

GATEWAY INSIGHTS

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28 ETFs v managed funds - not a binary decision

While the use of ETFs continues to accelerate in the Australian financial services industry, institutional investors have been slow to adopt these investment tools. Research and anecdotal feedback indicates the same themes of need for education and investment application still apply. Largely that potential investors believe ETFs are a more suitable investment tool for retail and self-directed investors. Whilst the local experience contradicts that of other investment markets, there are signs of change coming.

This edition of Insight focuses on the slow but increasing use of ETFs by institutional fund managers and how the use of ETFs can be additive to active funds management offerings when applied in a suitable manner. Gateway and ETF Consulting concur with the view that there remains a very strong need for education and information around the use of ETFs in portfolios and with portfolio construction implications. It is not a question of using ETFs for all investment solutions, but rather understanding ways that this proven technology can add value to existing investments and tools used. This Insight addresses issues from the perspective of an institutional audience, focusing on blending ETFs on a case-by-case basis in strategic and tactical scenarios.

Strategic asset allocation

Whilst there is common agreement that asset allocation decisions drive the variation in return of any portfolio, we see increasing evidence of institutional investment experts breaking down broad asset classes into more distinct exposures – eg global equities (thematic, regional, developed, emerging, frontier etc). To assist this practice, the growing selection of ETFs (locally and globally) enable superior precision (and control) in SAA and provide ways to implement the theoretical portfolio in a cost effective manner, often for much less than an active exposure. This also enables the allocation of the portfolio to a combination of active and passive strategies – dependent on the ability to add alpha in specialist areas. It is possible to access regional and country specific markets across say Asia and Europe with better diversification than simply picking individual stocks.

The added attraction is reduction in administration (initial and ongoing), combined with ease and speed of implementation of the trade.

However a key point to note is that total ETF usage for portfolio construction is definitely the exception to the norm. Although the introduction of “MySuper-like” low cost portfolios could see the introduction of beta only diversified portfolios. Where asset managers, research teams, consultants and superannuation funds can utilise their skill and processes to identify superior, cost effective active management, they can (and do) combine high quality alpha strategies across asset classes with appropriate ETF inclusion. The much discussed investment strategies of Harvard and Yale University Endowment Funds show such theory in action.

<http://harvardmagazine.com/2011/09/harvard-endowment-rises-to-32-billion>

Tactical asset allocation

For investors and managers seeking alpha through TAA, ETFs provide an access trade – a way to get the good ideas into the portfolio easily. Taking tactical tilts in a portfolio in say, resources or financials, (both themes have been very dominant lately), can be executed via ETFs, without stock specific risk. The active decision can be expensive in the short term, or hindered by other considerations such as speed of implementation, administration or excessive risk through individual securities.

A report out last week in the US highlighted the high level dissatisfaction with buy and hold strategies over the last 5 years through the GFC as some investment strategies and asset allocations have been exposed. (<http://www.etftrends.com/2011/12/etfs-as-tactical-investing-tools/>). This theme in conjunction with the ability to take tactical portfolio bets in a measured manner has focused further attention on ETFs in many markets.

<http://www.ibtimes.com/articles/157922/20110606/a-look-university-endowment-etf-holdings.htm>

The key theme here is these large US endowment funds (which resemble large pension funds in Australia) blend their active allocations with ETFs – especially in global equity markets. Precision, liquidity and flexibility are paramount.

Interestingly in the US in the last 2 months, there has been a re-shuffle of traditional ETF usage and rankings. In addition to the usual broad market indices in large cap, small cap and emerging markets – we saw the most traded ETFs include gold, silver, financials, energy and long term bonds. (Source – NYSE Euronext October US ETP Monthly flash).

For example, the volatility and turmoil in Europe may drive positive or negative views on that region and countries as we have seen in recent weeks.

<http://www.portfolio-adviser.com/news/macro-news/emerging-markets-replace-europe>

Locally the pending arrival in 2012 of fixed income ETFs into the Australian market will expand the opportunity set markedly. For example the ability to invest into corporate bonds easily and safely with low denominations will be very useful for institutional investors.

So where to from here

Our view is that ETF usage will only increase in Australia – including by institutions. For local institutional flavour, we suggest a good research paper for further reading is –“Digging deeper: Institutional ETF investing in Australia – Insights and implications. May 2011”. Refer http://www.asx.com.au/documents/products/Russell_Investments ETF_Research_-_Australian_Securities_Exchange_-_ASX.pdf

Our key takeouts are:

- Institutional adoption of ETF is still in the early stages but interest is growing

- There exists a disconnect between institutional perceptions towards ETFs and the role they can play in their investment programs.
- Innovation, education and improved systems are the keys to growth.

Tim Bradbury is the Principal of ETF Consulting (www.eftconsulting.com.au). Tim has more than 20 years' experience in financial services across a range of businesses spanning asset management, financial advice, investment banking and financial markets. In his 11 years with Barclays, he co-launched and managed the iShares ETF business in Australia and worked on numerous exchange traded projects.

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 Australian 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 15 years' experience in the financial services market, concentrating in relationship management, product management and marketing. They both have extensive contacts in the financial services market especially with key decision makers.

If you would like to confidentially discuss your current approach to the 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.