Looking behind the ETF curtain

As exchange-traded funds take off, and product specialisation increases, there's a growing demand for information on how these vehicles work. Research houses are responding. Simon Hoyle reports

In keeping with the "only in America" cliché, earlier this year a highly-specialised exchange-traded fund (ETF) was launched. Called the Wound Care ETF, it was exactly what the name suggests.

"It only invested in companies that provided wound care, such as bandages, sutures and that kind of thing," says Zac Wallis, ETF strategist for Morningstar.

"It was a very limited universe and the ETF subsequently received very little support and actually was shut down.

"Obviously Australia is nowhere near the maturity of the US [ETF market], and I think a lot of the ETFs that will come to market in the next year or so will be based broadly on common, widely-known and more popular indices."

The Wound Care ETF illustrates an issue that is likely to become bigger for financial planners as the market develops beyond the plain-vanilla, big, liquid index ETF concept. The next step will inevitably involve products that are more complicated or esoteric than current ones.

Already overseas there are - among others - leveraged ETFs, inverse ETFs (where the return from the ETF is the inverse of the underlying index) and synthetic ETFs that do not hold physical stock at all.

While the market is holding its breath waiting for the Australian Securities Exchange (ASX) to change its listing rules to allow fixed income ETFs to be listed, *Professional Planner* understands that synthetic ETFs are likely to be available to Australian investors before year's end. A newcomer to the ETF space is reportedly posed to launch four new products, structured in a way that Australian investors have not seen before.

To date, ETFs available to local investors have adopted either a full-replication approach (where the ETF holds every stock, in the same proportions, as an underlying index), or "optimised sampling" (where a subset of index constituents are put together to mirror the index characteristics).

"There's another method that's not necessarily widely known in Australia at the moment, and that's around synthetic application," Wallis says.

"That is a tricky one. Elsewhere [overseas] they have become popular, because there are some very attractive prices on these; and what it basically is, is a product provider entering into a swap contract with, typically, an investment bank.

"It's a total-return swap for the index outcome. So there's no tracking error, and you will get the index outcome. But there is counterparty risk associated with that investment bank. And that's a scary thing for a lot of investors.

"Obviously, there's collateral being posted by the investment banks to reduce some of that counterparty risk and, post-GFC, counterparty risk has become a big issue and it's more front-of-mind when entering these types of things.

"But collateral today, versus, say, two or three years ago, is of a higher quality, and the credit standards that are imposed are more stringent. So counterparty risk is less of a concern today than it was two or three years ago, but it's still a risk."

Keeping up with these developments, and unravelling the different structures - both of the ETF providers themselves, and the underlying indexes - is a full-time job. Leading research houses are moving to meet demand for information by launching ETF ratings and research services.

Dug Higgins, senior investment analyst for Zenith Investment Partners, says the newer entrants to the ETF research game are, in fact, those more likely to be familiar to financial planners.

"It's interesting from the point of view of the provision of research in the Australian market [that] there's been some guys coming out of the US who have been in this market for some time…and some stockbrokers," Higgins says.

"Up to now the 'mainstream' fund management researchers, like ourselves and S&P and the like, haven't been in this space.

"A lot of the other groups are looking at ETFs from the point of view of being equities, so they are issuing 'buy', 'sell' or 'hold' recommendations. The managed funds guys, on the other hand, are going down the path of rating ETFs like managed funds."

So instead of issuing things like price targets or earnings targets, as with traditional stock research, the fund research cohort are focusing on issues and putting out ratings far more familiar to planners.

"It's looking at it much more from the point

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of view of saying, firstly, what is the index I am getting exposure to? Who is providing the index construction, and is it worthwhile getting into?" Higgins says.

As *Professional Planner* was finalising this article, S&P issued its first ETF rating; it put out a "very strong" rating on the SPDR S&P/ASX 200 Fund (ASX code: STW) - an ETF managed by State Street Global Advisors (SSgA).

The rating would be familiar to anyone who has read an S&P managed fund report; in part, it said: "The rating reflects a combination of very low direct and indirect costs, a highly liquid secondary market, a simple and transparent portfolio-construction approach and historical performance that has been very true to style.

"Additionally, STW has proven, and will likely continue to be, a highly tax-efficient investment vehicle; in a comparative sense, it may generate superior after-tax returns for investors with anything other than a zero per cent marginal tax rate."

Rodney Lay, a director of fund services at S&P - and the analyst behind the STW rating - says it's easy to think that all ETFs and all ETF providers are created more or less equal. But they're not, and Lay says that understanding the nuances of different ETFs, both their structure and underlying indexes, is critical for planners.

Lay says planners' general knowledge of ETFs is "probably reasonably good", but there are a lot of subtle differences that lurk beneath the surface between products and issuers.

Lay says that even the taxation status of ETFs is full of potential traps for the unwary. The taxation of an ETF can be very different from that of an unlisted managed fund, even if the underlying index or portfolio is identical, because of the redemption and creation process that underpins the ETF market.

That's the theory - but in practice, Lay says, because demand in the local market for the

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creation of new ETF units has to date generally outstripped redemptions, those differences have not yet really been shown up.

"In theory the ETF should be more tax-efficient, but they haven't been as efficient as the theory would say," Lay says.

Although the products may superficially look similar, Wallis says it is "definitely a common misconception" that they are all, in fact, the same.

"There are a number of different ways to skin a cat; the same applies to ETFs in regards to the way they're structured," Wallis says.

"If you just look at the market currently, Vanguard use an optimised sampling approach to create an ETF…so they mirror the key risk and return characteristics of the underlying index by holding more or less of certain stocks in that index, to avoid having a long tail and [to avoid] churning the portfolio at reconstitution dates. And they've proven to be quite successful at doing that over time. It's exactly the same approach they apply [to their unlisted index funds]. They have strong experience in doing that.

"And it's worth knowing that all the Vanguard ETFs in Australia currently are separately listed share classes of their unlisted managed funds.

"So it's a different way that they have structured their ETFs, whereas State Street have a full replication process, where they hold every stock in the index."

The index replication approach has implications for the return characteristics of an ETF, Lay says.

As a general rule, a full-replication approach has lower tracking error, but it may incur relatively high transaction costs (particularly if the index in question has many stocks in it, or if some of those stocks are illiquid). On the other hand, an optimised sampling approach may reduce transaction costs (because it does not hold every stock in an index) but it exposes investors to "alpha risk" - the risk that it may not accurately track the underlying index.

"Planners need to be aware of what the exposure is in an ETF," Lay says.

"The portfolio may be tracking a chosen index, but the portfolio may have less stocks in it than the index.

"Advisers should be aware that this ETF tracks an index, but don't think that you're getting full replication of it - there are stocks that have been removed."

Full replication works when "all the stocks [in an index] are sufficiently liquid, so they do not need to cut particular stocks out", Lay says.

Higgins says that fundamentally, investors and advisers "need to know what an ETF is designed to do". But before even exploring an ETF as an appropriate solution for a client, they need to be sure that a passive approach is what they want. He says not even that is a given.

"One of the things I've noticed from advisers is that they are not all that interested in an index play at the moment," Higgins says.

"But if they are a fan of passive, ETFs do pretty well at that. The only curve-ball is that advisers need to be careful about what index they're getting into. Some are not very mainstream indices; some of them are very narrow. In looking at some of the ones that are operating, one of the

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things that occurs to me is, OK, it's useful for some people to get liquid, low-cost exposure to these markets, but the fact that these vehicles are there doesn't necessarily mean it's a great way of doing it.

"Because there's not a lot of competition yet - there's only one ETF [covering] Taiwan and I think there's only one ETF giving you exposure to South Korea - the question is, is it necessarily giving you good exposure? Are they very heavily weighted towards the mega-caps?

"Just because you can, doesn't mean you should. Advisers are going to have to look behind the label a little bit.

"Then, to take a step on from that, you have to look at the indexes - how they are constructed, and who is constructing them."

And finally, a close look needs to be taken at the ETF providers themselves.

"Managers in any sector are not all created equal," Higgins says. The "risks of partnering some of the entities that are around" is greater than partnering with some others, he says.

Wallis says S&P's ETF research methodology is "similar in some respects to what we do in the funds research space".

"There's a number of different factors we look at: the parent, obviously, looking at the ETF issuer and how that is as a business; and identify any issues in relation to the business and their needing to outsource things like custody or implementation, or things like that.

"Once we get the compliance thing with the parent ticked off, you're looking into the physical products. The big thing about ETFs is, I guess, there's two ways to look at it. You can look at it for a short-term investment opportunity for specific sector exposure or specific exposure that you need or don't have in your portfolio already; and there's one for a more long-term holding, and you buy an index just for that beta exposure.

"For the more long-term holding, you're looking for an index that makes sense; it's actually a factor of the market, it's not something that the product provider has just built to be self-serving.

> 'A number of lessons have been learned in other markets, particularly the US'

"The STW ETF, which tracks the S&P/ASX200 Index, if you're an investor looking for market exposure, that's a very suitable ETF. The index makes sense, there's no holes in it, in the way the index is created or in the way State Street implement that portfolio.

"That's an important part too: the implementation. The index creator might have an effective way of building that index, but whether or not the ETF provider can implement and run that, and manage it effectively, is a different story.

"A number of lessons have been learned in other markets, particularly the US, around the implementation issues that have popped up. It's been interesting to see some of the tracking error risk on some products, particularly some of the 'nichey' type indexes; the tracking error has blown out substantially.

"It comes back to the parent being experienced and having a portfolio implementation and management capability that's proven and robust. It's typically, to date, the managers who have had success in the passive funds space who have had success in that regard."

Higgins says planners also need to be wary of products that are too specialised - the Wound Care ETF is a case in point. Picking an ETF that fails to attract enough money might mean it cannot operate efficiently (and so costs more than it should), or has to close down altogether. While investors would probably not lose money if an ETF shut down, it can be a hassle to have to revamp a strategy or to find an alternative investment option.

When you add so-called cross-listed ETFs into the picture, it becomes more complicated again.

Wallis says that "there's a few things we're trying to make clear to our adviser clients, and first and foremost is understanding the nature of the product, which is the index".

"Things like emerging markets and BRIC and China, it's all been publicised that it's working well, but there are certain characteristics to investing offshore with ETFs at the moment that investors need to be aware of - particularly with the iShares products, which are cross-listed from the US," he says.

"Australian investors are just getting an Australian-dollar version of a US outcome. If you bought an S&P500 ETF, the Australian dollar has rallied [against the US dollar], so Australian investors have had a negative experience there. Because the S&P is more or less flat and the Australian dollar has gone up, they've lost money.

"It's quite common to get the complaint that we saw the index do XYX, yet my outcome is this. And you have to explain that over the period that you've suffered some sort of currency translation loss on that transaction.

"There's also some tax implications on investing in cross-listed securities; Australian investors are subject to withholding tax on cross-listed ETFs, so there's a 15 per cent tax on income. And they're also subject to estate tax, should the investment amount on an inheritance from a deceased estate go past a threshold limit, which

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is $US60,000. So for example, if your parents passed away and they had $US100,000 in US S&P500 ETFs, there would be tax implications for every dollar invested in excess of $US60,000. And that's something that's not widely known."

Wallis adds that the exact treatment also depends on what type of investor you are, and how you invest in the ETF - for example, whether you're investing as an individual, or as self-managed super fund (SMSF).

"iShares are very transparent in providing information around that," he says.

"The withholding tax is actually higher than [15 per cent] but iShares are proactive in providing the W8-BEN form, which is like a dual tax treaty between Australia and the US, and if investors fill out this form they get the lower withholding tax.

"They're very proactive in the way they disclose that and in providing information to investors on that issue."

The providers of ETFs have to deal with two distinct styles of research. There's the traditional stockbroker-style research (which tends to be bottom-up in nature), and the research more typical of the managed funds sector (which tends to be more top-down).

Graham Smith, business development manager for SSgA, says neither approach is intrinsically superior; rather, they have different objectives and therefore cater to different audiences. Smith says advisers who are deeply into ETFs, and have been using them for several years, tend to blend the different styles of research to gain a more rounded picture of the sector and its products.

Overall, Smith says SSgA welcomes the additional scrutiny that the sector is under.

"We're very pleased that the main research houses in Australia, as well as the leading stockbrokers - so it's not just the S&Ps and the Morningstars, it's the Bell Potters and other brokers - are all starting to provide a lot more

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scrutiny in this area," Smith says.

"It's driven by demand. And we're pleased to see the additional level of investigation - it shows that ETFs are coming of age."

Smith says stockbrokers and managed fund researchers "are coming at it from different angles –and they're deliberately different".

"Our experience - and a lot of this is relatively new in the space in Australia - is that the level of scrutiny the bulk of the fund research guys are going to is very deep, and very appropriate," he says.

"We found that it was a very intense process, and they're looking for a lot of detail, a lot of detail that we are not used to providing around these listed instruments.

"And the conclusions that they have drawn, we are very comfortable with."

Smith says the fund research houses are also serving to educate the financial planning community about what ETFs are, how they're structured and what they are designed to do.

The managing director of iShares in Australia, Tom Keenan, says anything that gives "an independent, third-party endorsement of a product is very beneficial for advisers who want to use ETFs".

"It solves a compliance issue for them." Keenan says.

"Research is a critical piece of the ETF ecosystem that is falling into place and will help make ETFs more mainstream – a number of things have to happen for them to become more widely used, and research is one of them."

Just as researchers say that not all ETF providers are created equal, so ETF providers say that not all research is created equal. Keenan ventures the opinion that "Morningstar is certainly leading the way".

"They've got a significant ETF research capability in the US that they're very easily able to leverage," he says.

"There's no doubt that they've taken the lead in ETF research in Australia. And I think Lonsec is doing some good research as well.

"Everyone is still educating themselves on ETFs, and researchers and research houses have had to do the same."

Keenan says the emphasis of research houses coming from a managed funds background is quite different from researchers from a stockbroking background. Broker research tends to focus on "trading ideas, and the research to back that up", while the managed fund-style research "is more focused on the structure of the ETF and the ETF provider, and whether that ETF is going to deliver the outcome it says it's going to deliver".

"The next step in all of this is for researchers to start providing guidance on how ETFs are used in portfolios," Keenan says.

"How do you build a portfolio? In time, we're going to start seeing model portfolios containing ETFs being rolled out by research houses. That will proliferate when we get ETFs across different asset classes.

"Research houses can add value by providing guidance on how to implement asset allocation decisions.

"This is a natural evolution of the industry, but it does start to change, to a certain degree, the services that a lot of these research houses have been providing." ■

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