Using Exchange Traded Funds

The unique attributes and benefits of Exchange Traded Funds (ETFs) appeal to both institutional and individual investors. Typically structured like managed funds, but listed and traded on an exchange like shares ETFs are flexible trading and investment vehicles that can be used to help satisfy a number of critical investment needs.

Asset Allocation

Savvy investors are discovering what institutional investors have known for some time: asset allocation, not security selection, helps drive long-term investment results. However, advanced asset allocation strategies have been difficult for many individual investors to implement, given the costs and asset size required to achieve proper levels of diversification.

The introduction of ETFs now offer investors a sophisticated tool to efficiently gain exposure to broad market segments, encompassing a wide range of asset classes, equity market capitalisations and sectors. This enables investors to build customised investment portfolios consistent with their financial needs, risk tolerance and investment horizon. It's important to remember that diversification and asset allocation do not ensure a profit or guarantee against loss.

Sample Uses

Strategic Asset Allocation

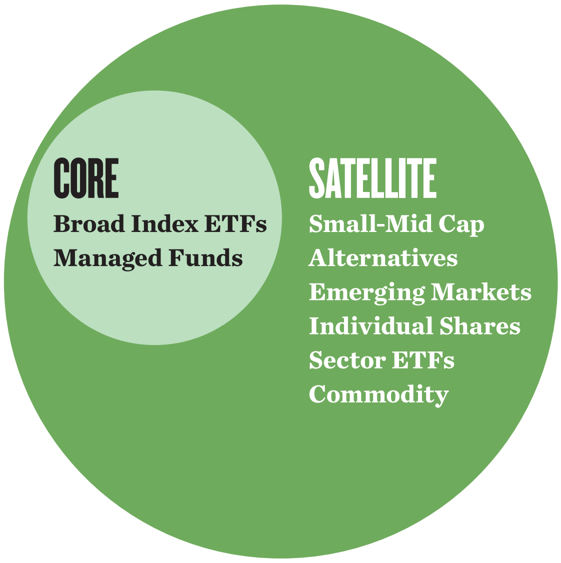
Research shows that a properly allocated portfolio is the most critical factor in explaining the difference in returns across portfolios. The value of asset allocation has been witnessed at most during and after the global financial crisis.

After an investor decides what its long term asset allocation will be, i.e. equities vs. fixed income vs. commodities, it can then utilise passive investment vehicles like ETFs to provide easily managed, low cost proxies for the broader asset markets.

Core-Satellite Strategy

Investors can also use ETFs to achieve their core-satellite strategy by holding relatively stable and diversified investments as their "core" holdings to form a shock absorber and add "satellite" positions around their core investments in the hopes of generating alpha.

A Core-Satellite Strategy



Broad-based ETFs can be used as the core of an investment strategy and complemented with other style- and sectorspecific ETFs or unit trusts funds.

Sector-, commodity-based or other ETFs that track "satellite" asset classes can be used as a cost-effective and efficient complement to a "core" investment in a separately managed account, unit trusts or broad benchmark ETF.

Tactical Asset Allocation

In today's ever changing macro and geo-political environment, investors often need to make real-time adjustments to their long term asset allocation to reflect changing views on short term asset class performance. ETFs provide a fast and efficient vehicle to access markets to help facilitate these tactical adjustments. Investors can also unwind the positions just as easily as when they were first implemented, after the effects that motivated the tactical adjustment have run their course.

Rebalancing

As investors near retirement they may choose to position their investments more conservatively and opt for a higher yielding equity ETF such as the SPDR® MSCI Australia Select High Dividend Yield Fund (ASX: SYI). Or if an investor would like additional diversification in property related stocks they could employ the SPDR S&P®/ASX 200 Listed Property Fund (ASX: SLF). The targeted exposure and deep liquidity of ETFs allows

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for the simple implementation of periodic portfolio rebalancing. At its most basic level this will involve buying or selling ETFs, individual stocks and bonds in relatively small amounts to reestablish the fund's predetermined asset allocation and coresatellite positioning. Rebalancing for ETFs is as easy as buying or selling a few shares of stock however individual investors such as Self-Managed Super Funds (SMSFs) that invest with managed investment schemes may find rebalancing more difficult because of restrictions and fees on short-term buying and selling of units.

As an example, a SMSF investor nearing maturity may want to reduce its holdings of large cap stocks opting for stocks of companies paying high dividends. If the investor had used a large cap equity managed investment scheme, some of the schemes may have a minimum holding period or apply fees for liquidating these positions. The SPDR S&P/ASX 50 Fund (ASX: SFY) that tracks the S&P/ASX 50 Index on the other hand has no such trading impediments making it an optimal vehicle for rebalancing large cap equity holdings. The institution could freely sell its investment in SFY and use the proceeds to buy SYI, for example

Short Term Cash Management

ETFs can provide a ready, liquid and low cost investment to help bridge the gap between two other investments. If an individual investor redeems from an external manager or some other investment, and plans to roll the proceeds into a new investment that it has not decided on yet, an ETF could be used as a temporary placeholder for those assets. An example of this transition management process could involve an institution choosing to reduce its large cap equity exposure in order to take advantage of opportunities it is seeing in the commercial real estate sector. After liquidating the fund's equity holdings the fund then has the choice of immediately investing in an ETF such as SPDR S&P/ASX 200 Fund (ASX: STW) or SFY which will continue to hold its place in large cap equities, or it could opt to invest in SLF to approximate the returns of its new real estate investment until it can be finalised.

Access Overseas Markets

ETFs are a highly effective way to access the growth potential of overseas markets, without the complexities of a direct investment or challenges of a managed fund. By investing offshore, investors can potentially benefit from lower asset prices, new growth opportunities and more effective diversification. International equities provide exposure to sectors that are either poorly represented or entirely absent from the Australian market, such as pharmaceuticals and information technology. These include fast-growing sectors that are yet to reach full maturity and sectors with very different growth profiles to those which dominate in Australia. Given these benefits, an allocation to international equities could suit investors who are looking for capital growth in preparation for retirement or looking to move their current cash holdings into growth assets.

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ETFs trade like stocks, are subject to investment risk, fluctuate in market value and may trade at prices above or below the ETFs net asset value. Brokerage commissions and ETF expenses will reduce returns.

These investments may have difficulty in liquidating an investment position without taking a significant discount from current market value, which can be a significant problem with certain lightly traded securities. Diversification does not ensure a profit or guarantee against loss.

Passive management and the creation/redemption process can help minimise capital gains distributions. Frequent trading of ETFs could significantly increase commissions and other costs such that they may offset any savings from low fees or costs.

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