ETFS

Add sophisticated products, spoil the broth

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Investors seeking exposure to shares, property and currencies have acquired a taste for ETFs, but spicing up the ETF broth with synthetic products would be a error.

Drew Corbett, BetaShares: Wealthy clients and full-service brokers were early adopters of the US dollar ETF. **Photo: Rob Homer**

If you were to sit down and list the major events of the early years of the decade that began in 2000 in Australia, some that might spring to mind include the Sydney Olympics, the worst NSW floods in 40 years, and Ansett Australia closing up shop.

One significant event that snagged fewer headlines was the debut of a product on the local investment landscape: the exchange-traded fund.

ETFs, which were already well established overseas before their arrival in Australia, started out small and grew slowly in take-up terms during the early days.

Education about the products was limited, and ETFs were up against the juggernauts of established index funds.

But jump forward just 10 years, and the sector is booming in Australia. And if the trend is to be believed, the sector's expansion shows few signs of stopping.

Australian Securities Exchange-listed ETFs now cover domestic and international equities, property, commodities and, since February this year, currencies.

There are now nearly 50 exchange-traded products listed on the ASX with a total market capitalisation of about $5 billion. That's a growth rate of nearly 40 per cent during the year to December 31, 2010.

In the financial planning world, 27 per cent of advisers provide advice on ETFs according to researcher Investment Trends – that's nearly twice as many as in 2008.

"There's a further 27 per cent who intend to begin advising on ETFs in the coming 12 months," says Investment Trends analyst Recep Peker.

Demand is coming from non-bank aligned planners in particular, and from investors looking for alternatives to managed funds, industry commentators say.

However some planners are not convinced that more products is necessarily a bonus, or if sophisticated products give advisers more choice.

Less, in fact, is more, planners urge.

Rick Di Cristoforo, managing director of Matrix Planning Solutions, says the core reason ETFs matter to investors and their advisers is the products' simplicity.

There is already a plethora of ETFs in Australia, and Di Cristoforo fears that bringing more sophisticated and synthetic products into the market may just add unnecessary complexity.

"Using synthetics is not the issue. It's what you do with the stock value where there is some concern, like in the US," he says.

In particular, he is worried about products that include on-lending of ETF securities. Liquidity is paramount in an ETF. If providers are sacrificing liquidity by including complex synthetic instruments to enhance the performance of an ETF, the product could be difficult to liquidate if clients wants to get out in a hurry.

"If the market locks up, there is a real difference in your ability to sell synthetic rather than real securities," he says.

Ashley Owen, chairman of the asset allocation committee and head of market analysis at dealer group Centric Wealth, is also sceptical about the need for an influx of products into the market.

There are more than 3000 ETF products worldwide, a lot of which Owen considers to be “interesting, but not terribly useful”.

“Australia is a tiny market, so you don’t need all the sector ETFs, for example. If you want to buy banks, you can buy four stocks,” he says.

Owen also believes that ETFs can fuel volatility in a market, particularly in more speculative or volatile asset classes, such as gold. “They tend to push prices in a bubble, or push down prices in a bust,” he says.

That said, ETFs have their place in a portfolio and advisers openly acknowledge that the products are gaining momentum and popularity with their peers and clients.

The banning of commissions and volume-based rebates will likely lead to a rise in demand for the products among planners, as they move to a non-commission remuneration structures.

Di Cristoforo says ETFs are particularly useful when advisers want to make a quick, strategic passive play for their clients. “The speed that you have on the price [of an ETF] is an advantage,” he says.

ETFs can also help advisers to quickly gain exposure to regional or thematic markets, although Di Cristoforo is cautious about ETFs that are “too niche”.

“We tend to stay more towards regional and thematic, rather than take a particular country,” he says.

Paul Foster, chief executive of West Australian-based financial services firm Addwealth, says the dealer group does not use ETFs widely at the moment. But he acknowledges their advantages and does not rule out using them more in the future.

Addwealth, which offers its own managed fund, uses ETFs as a temporary “parking site” for extra incoming funds.

“If someone drops a couple of million on us, and we may not have allocated it [yet] to a particular fund manager, we can have ETFs lined up to use,” he says.

“If the money comes in above what we expected, then we have a place to go – ETFs, it will get us placed.”

Meanwhile, fund managers are reporting other trends among planners.

A growing number of advisers are looking at ETFs in other asset classes besides equities in a bid to make strategic plays for clients.

Some are turning to currency ETFs, for example, and using the products as an alternative to foreign currency bank accounts.

BetaShares launched a US dollar ETF in February. BetaShares Capital head of investment strategy and distribution Drew Corbett says early adopters of the product include full-service brokers and high net worth investors, and there is interest from small businesses looking to use the ETF as a hedge in buying US dollars.

“We [had] only $ 1 million in assets to start with, and we’ve passed $120 million in assets now,” he says. “They see it as a diversification tool out of the Australian dollar.”

Interest is particularly building among planners from boutique advisory practices, Corbett says.

But why would a planner use a currency ETF rather than trade directly? According to Corbett, the ETF allows financial planners to manage currency transactions at a tenth the cost of going to a bank.

Investing $10,000 in a US dollar bank account can cost an individual up to $700 over six months in fees, costs and losses on the exchange rate that banks offer. The more favourable exchange rates offered by the BetaShares ETF means the same investment would only cost about $70 over that time frame, Corbett says.

“In addition, we are finding that there are a significant number of investors who are investing in this product as a simple way to get exposure to the potential recovery of the US economy,” he says.

Advisers are increasingly using ETFs to rebalance client portfolios and tilt them towards a particular sector, says Annmaree Varelas, chief executive of boutique firm Australian Index Investments.

For example, advisers use Australian Index Investments products – which include financials, resources and metals and mining ETFs – to gain quick exposure to sectors that are outperforming.

In allocating more of a portfolio to the stronger performing sectors, it then becomes underweight in the sectors

that may be out of favour at that time. “Sector rotation using ETFs is in its infancy, but the appeal for fee-for-service advisers to cheaply reposition portfolios will grow,” Varelas says.

“These advisers wanting to show their stockmarket skills without the costs of research and direct share transaction costs should assist in the growth of ETFs over time.”

Meanwhile, Russell Investments has taken a different approach with its latest product. The Russell Australian Value ETF is aimed at institutional investors.

The firm’s “value style” ETF is a first in Australia, and can be used as a plug for an active manager while institutional investors or dealer groups hunt for a new manager to round out their portfolios.

The fund amassed $12 million directly from the market in just five days of trading.

While targeted at larger and more sophisticated investors, Russell is not discounting planners from the equation and is preparing to begin to receive inflows from this segment, says Amanda Skelly, director of ETF product development at Russell.

“We do have some retail investors come through,” she says.

“We’re talking to planners, creating material for them, and the independents are definitely interested.”

Need for education

Momentum might be gaining in the uptake of ETFs, but there are still some hurdles in the way before the sector can claim to have reached maturity.

Advisers are crying out for more information. A lack of education about how to best use exchange-traded products is a concern that the industry is trying to address.

Almost 40 per cent of financial planners say that a lack of knowledge prevents them recommending more ETFs, according to Investment Trends’ research.

“Knowledge is still a barrier for those who are planning to advise on ETFs,” says Investment Trends’ Peker.

It’s a problem that many product makers acknowledge, and one that they are trying to tackle in the planning and investor community.

“Most people are just starting their due diligence on ETFs,” says Tom Keenan, head of retail at BlackRock Asset Management’s iShares business, which is one of the world’s largest ETF providers.

“You’re seeing a lot more research on ETFs and that’s critical to making ETFs more mainstream, but [advisers] still need to be more aware when they’re choosing an ETF,” Keenan says.

An important element in the education process is identifying the differences between ETF providers.

Keenan promotes the importance of brand and the size of the ETF, where a larger fund could provide investors with more clout, liquidity and arguably lower fees.

There is another gap in the market – there is a lack of “forward looking” research undertaken by ratings houses.

“It’s about research that gives investors a reason why to invest in the ETF market,” Keenan says. “[This research] might contain forward-looking earnings, estimates and forward looking traditional stock valuation.”

It’s also important to note that the education focus among planners is shifting, says Robyn Laidlaw, head of product management and development at Vanguard Investments Australia.

“Two years ago, we were at the point where [planners] asked: ‘what is an ETF?’ Today, it’s how do we use them in portfolio construction, what do we need to know about when we’re buying and selling on an exchange,” Laidlaw says.

Education needs to continue for some years, she says.

As product, providers continue to chip away at the education process, and many in the sector are allocating resources to seeking out new asset classes that can be bundled into exchange-traded products.

Keenan from iShares says his business will definitely be launching new exchange-traded products. “One very interesting area is fixed income,” he says.

Other product makers have also flagged fixed income as the flavour of 2011, including Russell and Vanguard.

But the introduction of a fixed income ETF hinges on the changes in the ASX Quoted Assets (AQUA) rules, which is expected later in 2011. The AQUA rules support the quotation of exchange traded products and other structured investments that could not previously be accommodated easily on the ASX.

Vanguard's Laidlaw says: "We're waiting to see what happens in terms of what the exchange, what the regulator will do, to allow fixed income ETFs."

Fixed income is on Russell's list, but Skelly says the firm is also casting its eyes around Asian countries and opportunities in foreign markets. "We want to keep that branch open, and go to our advisers and see what they're interested in buying," she says.

The key to the decision comes back to financial planners making sure that products meet their needs, and are ultimately what
clients want, says Skelly.

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