



## GATEWAY INSIGHTS

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### # 11 Why ETF's have a place alongside active managers in investor's portfolios

#### Background

Exchange Traded Funds (ETFs) are gaining popularity in Australia as a quick and easy way into specific market segments. Although ETFs have been available in the US since 1993 and in Europe since 1999, ETF's are one of the more innovative new financial products to emerge from the financial industry in the last two decades. In this Insight we take a look at what are ETF's; what are the differences between an ETF and a managed fund and why ETF's can have a place alongside traditional active managed funds in investor's portfolios.

ETFs are open ended managed funds listed and traded on a stock exchange such as the ASX or NYSE. Mostly, ETFs track an index such as the ASX/S&P 200 but more recently ETFs have increased in popularity because they are being tailored to specific regions, sectors, commodities, bonds, futures, and other asset classes.

An ETF combines the valuation feature of a managed fund which can be bought or sold at the end of each trading day for its net asset value, with the tradability feature of a closed-end fund/ listed share, which trades throughout the trading day at prices that may be more or less than its net asset value (usually very close to NAV). Closed-end funds and Listed Investment Companies (LIC's) are not considered to be ETFs even though they are funds and are traded on an exchange as they have no primary market issuance and cancellation mechanism and thus regularly trade at premia/discounts to NAV.

One of the key advantages of ETFs is that the portfolios are transparent as the manager provides the ETF portfolio composition to the market on a daily basis. ETFs offer investors an undivided interest in a pool of securities and other assets and thus are similar in many ways to traditional managed funds, except that shares in an ETF can be bought and sold throughout the day like stocks on a securities exchange through a broker, providing instant liquidity.

'Buying behaviour' for ETFs is also important. Gateway believes there are two main segments.

1. Asset allocators -(SAA advisers and Self Managed Super Funds
2. Transactional – brokers, hedge funds, transition managers and fund managers

What is the difference between a managed fund and an ETF?

The 2009 Deloitte Research report titled "Exchange-Traded Funds Challenging the Dominance of Mutual Funds?" summarises the key differences between managed funds and ETFs as follows:

- Management type – active vs generally passive with ETFs
- Transparency – ETFs have to disclose all holdings every trading day vs managed funds
- Tax efficiency – capital gains tax can be greater in managed funds if portfolio holdings are sold to fund redemptions
- Pricing and trading – ETFs provide live publically available pricing every trading day vs managed funds where pricing is most often daily
- Transactions costs/fees – ETFs are cheaper than active managed funds with fees for active funds around the 1.00% mark for growth assets vs often half that for ETFs, although brokerage needs to be paid on an ETF transaction

Taking into consideration the above points it would appear that investors should only use ETFs and do away with active funds! To take this a step further, below we discuss the advantages and disadvantages of ETFs in order to build the case that they can be used effectively together in portfolios.

Advantages and disadvantages of ETF's

ETFs generally provide the easy diversification, low expense ratios, and tax efficiency of index funds while still maintaining all the features of ordinary shares, such as limit orders, short selling and options. Because ETFs can be economically acquired, held, and disposed of, some investors invest in ETF shares as a long-term investment for asset allocation purposes, while other investors trade ETF shares frequently to implement market timing investment strategies. The key point here is that the activity of different buying behaviours does not impact other investors in the same fund – quite unlike a traditional managed fund. Among the arguments for ETFs are the following:

- Lower costs – whilst managed funds and ETFs both have upfront costs such as brokerage, ETFs generally have lower costs because most ETFs are not actively managed. Investors in an actively managed fund, based on the law of averages, only have a 50% chance of outperforming the Index but are still required to pay up to 2% annually in fees.

- Buying and selling flexibility - ETFs can be bought and sold at current market prices at any time during the trading day, unlike managed funds. As publicly traded securities, their shares can be shorted as well as enabling the use of hedging strategies, and traded using stop orders and limit orders, which allow investors to specify the price points at which they are willing to trade. These factors provide additional flexibility and potential gains to investor's portfolios.
- Tax efficiency - ETFs generally generate relatively low (usually zero) capital gains impacts because they typically have low turnover of their portfolio securities. While this is an advantage they share with other index funds, their tax efficiency is further enhanced because they do not have to sell securities to meet investor redemptions.
- Market exposure and diversification - ETFs provide an economical way to rebalance portfolio allocations by investing in a particular theme or Index quickly.

Among the arguments against ETFs there are the following:

- Time horizons – the daily trading nature of listed securities, of which ETFs are part of, may not suit investor's portfolios that have a long term strategy. Asset allocation and portfolio construction decisions need to factor in how ETFs will add value over the long run.
- International limitations – as mentioned, the US and Europe have utilized ETFs for some time now, but in some other regions and countries there are a limited number of exchange traded funds in which to invest and most are large cap type offerings only.
- Trading volumes – when trading volumes are larger the advantage of purchasing an ETF over an Index Fund diminishes, as the bid-spread can be too wide to be cost effective, although market makers for ETFs often will negotiate on the spread based on the investment size.
- Tax implications – tax laws vary from country to country so investors need to be aware of potential tax implications of using international ETFs.

Why ETFs and active managers can both feature in an investor's portfolio

Investor's motivations for utilising ETF's have expanded over the past couple of years, with broader market access plus the ability to invest in specific themes and the cost advantages all driving investor interest. Examples of strategies being implemented include managing asset allocation, taking tactical positions, or removing existing unwanted exposure, and/or expressing a negative market view without the associated costs.

In the Australian market active share managers have been strongly supported over many years. But is there a place for both ETFs and managed funds in investor's portfolios? Or is the debate

simply about active vs passive investing? For investors that prefer active management then managed funds are the answer, but for those who feel they cannot pick market rallies such as the one experienced since March this year by the Australian equity market, then perhaps some index exposure via ETFs is well justified. If you believe thematic investing has a place, then ETFs or passive index exposure can assist with the implementation of this.

Interest levels historically for EFTs for asset allocators and investors have been based on their in-house views and methodologies around SAA and portfolio construction (eg alpha and beta), risk management, ability to find alpha generating investments and positions they want to implement around TAA.

iShares, recently sold by Barclays Global Investors to Blackrock are a prominent provider of ETFs in the Australian market and as a house they promote the concept of a "core/satellite approach" to portfolio construction where essentially indexed and active investments can work together. Their suggested strategy is to "build a low-risk, cost-effective core investment using broad-based index funds, while pursuing higher returns with more aggressive satellite investments in active funds, exotic index funds and individual stock positions"<sup>1</sup>.

Gateway believes the key advantage of using both EFTs and active managed fund products is that portfolios can be tailored to meet all kinds of risk and return requirements that investors present. More expensive actively managed funds can be used in a portfolio with cheaper ETF funds that can give portfolio tilts to opportunities such as Emerging Markets, Commodities and Gold. Hence, it is in active manager's interests when looking at where their fund fits in or big picture asset allocation to also consider ETFs and how these two types of investments can be used side by side. Other uses of ETFs in portfolios could be for portfolio tilting to accommodate short term investment views, portfolio rebalancing and as a risk management tool.

Where to from here....

Going forward, Deloitte Research suggests "looking beyond the subprime crisis, it is likely that new ETFs will tend to focus on Commodities and Emerging Markets.....the reality is that the demand-supply equation for a lot of Commodities, particularly oil, is still tight and prices will likely firm up as the economic situation gets better"<sup>2</sup>.

Currently there is only a limited selection of ETF's are available in Australia, but that is improving all the time. The key players are iShares, State Street Global Advisers and Vanguard. International ETFs offered by these organisations, for example, offer good exposure to overseas equity indices for Australian investors.

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<sup>1</sup> <http://au.ishares.com/publish/content/documents/pdfs/core-satellite-portfolio-solution.pdf>

<sup>2</sup> Deloitte Research – Exchange Traded Funds – Challenging the Dominance of Mutual Funds

One of the ongoing fallout effects of the global financial crisis has been to some extent disenchantment amongst both investors and financial planners with managed funds both on the basis of performance, insufficient liquidity and high fees. Combining passive exposure into portfolios via ETFs goes some way to addressing these issues and should not be overlooked.

#### About Gateway

Gateway Financial Marketing (Gateway) was established in February 2004 by Amanda Rethus and Edwina Best for the purpose of offering fund managers, other product providers and international new entrants, expert advice, services and assistance in negotiating entry into the Australian Retail Financial Services market. Use of Gateway's services provides the opportunity for clients to overcome the hurdles that can often confront fund managers when transitioning from institutional to retail and hence improve participation in retail funds flow. Prior to Gateway, Amanda and Edwina spent over 30 years combined with major institutions in the Retail Financial Services market.

#### Our qualifications

Amanda has over 20 years experience in the Financial Services industry and was formerly a Divisional Director in the Financial Services Group of Macquarie. Amanda managed investment portfolios for over 10 years, and has spent in excess of 10 years introducing investment products to the Australian Retail market.

Edwina has a Bachelor of Business from UTS majoring in Marketing and International Business. She has over 12 years experience in the financial services market, concentrating in relationship management, product management and marketing. They both have extensive contacts in the retail financial services market especially with key decision makers.

If you would like to confidentially discuss your current approach to the retail market or have any questions on the above please do not hesitate to contact us on – Edwina 0404 046 179 or Amanda or 0414 658 323.