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Exchange Traded Funds (ETFs)

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What is an Exchange Traded Fund (ETF)?

In its simplest sense, an ETF is a collection of investments packaged into a single instrument that can be traded on a stock exchange in the same way a share is.

An ETF is an open-ended investment fund, which means that the issuer may continue to issue shares based upon the current value of the assets in the fund. Essentially an ETF can never run out of shares to offer.

In many ways, ETFs are like traditional open-ended managed funds because:

1. As an investor in an ETF you own a proportional interest in the pooled assets of the fund;
2. The issuer of the ETF is the manager or may appoint managers to curate the assets within the fund and will charge a management fee for their services.

Unlike traditional managed funds however, ETFs are exchange traded meaning that buying and selling is straightforward. You can also view the price immediately in the same way you can a listed share - it is simply the market price of the ETF.

High levels of transparency, diversity and accessibility has led to a boom in ETFs not just in Australia but globally. There are many good reasons for the growing popularity of ETFs, especially for self-directed investors, we will address each of these in this guide. We will also cover some of the pros and cons for investing in ETFs plus how you can incorporate ETFs in your investing strategy.

History of ETFs

ETFs started out in 1993 with the launch of a single S&P 500 tracking fund in the US. Since then, funds invested in ETFs have grown exponentially. By the end of 2019 there was over US$4 trillion invested in ETFs listed on the US markets, and over $6 trillion globally.

In Australia, there are currently over 250 ETF products provided by the major issuers including Vanguard Australia, BlackRock (iShares), ETF Securities, VanEck, and BetaShares. According to the most recent monthly figures, investments in exchange traded products in Australia have topped $64 billion.

Initially used by institutional investors and large US pension funds to implement complex investment strategies, ETFs are now widely used by all types of investors, from beginners to professional investors across the globe.

Advantages of ETFs

ETFs are rapidly growing in popularity as an investment option, particularly in Australia, let's look at some of the key reasons why you might wish to consider ETFs to achieve your investment goals.

Diversification

ETFs are an easy way to get diversification, it is as simple as buying a share. Investors can gain exposure to a wide range of asset classes, investing strategies and markets both in Australia and globally. These are just some of the ASX listed ETFs, along with the investment areas they represent:

ASX Code	Exchange Traded Fund	ASX Code	Exchange Traded Fund
Australian Stocks Exposure		**Fixed Interest Exposure**	
IOZ	iShares Core S&P/ASX 200 ETF	BOND	SPDR S&P/ASX Australian Bond Fund
STW	SPDR S&P/ASX 200 Fund	VACF	Vanguard Australian Corp Fixed Interest INDEX ETF
VAS	Vanguard Australian Shares INDEX ETF	**Cash Exposure**	
International Stock Exposure		AAA	BetaShares Australian High Interest Cash ETF
ASIA	BetaShares Asia Technology Tigers ETF	MONY	UBS IQ Cash ETF
F100	BetaShares FTSE 100 ETF	ZUSD	ETFs Enhanced USD Cash ETF
HJPN	BetaShares Japan ETF-Currency Hedged	**Short Exposure**	
IVV	iShares S&P 500 ETF	BBUS	BetaShares US Equities Strong Bear Currency Hedged (HF)
IZZ	iShares China Large-Cap ETF	BEAR	BetaShares Australian Equities Bear (Hedge Fund)
VEQ	Vanguard FTSE Europe Shares ETF	**Themed Exposure**	
High Yield/Dividends		ACDC	ETFs Battery Tech & Lithium ETF
IHD	iShares S&P/ASX Dividend Opportunities ETF	CORE	ETFs Global Core Infrastructure ETF
RDV	Russell Investments High Dividend Australian Shares ETF	HACK	BetaShares Global Cybersecurity ETF
VHY	Vanguard Australian Shares High Yield ETF	MVS	VanEck Vectors Small Companies Masters ETF
Sustainable/Ethical Investments		RBTZ	BetaShares Global Robotics and Artificial Intelligence ETF
ESGI	VanEck Vectors MSCI International Sustainable Equity ETF	**Other Asset Classes Exposure**	
RARI	Russell Investments Australian Responsible Investment ETF	DJRE	SPDR Dow Jones Global Real Estate Fund
UBA	UBS IQ MSCI Australia Ethical ETF	QCB	BetaShares Commodities Basket ETF-Currency Hedged (Synthetic)
VESG	Vanguard Ethically Conscious International Shares INDEX ETF	USD	BetaShares USD ETF

Figure 1: A (very small) sample of ETFs listed on the Australian Securities Exchange (ASX)

An investment in an ETF gives the investor instant exposure to assets within the fund. In some cases, this can be hundreds, or even thousands of underlying shares. This creates the possibility of achieving instant diversification with one single trade.

Low investment costs

ETFs are typically 'passive' investments, they are passive because most ETFs are designed to simply track an underlying index or sector. For this reason, the low degree of management required for ETFs leads to much lower management fees.

Actively managed funds that seek to outperform their benchmark indices, typically charge much higher management fees.

Figure 2: A 1% saving in fees per annum can have a major impact on earnings over a long investment horizon

If the fee for an active Australian share fund is 1.30% p.a., while a comparable ETF is at 0.3% p.a., that 1% p.a. difference may not seem like much however it can add. Figure 2 demonstrates that over 20 years, an investor starting with $100,000 and earning 7% per annum instead of 6% per annum, would be better off by around $70,000. ETFs are typically low cost and can offer excellent value for money.

Liquidity

ETFs are traded on the ASX allowing investors to buy and sell their holdings quickly as they could a share. This is different compared to many managed funds which can only be bought or sold once a day. In addition to normal market activity, each ETF issuer must appoint a Market Maker to maintain liquidity. This means when you want to sell you have the Market Maker who will step in and offer to buy your ETF at the net asset value (NAV) less a small spread.

Easy to understand

ETFs are typically very transparent investments, it is easy to see what they are investing in, what their past performance has been and what costs might be associated with owning them. As they are traded on the ASX charting, dividends, daily NAV, 52 week high and low is easy to find from independent sources.

What are the risks of ETFs?

Broadly speaking, the risks of a particular ETF are in line with those of the index or sector the ETF represents, these risks include:
Investment risk – markets go up, markets go down and so will the price of an ETF. Investing in any asset class carries risk, including the fact you may not time your entry and exit favourably.
Currency risk – an ETF that invests in international assets or assets not denominated in Australia dollars will be exposed to currency movements. While some ETFs hedge their currency exposure for which there is a cost for doing so, not all do.
Liquidity risk - you may have difficulties selling your shares due to a lack of buyers at the price you would like. As covered earlier, all ASX listed ETFs have market markers which stand ready to buy or sell ETFs and ensure the smooth trading.

What to look for in an ETF?

With over 250 ETFs in Australia and that number growing by the quarter, there is a wide range to choose from. Match the ETF with your investment goals and your risk tolerance, here are the some more practical considerations to take into account before selecting a ETF for your portfolio.

Fund holdings

When you invest in an ETF you are indirectly investing in each of the assets held by the ETF. You should research the sector, asset class or index the ETF aims to track before you invest.

Theme or style

You may be looking for exposure to a particular asset class, for example gold or oil or to a market sector such as healthcare or technology. ETFs typically have a theme, and in most cases, the name of the ETF is a pretty guide as to what that might be. As an example, the BetaShares Global Robotics and Artificial

Intelligence ETF (ASX code: RBTZ) aims to track the performance of an index that includes global companies involved in the production or use of robotics and artificial intelligence products and services. Each ETFs issuer will have their objective and strategy on their website and further details in their Product Disclosure Statement (PDS).

In terms of style, some funds are 'long only' funds, that is, they stand to benefit when the assets they hold rise in value. Others are 'short' funds which benefit when the assets the fund is exposed to fall in value. The latter may be attractive to you if you are looking to gain short exposure.

Potential returns & risks

The PDS will also contain detailed information on the any distribution schedule of the fund (i.e. dividends). It will also provide an overview of some of the potential risks involved in investing in the fund. In terms of potential returns, the issuer's website often has returns over various periods, for example, 1 year, 3 years, 5 years, and since inception. It is worth comparing these returns to other similar ETFs and to the index, asset or sector they are aiming to track, for example the Australian benchmark S&P ASX 200 index.

Costs

Each ETF is managed by an issuer which charges a fee that incorporates the management, administration and operating costs of that specific ETF. This is often expressed as the ‘management expense ratio (MER)’, for example, if an ETF states an expense ratio of 0.27% p.a., it means that you can expect to see the ETF issuer collect $2.70 for every $1000 exposure each year. The typical expense ratio for Australian ETFs is around 0.3%-0.7% p.a. making them low cost investments compared to traditional managed funds. Issuer expenses are detailed within the ETFs PDS.

ETF Investing Example

An investor wanting to gain exposure to the top listed Australian companies can buy individual shares of each of these companies, alternatively they could buy a suitable ETF with one single trade.
One ETF investors use for gaining exposure to the ASX200 is the iShares Core S&P/ASX 200 ETF (ASX code: IOZ). This ETF gives exposure to the 200 largest companies listed on the ASX and aims to provide the same performance (excluding fees and expenses) for holders. An investor wanting to buy would simply buy this on the ASX through a broker, they would immediately get exposure to the 200 largest companies listed on the ASX in a single trade.
Figure 3 shows that the iShares Core S&P/ASX 200 ETF (IOZ) has historically tracked the benchmark S&P ASX200 index very closely.
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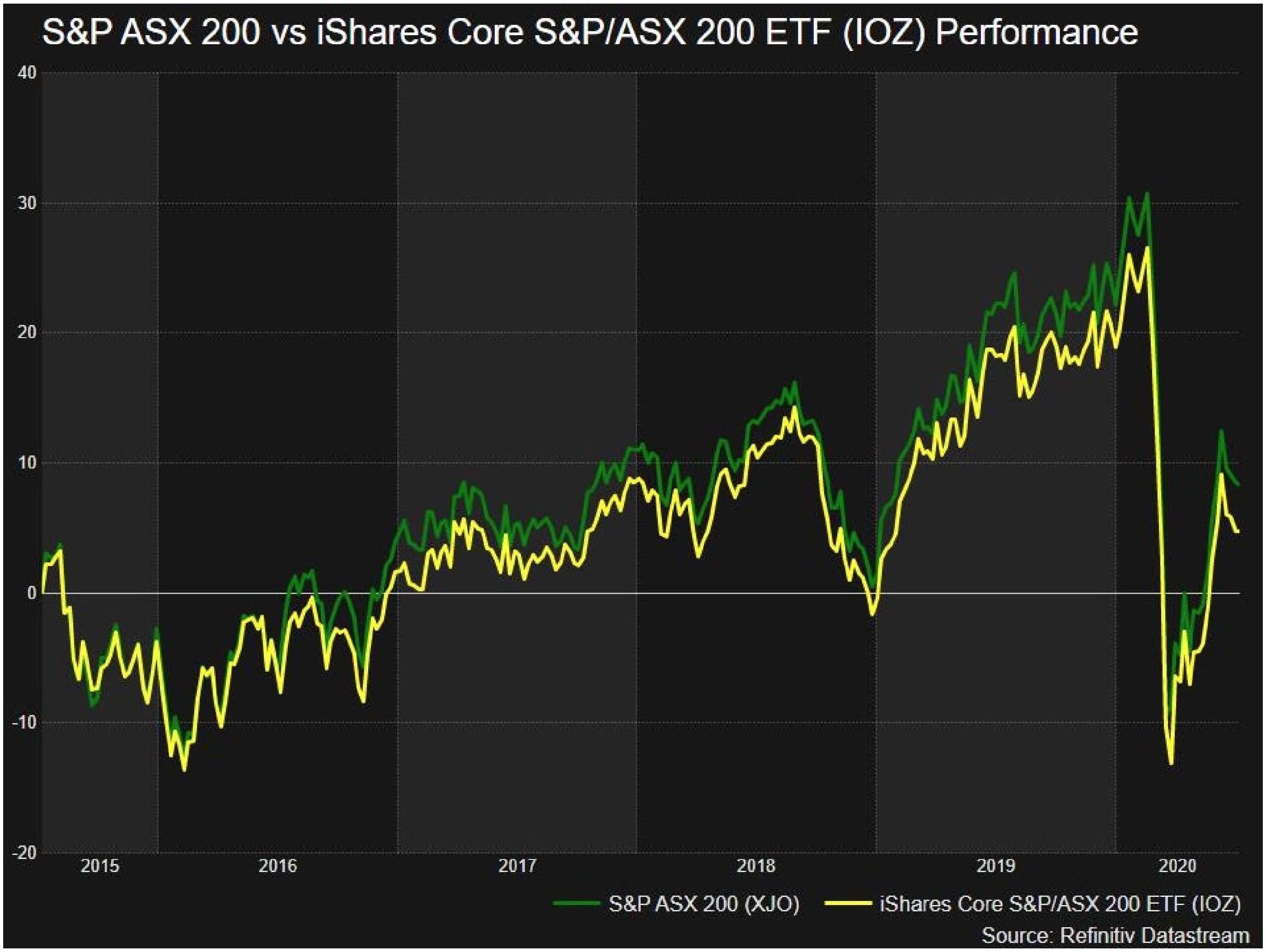

Figure 3: Benchmark S&P ASX200 index vs iShares Core S&P/ASX200 ETF listed on the ASX (code: IOZ)

How to invest in an ETF

You can buy and sell ETFs in the same way you would shares, through a broker. ThinkMarkets offers the ability to invest in all ETFs listed on the ASX, open an account today and search for the ETF you are interested investing in within the platform. Each time you buy or sell an ETF you will have to pay a commission; this starts at $8 per trade with ThinkMarkets with the minimum investment amount being $500.

Conclusion

ETFs have grown rapidly in popularity over the past decade because they simplify investing and empower self-directed investors to diversify with a single investment. Whether an investor wants local, international or specific asset class exposure, their will often be an ETF that meets an investor's needs. They are a simple to use, you can buy, sell and track just as you would a share, they are a low cost and transparent investment that can play a part in assisting investors achieving their investment goals.

Glossary

Active ETF
An ETF whose assets are chosen by the manager to outperform the benchmark. Generally, they require expert managers and therefore are usually associated with higher costs than passive ETFs

Active management style
Active managers use expertise and analysis to construct a portfolio of assets they feel will outperform the benchmark. Active managers will buy and sell stocks from the portfolio they feel are undervalued/overvalued.

Alpha
The amount by which an investment outperforms its benchmark. Alpha is the goal of active managers.

Authorised Participants (AP)
Large financial institutions or investment banks purchase and sell the securities of the fund. Appointed/engaged by the fund's manager.

Beta
Beta is the return of an investment relative to its benchmark. High beta stocks tend to move up and down more than the benchmark, and low beta stocks move up and down less. A beta of 1 means the asset moves the same amount as the benchmark.

Bid/Ask spread
Also known as the bid/offer spread. It is the difference between the highest price a buyer is willing to pay and the lowest price a seller is willing to sell. The spread represents a cost to the ETF investor and therefore smaller spreads are preferred. More active ETFs tend to have a lower bid/ask spread.

Brokerage fee
Fee charged by a broker to buy or sell units in an ETF. Typically, a percentage of the transaction value, a fixed cost, or a combination of both.

Commodity ETFs
A type of ETF based upon a commodity, for example crude oil or gold.

Diversification
The act of investing in many assets, preferably with correlations in returns less than 1, with the aim of reducing volatility in returns.

ETF issuers
Also known as a provider or manager. Responsible for creating, marketing and administering the ETF.
Exchange traded ETFs
Are ETFs that trade on an exchange, for example the ASX.
Expense ratio
The annual fee charged by the manager of the ETF as a management fee, this is expressed as a percentage.
Index ETF
A style of ETF that aims to replicate the performance of a specific index, for example the S&P ASX 200, or the Nikkei 225. Generally, these are passive funds with high levels of diversification and low fees.
ETF
Open-ended investment fund traded on a securities exchange.
Liquidity
The ease of which an asset may be purchased or sold in a timely fashion without changing the price of the asset. Typically, the higher the degree of activity in a market, the greater the liquidity.
Market maker
Market participant or member firms of a securities exchange who provide a ready market for investors to transact in. The market maker aims to ensure the smooth operation for the market of the asset they make by being a provider of liquidity as a last resort.
Market price
The price at which the ETF trades at in the market. For a buyer, this typically represents the offer price, and for a seller the bid price.
Management expense ratio (MER)
The fees charged by the ETF provider for managing the fund. This is typically expressed as a percentage of the ETFs net asset value.
Net Asset Value (NAV)
The total current value of the assets held by the fund, displayed on a per share basis.
Open-ended fund
The number of units in the ETF can change with investor demand.
Passive management style
Passive managers aim to replicate the performance of a benchmark by holding as close to the benchmark portfolio as possible. This means that as the constituents of a benchmark change, the passive manager is compelled to make corresponding changes to the holdings of the fund.
Primary market
Consists of ETF issuers and the Authorised Participants, who trade ETF units and the underlying securities.
Secondary market
Consists of buyers and sellers of ETF units on a securities exchange like the ASX.
Style Drift
Occurs when the assets within the fund do not reflect the initially stated style or purpose of the fund.
Volatility
The range of movement in prices. Usually represented by the standard deviation in prices.

Yield
The return on an asset derived from regular distributions such as dividends. Expressed as a percentage of the price of the asset, for example a return of $5 on a $100 investment represents a 5% yield.

Disclaimer

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