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Why use ETF’s, benefits, risks and costs

Here are some of the reasons why you might want to use Exchange Traded Funds (ETF’s) to save or invest and also some of the things you should think about before you do.

Benefits.

Low costs.
The cost of buying an ETF or a portfolio of ETF’s is usually significantly less than investing in shares individually. Think of the cost of buying the top 50 or 100 shares listed on the ASX let alone buying 3000 US small companies. ETFs are also likely to be more cost efficient than investing in managed funds. Generally speaking the management fees are lower. Most ETF managers replicate an index so they don’t need an army of expensive analysts, that’s why their costs are so low.

Diversification.
Diversification is really important. Don’t put all your eggs in one basket. But diversification can be expensive if you are trying to do it yourself. To have a diversified Australian share portfolio you would need to buy at least 20 different shares. Then you would need to buy overseas shares and then fixed income securities. ETF’s make diversification simple and cost effective. You can buy an ETF that invests in

the top 200 companies in Australia. The cost is just the same as buying one share.

Potential tax efficiency.
Tax can impact investment returns. The low turnover of an indexing approach, such as is used by many ETF's, minimises the capital gains distribution impact. This can improve after-tax performance and tax efficiency over the longer term.

Transparency.
The issuer of each ETF provides daily information to the market including what shares the ETF holds and the Net Asset Value (NAV) of the ETF.

Liquidity.
Unlike unlisted managed funds, investors are able to trade ETFs during ASX trading hours and at a price quoted on the ASX. Because ETF's are able to be created and redeemed the ETF should trade on the market very close to its NAV, so most of the time liquidity isn't an issue. Read more about our execution policy.

Risks to be aware of

Like all investments, ETFs carry risk. The main risks are that: 1) the value of the portfolio falls; 2) fluctuations in the value of the Australian dollar affect the value of ETFs over international assets; 3) you may not be able to sell your ETFs for a fair price.

Market risk.
If you buy an ETF that invests in Australian shares and then Australian shares fall in value, well your ETF is going to fall in value too. That's the market risk. Most ETF's are well diversified so stock specific risk is limited.

Currency risk.
An ETF that invests in shares outside of Australia carries another potential risk. Even if the assets in the ETF perform well, if the currency in which those assets are held moves against you, you might lose money. So a US ETF could fall in value if the Australian dollar appreciates against the US dollar. This risk is lessened by some ETF managers by hedging their currency exposure. Use Bigwig to look for ETF's that have a "currency hedge".

Liquidity risk.
This is the risk you may not be able to sell your ETFs for a fair price. Liquidity can vary between ETFs. However, Bigwig only offers ETF's with what we consider to be reasonable liquidity. We look very closely at buy sell spreads to make sure that the cost to buy or sell your ETF's is not too high.

Costs.

There are three types of costs that you will bear if you invest using ETF's.

Brokerage Costs.
This is the fee you pay to Bigwig and our partners for buying or selling the ETF on the market. This fee will be $30 plus 0.1% of the value of the transaction. So if you buy $5,000 of an ETF we will charge you $30 plus $5 so $35 in total.

Management Expenses.
You might not notice this fee but you should be aware of it. The manager of the ETF that you buy charges a fee to manage the portfolio. This fee can be anywhere from 0.05% up to more than 5.00% per annum. So if you invest $10,000 in STW (an ETF that tracks the ASX top 200 shares) for instance, the manager charges you 0.19% p.a. or $19.00 to manage the fund. That money gets taken out of the value of the portfolio on a pro rata basis. So if you hold it for 6 months you pay $9.50. A few managers also charge a Performance Fee. This fee is usually about 20% of the outperformance of the fund. What that means is that if the fund benchmark goes up by 10% and the ETF value goes up by 20% then the manager takes 20% of the outperformance, so 20% of the difference between 10% and 20%. In other words rather than getting a 20% performance from your ETF you only get 18%. Read the Factsheet for any ETF with a performance fee.

The Buy / Sell Spread
You might not think of this as a cost but it is. This is the difference between the price you can buy an ETF and the price you can sell it. Bigwig only offers ETF's that have reasonable buy sell spreads. Most passive ETF's have a spread that is less than 0.5%. We take this into account when we are scoring so if you buy ETF's that have a four or five star Bigwig rating the spread cost is likely to be small. For example the highest spread for an ETF with a Bigwig rating of 4 stars is 0.39% and the lowest is 0.01% so thats going to cost you between $20 and 50 cents.