Understanding Exchange Traded Funds (ETFs)

Exchange Traded Funds (ETFs) are traded on the ASX just like ordinary shares. They have ASX codes like STW, IOZ, NDQ and are bought and sold in exactly the same way you would buy and sell CBA, BHP or TLS. ETFs are created by issuers such as Vanguard, BetaShares and iShares who create funds based on themes like indexes, sectors, yield, ethical investing, etc.

And they are becoming more and more popular with investors around the world as they are proving to be just as profitable as share portfolios, but with much higher diversification and lower volatility. This means they have the same benefit with less risk and without the need for individual stock selection and it's associated level of active management.

Of course there are individual shares that outperform the broader market (and their associated ETFs). So the commonly adopted approach is to hold a basket of 3 or 4 ETFs as your core portfolio while still having other portfolios & holdings which are deemed satellite investments.

Here's the simple logic that underpins this tactic…if you own just 4 shares from two sectors that are outperforming the broader market and the rest of your capital is tracking the index then you will outperform the market. But there is lot more to understanding ETFs than just this simple logic so I'm going to tackle some of the more common areas of confusion.

Income ETFs

One key area of confusion is the use of income ETFs. Take Betashare's actively managed 'Dividend Harvester Fund', HVST. In the last year it has enjoyed an average distribution yield of 11.3% plus 66.6% franking credits. This equates to a gross distribution of 14.5%.

BUT…when we take into account the price trend of HVST, we see a different picture. The indicator located at the bottom of the above chart measures ‘Total rate of return’, taking into account the last 12 months of distributions, average franking credits and the prevailing trend. And on that basis you can expect a total return of 10.19%pa from HVST, from this moment on.

So when you take into account capital growth with the big four banks then they easily beat HVST. And what’s more, an ETF can’t be employed as a lifetime income producing asset given its very nature. This is an actively managed fund which I believe even employs option trading to enhance income generation, albeit conservative. And so how would you assess the underlying fundamentals? You simply can’t. Would Warren Buffett buy it? I sincerely doubt it.

Therefore ‘income’ ETFs are a bit of a furphy as the simple reality is that some ETFs focus on capital growth while others aim to optimise distributions, ie. income. Most are of a passive nature while some, like HVST, are actively managed. Therefore, in order to compare ETFs with ETFs, you need to know their total rate of return.

Comparing ETFs

You also need to classify them in terms of risk, this being a qualitative assessment. I think ETFs that track indexes are safer than actively managed ETFs and they are safer than sector based ETFs. Hence an index ETF, by its very nature, is more diversified. There is also local versus foreign ETFs where the latter has the added complication (read: risk) of currency exchange. So I classify all ETFs with a risk factor rating between 1 and 10, depending on all these factors.

Now to the task of quantitative comparison and as I’ve demonstrated with HVST, this is done by taking into account capital growth, distributions and any franking credits. Now it may surprise some readers to know that index ETFs commonly have distributions, and even franking credits. It may also surprise you to know that our local ASX200 index ETFs closely match U.S. ETFs in terms of performance. The U.S. is rising faster but our ETFs pay higher distributions.

So applying my TROR indicator to both iShares’ SP-500 tracking IHVV ETF and SPDR’s ASX200 tracking STW ETF, I can conclude that their performance is neck and neck. But I think our market represents less risk than the U.S. markets and so it wins on that basis.

Active Management

Hence I would own both ETFs for local and international diversification but STW would have the larger weighting. And we are standing on shifting sands here because if the U.S. markets were to accelerate then IHVV will become the better option. Furthermore when the current global rally ends (and it will at some point) then income ETFs like HVST will be a better option than any index ETFs. Hence, ETFs need to be actively managed.

There are now a lot of products available in the ETF space and it is attracting a lot of investors. These investors are rightly employing ETFs as a core component of their portfolios…but then managing them passively. This is because they don't understand product selection and how to compare different ETFs…nor how to monitor their performance.

Liquidity

But now to a non-issue with ETFs…liquidity. There are no liquidity restrictions when buying and selling ETFs. In the example below of STW, the issuer SPDR has to make a market. In other words as units of STW get bought, the issuer has to feed more of them into the market. Hence in the depth of market you will see at least one bid and one offer by the market maker…

STW $54.580 $0.070 (0.13%)

SPDR 200 FUND ETF UNITS

Bid ($)	Offer ($)	High ($)	Low ($)	Volume	Trades	Value ($)	Open ($)	Previous Close ($)
54.540	54.580	54.690	54.360	34,973	84	1,906,377	54.660	54.510

Market Depth

Buyers			Sellers		
No.	Volume	Price ($)	Price ($)	Volume	No.
3	33,988	54.540	54.580	20,006	4
3	35,000	54.530	54.590	20,000	2
1	1,000	54.500	54.610	1,000	1
1	5,000	54.300	54.800	1,000	2
1	320	54.250	54.900	2,000	1

In the above depth of market screen the two lowest offers to sell are both about 20,000 units. I’m certain at least one of these is the market maker and what you don’t want to do is exceed these offers. So if you want to buy more than 40,000 units then I would buy only 40,000 units and then wait for the market maker to place another offer. They are obligated to do this.

You will also notice in this example that the difference between the highest bids and lowest offers (called the spread) is a maximum of 6 cents. This represents a spread for a buyer of just 0.12% which is negligible. Hence ETF issuers don’t have the objective of profiting from price spreads, as they are often rumoured to do. But always be mindful price spreads with any financial instruments.

The future for ETFs

The world’s major Stockmarkets have been enjoying a bull run since 2009 and our market has risen along with them. But unlike the U.S. where the rally has been broad based, our Stockmarket has been rising in a far more sedate manner, in a narrow advance. So it makes complete sense that Australian investors should be seeking to invest in the index rather than individual shares and diversify into overseas markets, like the NASDAQ.

ETFs facilitate both of these functions, saving investors a lot of difficulty in managing offshore investments and not having to invest in unlisted funds or poorly regulated derivatives. Furthermore the increased usage of ETFs is having an impact on the very nature of our market, reducing buyer support for individual stocks. So if other investors are embracing them, then we need to follow the crowd and their money.

With my new ETF Top 10 Portfolio service I do all the hard work for you, identifying the top 10 most profitable (and safest) ETFs and then you use the top 4 ETFs from this list to create the core of your portfolio. What's more, I update the ETF Top 10 portfolio every week so you aren't caught napping. So know that understanding and dealing with ETFs just got a lot easier.

To find out more about my ETF Top 10 Portfolio service or to download and application form please visit my website at **https://alanhull.com/etf-top-10-portfolio**