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## Take control

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In the face of market uncertainty, focus on asset allocation, diversification and fees.

**By Robin Bowerman, Vanguard**

Investors crave certainty, and when markets are tracking sideways over long periods, buffeted by alternating pieces of bad and good news, they strain for signs of clear direction shifts - either up or down.

Confidence is a strong driver of investor behaviour and rising levels of certainty instil confidence. Yet if we consider what is actually within our direct control as investors - regardless of whether it is the share, property or bond markets - the rational argument is that we simply cannot control, let alone reliably predict, future events.

Yet a good deal of short-term media commentary is dedicated to trying to interpret what events mean for the future direction of markets and particular companies or sectors. That is the paradox investors have to deal with every day.

Certainly at the moment there is no shortage of things to be concerned about: sovereign debt crises, another US recession, weak retail sales in Australia, the carbon tax ... the list goes on.

Perhaps it's timely to reframe the debate and focus more on what investors do have control over.

It is also instructive at times to go back to basics, such as the regulatory guidelines provided to managers of superannuation funds, large and small.

While acknowledging that the appropriate level of diversification and the method by which it is achieved is up to the individual super fund, or investor, the emphasis is clearly on the need for diversification to manage the risk and variability of returns by spreading investments over a number of individual assets, asset classes, countries and/or investment managers.

A well-formulated investment strategy would not ordinarily provide that all or a large proportion of the fund's assets be invested in one asset (such as a single property) or single asset class, is how the regulatory guidelines express it.

Now that may be intended for those managing larger super funds, but it applies equally to people with a self-managed super fund and individual investors.

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The critical point is that in the face of uncertainty, the decision about which asset classes to invest in and the degree of diversification across and within asset classes, are two major decisions all investors have within their power to control.

The third decision that investors can control with certainty is the cost factor because the one simple truth of investing is that the more you pay the less you get to keep.

### **Diversification through ETFs**

One of the major market developments in the past decade has been the ability of investors to use products such as exchange traded funds (ETFs) as tools to implement asset allocation decisions and achieve the sort of portfolio diversification that previously was the exclusive domain of institutional investors.

There is nothing overly complex or technical about ETFs; the underlying structure is typically that of an index fund. ETFs are simply index funds that are quoted for trading on ASX.

Research group Investment Trends recently asked investors who had purchased an ETF what their reasons were for investing in these products<sup>1</sup>. The top four reasons confirmed that investors are really seeing the inherent potential of ETFs: diversification, low cost, reduced risk versus direct share investing, and liquidity. The research also found that 30 per cent of ETF investors see them as a good core component in a core-and-satellite portfolio.

The first step in building any portfolio is to decide on the correct asset allocation. You should consider exposure to cash, bonds, domestic and international shares, and property. In general, investors with a long time horizon could consider a more growth-oriented approach weighted toward equities; those within a few years of needing to access their money should opt for more conservative investment strategies based around cash and fixed interest.

### **Seek value for money**

Armed with an asset allocation plan, the next step is to decide how to implement the portfolio plan.

There are a number of ways in which ETFs may be useful in setting up your portfolio's desired asset allocation.

Core-satellite investing involves a portfolio construction technique that combines a low-cost and highly diversified core with a selection of satellite investments to complement or augment the core in areas of interest to individual investors. ETFs can be an easy way to introduce a diversified low-cost core component to a portfolio, or indeed can be introduced as a satellite investment in this strategy, given the growing range of ETFs in Australia, including those that are sector and country specific.

For core equities exposure, there are several ETFs that track major large-cap indices, such as the ASX/S&P 200 or 300.

One of the best ways to understand the value for money that ETFs provide is to consider what it would cost in brokerage, and how much capital would be needed, to buy each of the 300 shares in the S&P/ASX 300 index in proportion to each company's market capitalisation.

Index funds are traditionally low cost. Be aware, though, that investors who are dollar-cost averaging (regularly investing small amounts over time)

should watch broker fees that are incurred when buying ETFs and it may be that a traditional index managed fund will be more cost-effective.

The underlying approach of core-satellite investing is to build the foundations of your portfolio by locking in market returns at low cost. Then add satellite positions where you have specific aims - higher dividend yield for example, or perhaps where you want to take a particular tilt in a portfolio, such as to small companies or specific sectors or overseas markets.

Another role that ETFs can play in the portfolio is to complete or diversify an existing portfolio of blue chips. The Australian Taxation Office periodically conducts research<sup>2</sup> on self-managed super funds and found that investors acting as trustees of their SMSFs tended to have a pretty even split of investments in cash and Australian shares, which points to a lack of broader diversification in other asset classes such as international shares.

### **Just four trades can give exceptional spread**

A practical example of the power of ETFs as a portfolio construction tool is that if you split your equities allocation between Vanguard's Australian Shares, International Shares, US Market and Australian Property ETFs in just four trades, you get exposure to more than 5900 securities across 47 countries for a management fee of just 0.16 per cent per annum. That is \$160 a year for a \$100,000 portfolio (excluding brokerage, assuming this allocation represents the entire portfolio).

Tax and fees typically represent the biggest cost impact on any investment's net return, so a focus on minimising the tax bill makes good sense. One of the advantages of using index-based ETFs is their potential for tax efficiency. An index manager does not make bets on specific shares, so there is no driver to buy and sell shares unless the index changes. By maintaining a lower turnover of securities in the fund portfolio, capital gains realisations are kept to a minimum.

In many ways ETFs have burst onto the scene in the past three to four years, with assets rising by 70 per cent each year for the past three<sup>3</sup>.

Yet Australia is trailing the US and Europe in this type of product development and acceptance. For example, changes to market rules that would allow fixed-interest ETFs are still under consideration by the regulators.

ETFs are an investment solution that suits a range of investors - sharemarket newcomers, well-informed wealth accumulators, self-managed super fund trustees, institutional investors and financial advisers.

ETFs have effectively given what previously an institutional asset allocation tool, to individual investors at low cost.

### **About the author**

Robin Bowerman is Principal and Head of Corporate Affairs and Market Development at [Vanguard Australia](#), an ETF issuer. You should consider whether ETFs are appropriate for you. The examples used in this article are for illustrative purposes and should not be considered as advice.

1 Source: Investment Trends December 2010 ETF Report.

2 Source: Australian Taxation Office self-managed super fund statistical report, March 2011

3 Source: Tria Investment Partners '*Lift off: the Australian ETF market gains altitude*', April 2011.

**From ASX**

[The ASX ETF course](#) has seven modules covering the fundamentals of what ETFs are and how to buy and sell them. Subsequent modules take a detailed look at particular types of ETFs, including a case study.

The modules are self-directed, meaning you can work through them sequentially or go from, say; domestic ETFs to international ETFs or exchange traded commodities (ETCs). Each has summary slides and a quiz to help you be confident you have grasped the concepts.

Best of all, you can do the online course when and where you like, at your own pace, and print the notes. All you need is an internet connection and computer.

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