All aboard the ETF express

Advisers who fail to embrace ETFs risk missing out on booming consumer demand, reports Lisa Pennell

More than half of all investors currently using exchange-traded funds (ETFs) did not consult financial advisers, according to the recently-released Investment Trends December 2009 Exchange-Traded Funds Report.

Another 7 per cent of ETF investors said they had actually stopped using advisers in the past 12 months.

This consumer trend towards self-directed investment could well be reason for concern, as the ETF market in Australia is literally exploding. Figures from the ASX show ETF market capitalisation increased by 185 per cent to $2917 million during the calendar year ending December 2009 - incredible growth, especially compared to the year ending December 2008, when the increase in ETF market capitalisation was just 10 per cent.

There can be little doubt that in the aftermath of the global financial crisis (GFC), consumers are finding ETFs a compelling alternative to other higher-risk, higher-cost investments. The Investment Trends report showed the actual number of ETF investors doubled between November 2008 and December 2009 from 19,000 to 38,000. Perhaps providing a glimpse of this year's likely growth, a further 64,000 investors were not currently invested but were considering an ETF investment in December 2009.

But it seems some advisers might not be matching their clients' level of interest in ETFs. The Investment Trends report revealed the role of an adviser in recent ETF investments was limited, with four out of five investors whose most recent alternative investment was in an ETF saying advisers had not played a role in that investment decision.

Nigel Baker

It's not all bad news though; there is clearly a demand for planner advice on ETFs. The report indicated one in five investors who had used alternative investments said they'd like to receive more advice than they currently were. Interestingly, among those who said they weren't receiving enough advice on ETF, 20 per cent were using financial planners.

There's no doubt that some fee-for-service advisers have leapt on board the EFT movement, but there is clearly an even stronger pull directly from consumers themselves towards the product. And the results of the Investment Trends report could be a wake-up call for advisers who up until now have ignored what could be deemed the "ETF revolution".

In simple terms, ETFs are securities that track an index, a commodity, or a basket of assets like an index fund. They provide all the advantages of a traditional index fund but at a potentially lower cost and with the added flexibility of being listed and traded on a stock exchange.

The benefits of ETFs include a lower cost structure than managed funds, the ability to be bought and sold at any time during the trading day, tax efficiency, easy market diversification, transparency and liquidity. As with other equities, they can be purchased on margin or sold short and can be used with hedging strategies, stop orders and limit orders.

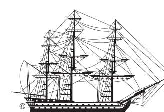
State Street Global Advisors (SSgA) were the first to launch a local ETF range of three products in 2001, followed by 19 ETF offerings by iShares, a division of Barclays Global Investors (BGI), which was sold to BlackRock in 2009. Vanguard is a relatively new entrant to the Australian ETF market, launching three products in May 2009. In less than one year, they have exceeded $100 million under management.

Robyn Laidlaw, Vanguard's ETF manager, says a fast-growing consumer awareness of ETFs has been reflected by a spike in the Vanguard web statistics and overall performance.

"ETFs are an established investment category in the US and other overseas markets. Experienced investors have been pleased to see their arrival here in Australia," Laidlaw says.

All three providers are among the biggest global ETF providers, accounting for 87 per cent of ETF assets under management in the US. Between them, Australian investors currently have access to 25 ETFs with a range of

Low Cost



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different exposures to domestic and overseas markets.

Another notable provider in the ETF space is ETF Securities, with five offerings (which they have renamed Electronically Traded Commodities, or ETCs) which track commodities, enabling investors to gain exposure to precious metals without trading futures or taking physical delivery. The most popular offering is ETFS Physical Gold (GOLD), which was originally listed in Australia in 2003, becoming the world's first ETF backed by physical bullion. The company now has more than $700 million under management in Australian funds.

Comparing the domestic ETF market to the global ETF market, it seems clear there's plenty of room for growth in Australia going forward. In December 2009, global ETF assets surpassed $1 trillion, with 1097 ETFs on offer, from 103 providers, listed on 39 exchanges around the world.

Even with last year's rapid growth, the market capitalisation of ETFs accounts for just 0.2 per cent of the ASX. In the US, ETFs represent more than 5 per cent of total market capitalisation, while in the European market, ETFs account for around 3.5 per cent.

The head of Australia and New Zealand ETF Securities, Nigel Phelan, agrees that globally, ETFs are far ahead of the Australian market. He says that on any given day on the NYSE, a Gold ETF will be among the top two equities traded. Further, out of the top ten most heavily traded stocks, the top six are ETF structures. Phelan believes gold and a variety of other ETFs have become more popular in the past 18 months as consumers have become more wary.

"Gold has been recognised as a key component of a balanced portfolio - 2 to 5 per cent held in gold reduces risk," he says.

"When the market was rising, virtually anyone could pick a stock, get a 10 to 15 per cent gain and look like a genius. When things

Robyn Laidlaw

became ropey, that's when it sorted the men out from the boys," Phelan says.

"ETFs won't appeal to advisers who base their fee structure on trail commissions. But pressure from investors for fee-for-service advice will make ETFs more appealing to advisers going forward."

A director of iShares, Tom Keenan, says that ETFs have a variety of applications; they are able to be used for strategic asset allocation for long-term investing or more tactical investing in the short term to suit the individual's risk profile.

"Strategically, ETFs can be used to replicate benchmarks for global equity investing or the ASX," he says. "Advisers can create core portfolios and use ETFs to tilt the portfolio, with allocations in the US, emerging markets or Asia."

Keenan adds that tactically, ETFs can be used the same way as any other equity; an individual or adviser might have an opinion on a particular stock, hold for a time and then sell. As an example, he says if they had an opinion about China, they could make a tactical call on emerging markets via an ETF.

Chris Schween, a director of Asset Builder, a small boutique specialist advisory firm, has been in business for 25 years and is now a passionate advocate of ETFs. He began using them for his clients two years ago and says since that time, his relationships with his clients have improved out of sight.

"ETFs have some major benefits over actively managed funds - they're transparent, they're tax-efficient, they allow for strategic asset allocation, they have clear returns and there's an ease of management," Schween says.

"ETFs provide effective indexing without getting too clever. I believe an index will always beat managed funds in terms of performance.

"You are in and out on the day you want to be. ETFs are a pure and straightforward investment - easy to monitor and nothing hidden. You can see exactly what stocks are underlying an ETF."

Schween believes ETF clients are far more proactive than traditional managed fund clients. He says ETF structures are becoming a more common element in self-managed super funds (SMSFs) and are ideal for use under separately managed account (SMA) structures or individually managed account (IMA) structures and the like.

And Schween points out the key benefit of ETFs should not be underestimated - their tax effectiveness. The ETFMate.com.au website says most traditional trusts, and especially active trusts, have an average turnover of up to 70 per cent. Such a high turnover results in a high level of realised capital gains, which are distributed to their investors, who then have to report them on their tax returns.

Broad index ETF products have a much lower turnover, like State Street's SPDR 200 ETF, which has a 5 to 8 per cent rate of turnover. While with ETFs all dividends and franking credits are passed on to investors, few if any capital gains are released. The key difference is that an ETF does not sell stock if there are redemptions - individuals just sell on the ASX

Diversification

to other investors, so there is no selling of shares by the ETF.

Schween says that over the years, he's seen many retirees invested in actively managed funds who haven't paid tax in years suddenly presented with large capital gains tax bills after fund managers have distributed high capital gains, seemingly without any regard to the possible tax consequences for investors.

"I had an 80-year-old client forced to take $50,000 from a portfolio which had already crashed by 30 per cent, just to pay a tax bill as a result of capital gains from a managed fund," Schween says. "Conversely, with ETFs we can take a passive approach with our clients over the long term and have them liable for little or no capital gains tax."

As to the application of ETFs, Schween is in agreement that it's important to take a balanced approach and consider the individual client's risk profile. He recommends investing in a mix of Australian and global ETFs with a passive approach, reviewing the portfolio every three to six months and tweaking the asset allocation where required.

"Ninety-five per cent of investment success is all based on asset allocation and a disciplined approach to maintain the allocation through good and bad times. ETFs are a great way to do that," he says.

Nigel Baker is principal of WHK Horwath Wealth Management, one of 20 businesses that form one of Australia's largest independent accounting groups, with more than $9 billion under advice. His business is also using ETF products, primarily as part of a passive approach, mainly for the core holding of large companies. He believes there will be even more growth in ETFs.

"Although ETFs are relatively new to our market, they're huge overseas and the trend will continue here," Baker says.

He sees the ability to access any market, as well as low cost and tax effectiveness, as being key benefits of ETFs - although he cautions that the lack of hedging on international ETFs should be considered. He also recommends advisers be cautious of liquidity and talk to the ETF operator about risk.

'ETFs can suit any client as part of a core strategy and are a great product for SMSFs'

"The international ETF offerings allow for tilting of a portfolio where appropriate, although we have tended to pull away somewhat and use managed funds instead due to the lack of hedging," Baker says.

"Still, ETFs can suit any client as part of a core strategy and are a great product for SMSFs."

Laidlaw says that while hedging on international ETFs does raise currency questions for consumers, investors need to be aware that this type of ETF is a journey and not a destination.

"You have to be prepared for some volatility along the way," she says.

Keenan adds that with unhedged international ETFs, currency returns matter, but that the currency exposure is actually [related] to where the basket of underlying shares comes from.

"Advisers will tend to have a hedging policy in place and use international ETFs as the unhedged component," he says. "There is a market risk with ETFs, as with any other investment. ETFs are another tool to use - not an end-to-end solution."

Douglas Turek, managing director of independent planning firm Professional Wealth, has a slightly different take on ETFs. For almost five years, he's been advising his clients (including executives, CEOs, lawyers, consultants and retirees) into unlisted index funds and sees only a modest advantage in using ETFs instead.

"What an ETF offers the retail investor is already available through unlisted index funds, although growth in ETFs may accelerate interest in these type of investments overall," Turek says.

"I don't see much difference between them, apart from ETFs being a new manifestation to access the product.

"If a business was based around trading, or an individual was more comfortable with that style of product, EFTs might be an attractive product. But if a client or an adviser is not used to buying and selling stocks, it would actually be harder to trade ETFs than to use unlisted funds.

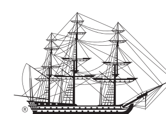
"In fact, we see a couple of cases where unlisted funds may be more attractive than ETFs - if a client is retired and not paying tax on investment income, under the international ETF products available here, 15 per cent tax would be withheld by the US Government. It may be more tax efficient in this case for the client to invest in a domicile unlisted fund, where no withholding tax applies.

"Secondly, if a client is making regular investments, rather than investing a large lump sum, the buy/sell spread of an unlisted fund is likely to be less than the brokerage fees associated with investing in an ETF.

"If an ETF proves to be cheaper than an index fund already being used, the cost saving may not be material relative to the cost of changing and so might not present a compelling reason to change."

Turek says ETFs will only become popular with advisers if the ETF offering allows them

Tax Efficiency



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to access things they couldn't already. Similarly, he says although ETFs could be used under SMA and IMA structures, if they cut across the adviser's value proposition, it's unlikely that they will be used other than in a secondary or supporting role.

Another issue Turek is wary of is hidden technical issues, and he says advisers who are considering using ETFs should ask the provider about their policy on securities lending.

Alan Dixon has been at the helm of 24-year-old firm Dixon Advisory & Superannuation Services Ltd for almost ten years. His firm administers 3200 SMSFs, with some $3 billion in assets. He says with SMSFs having experienced 24 per cent compound growth since 1995, ETFs are a great way for his clients to gain exposure to the Australian stockmarket.

"Our largest ETF holdings are in STW (State Street SPDR200 ETF) and GOLD (ETF Securities' Physical Gold ETF). We have used the Gold product [via] both ASX trading and physical lodgement and have been very happy with it," Dixon says.

"We also use ETFs as a 'placeholder' when setting up a SMSF, putting the total funds into ETFs to keep the client in the market and then selling down as we invest in various other securities."

Dixon says while his group has some interest in the international ETF offerings, they are domestically focused at this point. He says based on the ten-year average returns on the Australian market compared to the rest of the world, Australia remains their primary focus.

Conversely, Keenan says that growth in emerging markets has outstripped forecasts over the past five years and they are no longer viewed as risky, as they once were.

"Advisers are shifting the way in which they view global equity markets and introducing tilts towards emerging markets," Keenan says.

"Investing in emerging markets and mixing

'Advisers should ask the provider about their policy on securities lending'

that with developed markets gives the benefits of diversification without increasing the risk, as measured by standard deviation."

In a tactical use of ETFs, Dixon's firm purchased $30 million of physical gold in September 2007, had it directly delivered to the vaults of HSBC in London, and had share certificates issued for GOLD ETFs.

An executive director of Dixon Advisory, Chris Duffield, says that at the time, the group was becoming nervous about global debt levels and felt gold would be a good hedge against equity markets. Looking at overall exposure to Australian securities, they advised their clients to transfer on average 5 per cent of their holdings to physical gold.

"Although we had decided to move into gold, we had concerns about the stability of our financial institutions and wanted to eliminate counterparty risk as much as possible," Duffield says.

"In buying the gold through our HSBC dealer and converting it to ETFs, we had good security and were able to minimise transaction costs for our clients while retaining liquidity. In effect, we became a market maker.

"The STW ETF offers the same sort of benefits and can also be used as a short-term tactical tool for asset allocation - wherever you are and whenever you want to, you can trade in or out."

While in Dixon's opinion, ETFs do not suit every type of planner, he says direct assets are far more suitable for SMSFs than managed funds.

"Listed securities are far easier from a reporting and administrative perspective. The process is more complex with unlisted managed funds," he says.

Dixon recommends that to know which ETF is the best to use, it's important to understand the rules underlying the product and the guarantees on liquidity for each one.

In terms of ETF offerings, the providers agree that there will be more use for ETF products as the range of products broadens.

Laidlaw says: "The market here is newer and in the awareness phase. People are learning about ETFs and advisers are coming up to speed on them. An increasing range of products, and particularly non-equity based products, would be good to have."

"The market here will evolve and is poised for strong growth, particularly because of the growing SMSF base," she says.

Keenan says he expects to see a proliferation of new ETF providers and products in Australia as the market expands.

"I would recommend advisers review their ETF provider as they would any other provider," he says.

The need for advisers to get up to speed on ETFs and their various applications is clearly becoming more pressing than ever. But regardless of the statistics, comparisons and predictions surrounding the ETF market here in Australia, perhaps the most telling statement about the future of ETFs as part of the adviser/client relationship comes from Chris Schween.

He says: "It's fair to say that after embracing ETFs, I've become friends with my clients again." ■

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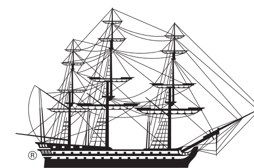

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