attract advisers.

Product evolution

The ETF sector is almost growing too quickly for its own good. Russell Investments has foreseen the launch of at least three new ETF providers in Australia in 2011, along with 15 new ETF products. The industry is set to surge to $6 billion by the end of the year — a jump of almost $2 billion, according to the Russell's recent analysis of ETF market trends.

Vanguard and Blackrock's iShares Australia business launched five new ETFs in a single month last year, while more growth is expected off the back of the Stronger Super reforms. The sector has also begun to diversify its product range, moving into new areas such as currency and futures contracts.

But the runaway growth of the sector may be generating problems for itself. As new ETF products continue to be rapidly developed, it will generate a bewildering level of complexity, and the original drawcards of ETFs (low cost and simple structures) will start to be threatened, according to Zenith senior investment analyst Dugald Higgins.

"The biggest issue will be that product evolution and increasing complexity driven by managers trying to differentiate themselves from the herd will undermine the original proposition of simple structures, transparency and low costs that were ETF hallmarks," Higgins says.

In its analysis of the sector, Russell gave the industry a warning about the imminent proliferation of different ETF products. Options, bonds, swaps, and new narrow sub-sector equity ETFs are all on the agenda for the coming year, the company stated.

State Street Global Advisors (SSgA), one of the biggest providers of ETFs to Australian investors, is also racing to exploit near-unexplored areas and sub-sectors of the market. SSgA recently announced plans to launch three new ETFs this month: one in the financials sector excluding real estate investment trusts, one in resources, and one in immature small-cap companies.

As the number of products increase, especially among the once broad equity market ETFs, advisers and investors may become confused about the changing nature and function of these once easy-to-understand products.

"Because we know this market is going to evolve very quickly and products will come that are not traditional ETFs, it is almost a certainty that some people will go into some of these newer offerings thinking that they're a standard ETF play — and they won't be," Higgins says.

Global growth

The overseas ETF sector is far more developed than in Australia, and can provide good insights into what to expect a year or two down the track. The equities sector there has become sliced into different

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segments. ETFs have evolved into a multitude of different products that often include increasingly quirky and high-risk investments. These ‘flavour of the month’ ETFs have multiplied like mushrooms, often for no other reason than that the market appetite for them seems insatiable.

Advisers should tread carefully and learn from some of the potholes explored by markets overseas, Higgins says.

The ETF overseas sector is primarily led by institutions. Informal data provided by industry experts in Australia suggests that institutions make up to 60 per cent of ETF investments in the US, with retail taking up the other 40 per cent. In Europe, the demarcation is even more pronounced, with the institutional sector holding up to 80 per cent of ETF assets.

However, the ETF sector in Australia is led by retail investors. Retail investors are responsible for 70 per cent of funds under management in BetaShares’ new currency ETF. So any ETF products imported from overseas may need to be altered before they are introduced to the market.

Russell Investment director of ETF product development, Amanda Skelly, says complex ETF products have evolved overseas in response to the way institutions and large brokerages are using ETFs in their portfolios, and they may not always be suitable for retail investors.

“Some of these complex ETFs might handle well for an institution, but probably don’t have a role for my mum who lives around the corner,” Skelly says.

ETF strategies that are imported from the US as well may not be as relevant for Australian investors, she says.

However, some fund managers are taking a more relaxed approach to the emergence of new ETF strategies. Blackrock head of research and implementation strategy, Deborah Fuhr, recently pointed out that investors are more interested in using broad-market based ETFs as a core investment rather than new niche alternatives.

No single stock or sector would consistently outperform its peers, while holding broad-market indices would help reduce volatility and achieve competitive returns, according to Fuhr.

Securitor planning practice Kearney Group only uses ETFs for exposure to global markets.

“Generally, the international sector seems to be the one that clients have chosen to use them in,” says practice principal Paul Kearney.

It is more straightforward to gain exposure to global markets through ETFs than through managed funds, Kearney says.

Advisers would do well to take note of the way that Zenith is approaching the ETF sector. Even though the research house only launched its ETF rating capability late last year, it is taking a cautious approach to the sector.

“Some are filtered out due to concerns around issues such as product longevity, manager stability, trading strength or other key issues,” Higgins says.

Some ETFs are bound to be withdrawn because managers will be unable to sustain demand, resulting in a possible loss of capital for the investors who have invested in newer products.

“This has been an issue in all the other major markets where product evolution has outpaced demand,” Higgins says.

“Advisers don’t want to go back to their clients and say: ‘This fund that we’ve just put an allocation of your money into has just disappeared.’ Client’s don’t like that,” he says.

The rapid expansion of ETF products could be resulting in some advisers becoming too reliant on ETF products and taking over full responsibility for asset allocation.

Previously, an adviser had to choose between 25 or more fund managers on an Approved Product List before he could allocate his client’s assets, a time-consuming process.

Now, the adviser can simply choose to allocate sector weights based on a few ETF products, with added bonus of lowering costs and keeping the investment decisions more under their control. It is a tempting proposition, but a dangerous one.

“Most advisers didn’t hire their planner to be a macro-economic manager, and you don’t really know how skilful these individuals are,” Morningstar global head of funds research Don Phillips said recently.

“There’s a segment of adviser who have probably gone overboard with the thrill of this new toolkit. I can see some people running amok with this, and you can do as much harm as good,” he said.

Making education a priority

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That harm is exacerbated when the knowledge of the way ETFs work fails to keep pace with their development.

“There’s a lot more work the industry needs to do to help educate advisers on how they can use ETFs and where they might be appropriate for clients. That’s been a major hurdle in seeing advisers really embracing ETFs,” Skelly says.

The underlying structure of most ETFs is a managed fund, which advisers are already familiar with. However, understanding the mechanics of the way that managed fund starts to trade on the Australian Stock Exchange (ASX) is something that advisers haven’t quite grasped. Russell Investments has started educating advisers on that front.

How ETFs work, their benefits, and how they fit in a client portfolio are all questions that advisers need answered, Skelly says.

“Advisers shouldn’t be scared of ETFs. In the end, it’s just another way to access a particular type of investment strategy,” she adds.

One characteristic of an ETF that isn’t promoted as often is that the assets are held in trusts on behalf of clients, meaning the assets can’t be diverted by fund managers.

“There’s a bit of mistrust over the last couple of years with fund managers, and that mistrust has raised a lot of questions. But with ETFs, everything is held on the benefit of the end investor,” Skelly says.

Because of that the ETF sector has been able to remain largely free of trust issues surrounding investments, Skelly believes.

Zenith Investments is seeing a lot of advisers who still don’t quite understand how ETFs work and are thus hesitant to try them, despite their interest.

“A lot of people think of ETFs as a totally different investment type, they don’t necessarily translate it back to being a very passive index fund — that is, if the market tanks, you’re going to tank too,” Higgins says.

Advisers are also under the misconception that ETFs can provide extra portfolio diversification even if they are already heavily allocated to equities.

That rudimentary misunderstanding can be dangerous. It’s easy for advisers to choose the wrong ETF structure.

When inverse ETFs were introduced overseas, investors flocked to the product because its basic premise was that if the market went down by 1 per cent, the value of your ETF would go up by 1 per cent, and vice versa. Investors believed they would be able to use them to prop up their returns when markets were sliding. But because the pricing of an inverse ETF is done on a daily basis, not yearly, those investors ended up worse off than before.

“We’ve seen that happen in the US and other places overseas, it will happen here, it’s almost guaranteed. And investors and advisers need to be really careful that they understand how the ETF they’ve chosen works, and is suitable for what they’re after,” Higgins says.

However, drawing on the experience of ETFs overseas as an indication of what will happen here isn’t a fair comparison, according to BetaShares head of product strategy Drew Corbett.

“I think it’s easy to look overseas and get ahead of yourself. You’re talking about much more developed markets over there as it relates to the products being around for 10 years,” he says.

“I think the ASX and the ETF industry as a whole have doing a great job getting on the front foot and getting out there and trying to educate the market,” Corbett says.

Once investors understand the benefits, ETFs prove to be highly successful and popular — so advisers should take the opportunity to get ahead of the ETF curve by educating themselves about the products, Corbett says.

The ASX in particular has just launched an ETF roadshow for investors that will run through the next few weeks around the country, and many ETF providers are involved.

“The ETF industry as a whole is very keen on getting advisers up to speed so they can be in front of growth in this industry,” Corbett says.

Closing the knowledge gap

There are signs that the funds management industry has a way to go with educating advisers about the benefits of ETFs and introducing new products suitable for investors. Some advisers are barely using ETFs, or not at all.

Principal of Shadforth Financial Group Ian Heraud believes in following a passive investment approach

with his clients, but says ETFs can't provide the returns he is looking for.

"Our approach to the core of our client's portfolios involves blending sub-components of the broad index to achieve superior results to the market," Heraud says.

Heraud's practice has created an individual unit trust, with 40 per cent of its assets in large companies, 40 per cent in companies with a high book-to-market value, and 20 per cent in small companies.

He doesn't know of any similar 'value company' ETFs for advisers searching for superior returns, Heraud says.

"If you get a Vanguard ETF, you're going to be getting the ASX300," he adds.

Similarly, Kearney Group have barely dabbled their toes in the ETF industry. Despite the explosive growth in the sector in the last two years, they has been using ETFs for only the past six to 12 months, as a solution for clients who have become tired of managed funds, Kearney says.

There are some indications that the ETF sector is too focused on attracting advisers with a narrow set of characteristics — that of cost savings and remuneration.

ETFs are often advertised as being a good way of lowering investment fees for clients, which is an attractive argument at a time of growing fee-for-service practices.

"The big thing that's going to spur growth in the ETF sector is advisers moving to a fee-for-service model. Because ETFs are low-cost instruments, and in a fee-for-service model they make a lot more sense to advisers," Corbett says.

That advertising angle has also received tacit approval from researchers such as Investment Trends, which said recently that an asset-based fee-for-service model was behind planner's interests in ETFs.

The only flaw in that argument is that advisers can find cost savings in other ways as well. Any easily found index fund offers savings to investors, while core-satellite funds offer savings as well as alpha — and both of them are surely competing for more advisers using the same arguments.

Kearney flatly rejects the notion that cost had anything to do with their decision to go with ETFs.

"In the conversations we've had with clients who have used ETFs, cost hasn't been a factor," Kearney says.

"They're looking for a particular result, and an ETF is just expected to target more closely a segment of the market," he says.

Whether you go through an ETF or a plain index fund, costs are very low and very similar, Heraud says.

"Costs shouldn't be the main driver. If you go to a Vanguard index fund or a Vanguard ETF, you're buying essentially the same thing for essentially the same price," he adds.

An alternative method of advertising ETFs may be by promoting the 'passive versus active' debate more vigorously. After all, many ETFs are essentially a passive investment approach anyway.

"More and more direct share investors are recognising that it is really difficult for them to consistently beat the market. And most benchmarking that we do with direct share portfolios shows that these investors are underperforming the market," Heraud says.

"Given the sub-optimal they've been getting, really they should be having a core of their portfolio more closely aligned with the index, and now they can do that with an ETF," he says.

There's a certain comfort value in there for a lot of those investors, Heraud says.

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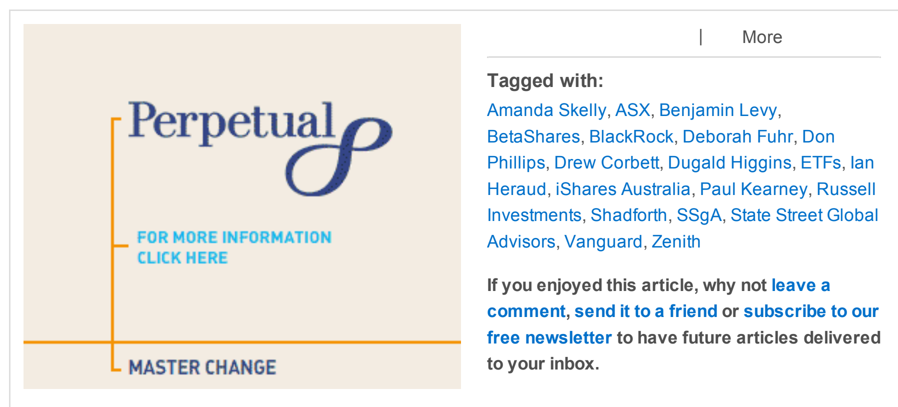

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