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Exchange Traded Funds (ETF’s) Explained

ETF’s allow ordinary investors to buy professionally managed portfolios of shares from Australia and around the world. There is plenty of choice in ETF’s, you can invest in US Tech companies or European Banks, companies paying high dividends or companies that follow ethical principles. It is the easiest and most cost effective way to invest and build wealth.

ETF stands for “Exchange Traded Fund” and it’s like a ‘Managed Fund’ only you buy and sell them on the stock exchange and their fees are generally a lot lower. There are now more than 180 ETF’s traded on the ASX. They offer investments ranging from the ASX200 (an index of the top 200 biggest shares on the Australian Stock Exchange) to Bonds, tech stocks, Chinese companies or even gold. ETF’s give investors an opportunity to buy portfolios of international shares such as the NASDAQ index (lots of technology stocks) or sectors such as the S&P Healthcare sector. Search Bigwig for an ETF that interests you.

So how do they work?

Most ETF’s are what is called a passive investment. The investments in the ETF closely resemble an index. The managers of passive ETF’s buy all the shares in the particular index they are trying to track, for instance the ASX top 200. The manager holds those shares in a trust structure and manages them to ensure that his portfolio looks and performs just like the ASX200. The manager charges a fee to do that, typically that fee is about 0.1% to 0.5% which is not nothing but is reasonable compared to traditional managed funds. The trust structure is important because it allows the manager to pass the dividends that are paid by the companies in the fund through to you the investor and some of those dividends will have franking credits which are really valuable to you (you can read up about franking credits in our blog). The fund is then listed on the ASX so that it can be bought and sold easily. When you buy an ETF you hope that the ETF you buy will perform in line with the index or sector that it is supposed to be replicating. You should get that performance, less of course the managers fee and don't forget the brokerage that you have to pay to buy and sell the ETF. ETF's can be a really important part of a portfolio, in fact they allow you to build a portfolio which if ETF's weren't around you would seriously struggle to build. Put simply they allow you to have a well diversified portfolio without having to buy hundreds of different shares. Think about the cost in both time and money of buying hundreds of shares! For most investors it's simply not possible to buy every share in the ASX 200. What that means is that many people only buy a few shares, which might be fine, but which could lead to significantly more volatility, or risk, than you probably want. So ETF's are an efficient way to get exposure to a wide variety of domestic and international shares and bonds.

Managed Funds

But what about managed funds, why not invest in them? Well my answer is maybe you should. There are now quite a few managed fund ETF's. They differ from the ETF's described above because the manager doesn't follow an index or benchmark but instead makes his own investment decisions. The managed or "active" ETF's available on Bigwig generally have higher fees and a slightly higher cost to buy and sell (the spread). You can also buy Managed funds outside of Bigwig that are not ETF's. You can go direct to the fund manager. These funds differ from ETF's in that they charge much higher fees but they expect to manage your money so that they perform better than the average of shares. They employ lots of people to research the markets and then they pick the stocks that they think are attractively priced. All that sounds good and clearly it would make sense to invest in a managed fund if you thought that the performance that you got was going to be greater than the fees that you are paying. And that's the problem. Many managed funds promise big things but the facts are that not many of them deliver results over the long term that justify their fees. Some do (whether they will in the future is hard to judge) so if you really believe that a particular fund manager has some insight into the market then by all means invest with them. If you are not sure then maybe ETF's are for you.

Diversification

If you want a fully diversified portfolio you are probably going to have to buy a few ETF's, actually about 3 should do it. Incorporate the main asset classes: Australian shares, international shares, fixed interest and cash (the cash can be held in your savings account).

Risks

Risks to consider when investing in ETF's
1. Market risk – share values can and do go down
2. Tracking risk – your ETF may not track the index exactly so your performance may differ from what you thought was going to happen
3. Liquidity risk - the risk that when you want to buy or sell an ETF you won't be able to do so at a fair price. For most index ETF's this risk is largely negated because market makers ensure the price reflects the assets of the fund but it may be an issue for actively managed ETF's.
4. Currency risk - If you are buying an ETF that invests in assets overseas then there may be a risk that the currency moves against you.