

ETFs on the up-and-up (and up)

After a slow start, the issuers of exchange-traded funds in Australia are convinced they're on the cusp of rapid growth and widespread acceptance by financial planners and their clients. Simon Hoyle reports

In the US in the space of a few short years, the popularity of exchange-traded funds (ETFs) has exploded.

From just a few dozen of these sharemarket-listed vehicles 10 years ago, there are now more than 1700, with a combined value of \$US790 billion (\$1 trillion), and the numbers continue to climb rapidly.

The first ETFs in the world were launched not in the US, but in Canada. The funds have been available in Australia since 2001, when State Street Global Advisers (SSgA) launched its ETF range, and then through iShares, a division of Barclays Global Investors (BGI, recently sold to BlackRock).

In May this year Vanguard entered the local market, taking the number of ETFs available to Australian investors to 25. SSgA and Vanguard each offer three ETFs, while iShares offers 19. These ETFs offer local investors a range of different exposures to equity markets here and overseas.

A BGI report on the global ETF market at the end of June 2009, said iShares is the largest ETF provider in the world, in terms of both number of products, with 386 ETFs, and assets of \$US380 billion, and a 48 per cent global market share.

It said SSgA is second with 104 products valued at \$US120 billion, and a 15 per cent market share.

And Vanguard is third, with 40 products valued at \$US60 billion, and a 7.5 per cent market share.

The growing willingness of financial planners to consider ETFs as a low-cost, tax-efficient way for clients to gain broad sharemarket diversification prompted Vanguard's recent entry, and is likely to



Robyn Laidlaw

attract additional issuers in coming months and years.

ETFs make sense in an investment portfolio for exactly the same reasons index funds already make sense for many investors.

Designed to replicate the performance of a particular market index, ETFs aim to do so faithfully, but at very low cost – lower, even, than existing, unlisted index funds – and with a high level of tax efficiency, by minimising portfolio turnover, and hence minimising both transaction costs and potential capital gains tax (CGT).

“The philosophy around indexing is that it's a low-cost way to achieve a highly-diversified exposure to a market,” says Robyn Laidlaw, ETF

product manager for Vanguard in Australia.

“The low-turnover approach that is typically associated with indexing is consistent with a tax-efficient approach to investing.”

ETFs are like the proverbial duck: On the surface all seems serene and simple; below the surface there's a bit more going on.

Financial planners and retail investors will generally only ever encounter ETFs “above the waterline”, as it were, in the so-called secondary market. This is where units in ETFs are traded, in exactly the same way as listed equities, on the Australian Securities Exchange (ASX).

“Below the waterline”, the so-called “primary market”, is the preserve of market-makers and authorised participants. These are generally broking firms, who have entered explicit agreements with the issuers of ETFs to create liquidity and drive the mechanisms for issuing and redeeming ETF units directly with the issuer.

In the primary market, brokers create a “basket” of stocks that mirrors the composition of a given ETF. They simply buy all of the stocks, in the same proportions, as the portfolio of the ETF.

That basket is handed over to the ETF product manufacturer, in return for units in the ETF. The investor can then sell its ETF units on the secondary market or directly back to the ETF provider.

Susan Darroch, head of global structured products for SSgA in the Asia Pacific region, says the acceptance of ETFs in Australia has been similar to in the US. SSgA launched its first ETF in Australia in 2001.

“It took time for them to take off,” she says.

“There was an education period. In Australia,

Vanguard ETFs.



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the same thing happened. It took up to five years before the market – institutions and financial planners – became used to what an ETF is and how they can use it, and [before] they started using it.

“We had that education period, and I think you can see from the growth in volumes coming through the secondary market that Australians are embracing ETFs.”

Darroch says an index fund portfolio can be “a broad, diversified portfolio, and an ETF is an extremely efficient way to get a broad, diversified portfolio”.

“In one transaction you have exposure to 200 stocks on the Australian exchange,” she says.

“I think another thing that has come to the forefront in recent years is cost. It’s an extremely cheap way for non-institutional investors to get exposure to an index fund.”

An investment in SSGA’s SPDR S&P/ASX 200 Fund, for example, costs 28.6 basis points a year. ETFs that track US sharemarkets are cheaper still - the Vanguard US Total Market Shares ETF has an annual cost of 7 basis points a year, and the iShares S&P 500 ETF has a cost of 9 basis points a year.

Laidlaw points out that with investments into two Vanguard ETFs, investors can gain exposure to 93 per cent of the world’s sharemarkets, at a cost of 17 basis points a year.

Darroch says: “If you went into an unlisted fund you would be paying a lot more in fees.”

“We have moved into an era where we’re looking at what the actual return to the pocket of the investor is,” she says.

“Fees are important in that analysis. ETFs can deliver on fees. And ETFs can deliver on after-tax returns, because their turnover is low. Where there is a capital gain in the portfolio, it’s going to have lower realisation of capital gains than an active-type portfolio will.”

Darroch says financial planners in Australia are alive to the possibilities that ETFs present for implementing investment strategies for clients.

“I don’t think they’re waiting,” she says. “I think



Susan Darroch

there are a couple of dynamics that are changing. Fee-for-service [advice] is one of the dynamics that’s helping ETFs grow in popularity now.”

Laidlaw says an important consideration in the growth of the ETF market is the changing nature of the financial planning industry.

“An important consideration for all issuers with these products is that they have typically been suited to the fee-for-service [financial planning] market, because they are not commission-paying products,” she says.

“And Vanguard, like other managers, sees the self-managed superannuation fund [SMSF] market as a potential buyer of the product - and a lot of these [SMSFs] are clients of financial planners.”

Darroch says that over time, familiarity and hence comfort with ETFs has increased, and that research houses are now looking at the funds more closely.

“It was about getting everyone in the market aware that they are here, they are good, and they’re here to stay,” Darroch says.

ETFs share another characteristic of index funds: It’s fairly pointless owning more than one if

they track the same index. Any fund that tracks a given index is pretty much exactly the same as any other fund that tracks the same index.

Unlike actively-managed funds, where using two managers with different styles can help reduce risk, no such benefit exists in combining ETF managers.

In the Australian market, ETF promoters seem to acknowledge this fact, if not explicitly.

For example, State Street offers ETFs based on the S&P/ASX 200, S&P/ASX 50 and S&P/ASX A-REIT indices. Vanguard offers an ETF based on the S&P/ASX 300 index.

Vanguard also offers overseas ETFs, based on the MSCI Broad Market Index and the FTSE All World ex-US Index. And these offshore ETFs do not directly overlap with the 19 ASX-listed products offered by iShares.

That is more than coincidence – partly for marketing reasons, and partly, says Deborah Fuhr, global head of ETF research and implementation strategy for BGI, because “that decision is often made by the manager of the index offering exclusive licences to indices”.

Darroch says it remains to be seen if that demarcation remains.

“So far in the Australian market there has not been that doubling up,” she says. “I guess we will wait and see what happens going forward, but I think that the ETFs that have been [issued] have been different enough.”

Laidlaw says that while Vanguard “has some products that are similar or the same as iShares overseas”, so far the issuers in Australia do seem to have avoided direct product competition.

When competing ETF issuers offer funds that track the same index, there’s usually a good reason. Fuhr says that in Europe, for example, the Undertakings for Collective Investments in Transferable Securities (UCITS) III legislation (which governs how funds are marketed to retail investors) says one fund may invest no more than 20 per cent of its assets into any other single fund. If a fund required, for example, 40 per cent exposure to a given market

Low Cost and Diversified.

index, it would need to invest 20 per cent of its assets in each of two ETFs tracking the same index.

Laidlaw says the market for ETFs in Australia is on the verge of taking off, a fact that acted as a catalyst in Vanguard launching its ETF range in May this year.

“A lot of our decision to be in this market was around what we’ve seen in terms of the use of ETFs and the growth of them in other markets, including the experience of our parent company in the US,” Laidlaw says.

“ETFs as a product have been phenomenally successful because of their versatility.

“This is another way of indexing; in Australia we’re indexing specialists and we think ETFs are very much part of what our core proposition is to clients.”

Vanguard has launched three ETFs as a start, and Laidlaw expects at least one more will be launched before the end of the year.

Laidlaw says ETFs are attractive to investors who both accept the philosophy of index funds management, and who also are attracted to the trading options presented by the products’ ASX listing.

“For investors in Australia – and this is the same as for investors overseas – a key feature is being able to buy the fund investment on the exchange,” Laidlaw says.

ETFs combine some of the key features of products already available – most obviously unlisted index funds and listed investment companies (LICs).

Like unlisted index funds, ETFs offer a low-cost, tax-efficient way to gain good diversification; they offer the liquidity and trading opportunities associated with LICs. But unlike LICs, ETFs are not likely to ever trade at a significant premium or discount to net asset value (NAV) – the mechanics of the primary market see to that. The activities of the authorised participants and market makers mean such arbitrage opportunities very quickly evaporate – if they arise at all.

Darroch says: “If on the ASX the price gets

ETFs on the ASX

| ETF | ASX Code | Management Cost (% pa) |
|--|----------|------------------------|
| iShares | | |
| iShares FTSE/Xinhua China 25 | IZZ | 0.74 |
| iShares MSCI BRIC | IBK | 0.72 |
| iShares MSCI EAFE | IVE | 0.34 |
| iShares MSCI Emerging Markets | IEM | 0.72 |
| iShares MSCI Hong Kong | IHK | 0.52 |
| iShares MSCI Japan | IJP | 0.52 |
| iShares MSCI Singapore | ISG | 0.52 |
| iShares MSCI South Korea | IKO | 0.63 |
| iShares MSCI Taiwan | ITW | 0.73 |
| iShares Russell 2000 | IRU | 0.20 |
| iShares S&P 500 | IVV | 0.09 |
| iShares S&P Asia 50 | IAA | 0.50 |
| iShares Europe 350 | IEU | 0.60 |
| iShares Global 100 | IOO | 0.40 |
| iShares Global Consumer Staples | IXI | 0.48 |
| iShares Global Healthcare | IXJ | 0.48 |
| iShares Global Telecommunications | IXP | 0.48 |
| iShares S&P MidCap 400 | IJH | 0.20 |
| iShares S&P SmallCap 600 | IJR | 0.20 |
| SSgA | | |
| SPDR S&P/ASX 50 Fund | SFY | 0.286 |
| SPDR S&P/ASX 200 Fund | STW | 0.286 |
| SPDR S&P/ASX 200 Listed Property Fund | SLF | 0.40 |
| Vanguard | | |
| Vanguard Australian Shares Index (Tracks S&P/ASX 300 Index) | VAS | 0.27 |
| Vanguard All-World ex-US Shares Index (Tracks FTSE All World ex-US Index) | VEU | 0.25 |
| Vanguard US Total Market Shares Index (Tracks MSCI US Broad Market Index) | VTS | 0.07 |

Source: iShares, SSgA, Vanguard

away from fair value, the players look at that and go and create baskets [of the underlying stocks] at a lower price, and sell them to people at a higher price.”

“This arbitrage...forces the price on the secondary market back to fair value,” she says.

“That mechanism allows investors to know that the price they’re paying in the secondary market is always fair.”

The ASX says that at the end of June, 2009, the

value of all ETFs listed on the market was about \$1.86 billion. There was an average of about 600 ETF trades a day - a low figure compared to, for example, A-REITs, in which there were almost 34,000 trades a day.

But as Darroch, Laidlaw and Fuhr agree, we’re on the cusp of significant growth in the Australian ETF market, and those figures need to be compared to earlier dates to gain an appreciation of how far the sector has come.

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In June 2008, for example, the ASX said the value of Australian ETFs was \$1.77 billion, and there were 368 trades a day. And in June 2007, the value of ETFs was \$1.15 billion, and there were just 123 trades a day.

When Fuhr started working in the ETF field in 1997, there were 21 products globally, worth \$8 billion.

Until June 2008, Fuhr headed Morgan Stanley's award-winning ETF research team, but as part of a cost-cutting initiative, that team was disbanded. By September the same year, Fuhr had resurfaced at BGI. Morgan Stanley's timing was poor - in the 12 months ended June 20, 2009, during one of the most severe global economic slowdowns in history, the value of the global ETF market increased by \$US80 billion.

Clearly, despite global economic conditions, investors and their advisers around the world have continued to favour ETFs as an investment vehicle.

The take-up of ETFs in countries where the products have previously have been rolled out has been "quite similar to what you're seeing in Australia," Fuhr says.

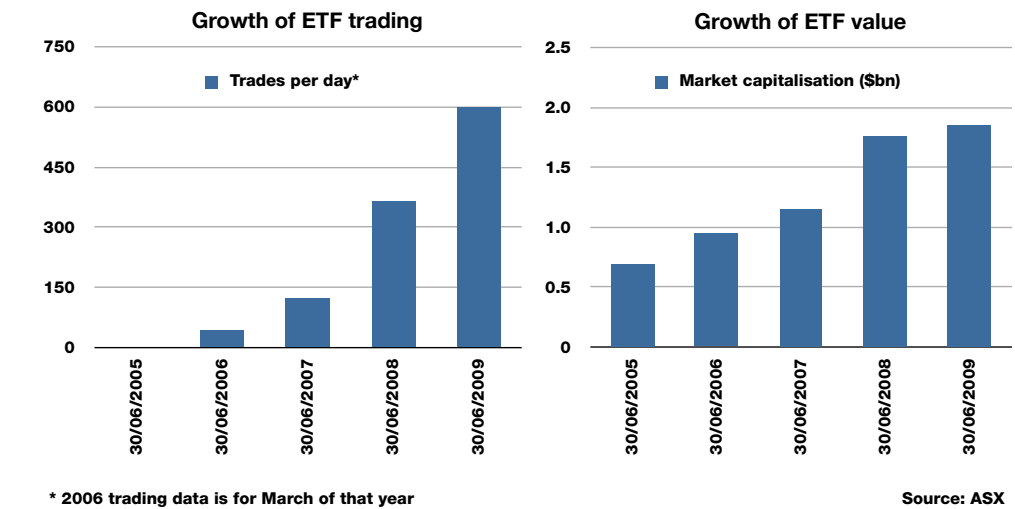
Generally, there's an initial period when the products are available, but remain largely overlooked. However, once the benefits and potential uses of the products are understood and sink in a bit with planners and investors, there's a relatively rapid acceptance; money starts to flow to the funds, and then there is an influx of new products and issuers.

Fuhr says one of the key attractions for investors is that ETFs are exceptionally low cost, even by index fund standards.

"Retail investors get the same economies of scale that hedge funds and large pension fund players get using ETFs, even when they [large investors] are putting in \$1 billion or a couple of hundred million dollars," Fuhr says.

"You can come along and put in a couple of hundred thousand, or whatever, and get the same cost benefit."

Fuhr says growing numbers of financial plan-



ners are embracing the idea of ETFs as they come to recognise that what clients are willing to pay for is not necessarily picking the next hot fund or fund manager, but getting strategic asset allocation right and using the most cost- and tax-effective structures for implementation.

"You're seeing this movement towards being paid for advice," Fuhr says.

"That goes along with the old [Gary] Brinson study where he looked at what drives performance and found that getting your asset allocation right is the key to driving performance.

"I have always positioned ETFs as being a tool to enable planners to do their jobs. Over the years, you've seen that story being embraced. If you look globally...you will see that many of the private banks have also embraced using ETFs, because they see that where they can add value is in advising clients as to where they should be investing.

"[And] if you look at the use of ETFs by funds-of-funds [FoFs], where their job has been to pick good active managers to do fund-of-fund strategies, I would say that over the past two years we've seen a significant uptake in the use of ETFs.

"It's hard to find good active managers, but they're also seeing increasingly that where they can add value is getting the asset allocation right."

Fuhr says regulatory change has also underpinned this take-up. In Europe, for example, while UCITS III still limits how much one fund may invest into another, the limit has been raised fourfold.

Fuhr says that in addition to low costs and efficient diversification, retail investors also enjoy other benefits by using ETFs to implement an investment strategy.

"With an ETF you can see what is inside of it; you can see what are the fees; you can see, in real time, the price - one of the appealing features is you can see them trading on an exchange," she says.

"You have the ability to trade with multiple brokers. And you can trade at any time during the day."

ETFs launched in Australia so far are exclusively long-only, index-tracking funds. But that may change in coming years as new issuers move into the domestic market. Overseas there are actively-managed ETFs, and in mid-July, ProShares launched the world's first 130/30 ETF - a fund that incorporates both leverage and short-selling.

Darroch says demand from local investors will drive the development of the Australian ETF market.

"I can see new products coming out," she says.

"I think that if demand is there, then new ETFs will be created." ■

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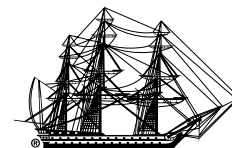
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