FUNDS

Why Choose ETFs?

Exchange-traded funds have proven to be resilient in both bull and bear markets. Here's why.

By Tho Li Ming

In 2008, fund flows largely went into cash and out of financial products. But despite the doom and gloom, funds continued to flow into exchange-traded funds (ETFs). "Reports over the past few months indicate that net investment flows into ETFs have been positive (compared with actively-managed funds with net outflows) despite the overall market having gone through the turbulent period," says Zainal Izlan Zainal Abidin, CEO and director of i-VCAP Management Sdn Bhd, the company managing Syariah-compliant MyETF. Lipper has reported that Europe, there was a net sales outflow of US$125 billion from mutual funds in the first eight months of 2008, while net sales of ETFs were a positive US$48 billion.

"ETFs have proven popular with investors in both bear and bull markets. According to Morgan Stanley's ETFs Global Review — Year End 2007, ETFs' global assets grew from US$105 billion in 2001 to over US$797 billion by end-2007, representing a remarkable annual growth rate of 39%," says Jane Leung, senior director of product, iShares Asia ex-Japan, Barclays Global Investors.

The ETFs have performed well as an industry thus far because there are a lot of substitutions going on, says Joseph Ho, managing director and head of ETF sales and marketing at Societe Generale. "There may not be new money (being injected into the market). Instead, money that is exiting individual stocks and traditional unit trust funds is being redeployed into ETFs."

Why the popularity?

Introduced this millennium, ETFs have sprouted like mushrooms. Leung says ETF assets under management have grown rapidly since the first US ETF was launched in 1993. Ho says ETFs have done well and are continuing to do well because of liquidity and transparency. "It's also because of the simplicity of diversification with the ETFs — if you want to have some exposure, you want to hold the whole market rather than a single stock in times like these."

ETFs are similar to conventional unit trust funds in that they can provide diversification with a smaller investment amount, and enable investors to play whole sectors, indices or selected commodities such as gold.

Says Ho: "We have gone through a very difficult and confusing year [2008]. Instead of focusing on what to buy this year, go back and look at a more diversified portfolio. A year ago, you would not have been able to invest in gold conveniently. However, these are all possible now in Singapore and Hong Kong. There were a lot of movements within the ETF markets in general. Prior to 2008, the most popular ones were emerging market ETFs but now they [investors] are going into bond ETFs, currency ETFs, broad market ETFs covering regions and countries, and even commodity ETFs."

Christopher Soon, an institutional consulting director with a major bank in Singapore, recommends investing in ETFs that have exposure to the entire country's indices such as the iShares MCSI UK Index, iShares MCSI Australia Index, iShares MCSI UK Index and iShares MCSI Malaysia Index. "This way, Malaysian investors do not need to be savvy about ETFs — they just need to be bullish on the country that they are investing in."

ETFs VS unit trust funds

DATIN MAZNAH MAHBOB, CEO, funds management division, at AmInvestment Bank Group, says ETFs provide market exposure and diversification as they generally track or follow the performance of an index, which represents the asset class itself, are traded on stock exchanges and have hybrid features of a share (equity), a unit trust and a closed-end fund. "An ETF combines the open-end unit trust feature, which is that it can be redeemed or purchased anytime with a tradability of a share (buying and selling can be done throughout the trading day via a securities exchange).

"Although a closed-end fund is also traded on a stock exchange, its prices can vary greatly from its net asset value, depending on its demand and supply. An ETF, on the other hand, trades at a price which is the same as the net value of its underlying assets over the stock exchange trading day," she adds.

Because it is traded like a stock, the cost of investing in ETFs is lower than that of a unit trust fund. This is because they tend to be index products and hence, do not require active management, says Eric Wong, head of research, Hong Kong at Thomson Reuters Lipper. "ETFs are insulated from the cost of having to buy or sell securities to accommodate investors' purchases and redemptions.

"ETFs are bought and sold through brokers; thus, there is less need for marketing directly to investors, which is not the case for unit trust funds. Also, unlike unit trust funds, ETFs do not charge sales load fees."

This means that ETF investors pay only the annual management fee, which ranges from 0.1% to 1%, a brokerage commission of 0.7% and minimal stamp duty (0.04%, or a maximum fee of RM500) and clearing fee (0.1%, or a maximum fee of RM200).

Maznah says this is less as compared to a unit trust fund, where "a person investing RM100,000 as an upfront fee for an active unit trust fund may have up to RM5,000 in charges immediately; which is much higher than any brokerage commission".

Christopher Soon, an institutional consulting director with a major bank in Singapore, says the difference in cost essentially results in better performance than many actively managed funds. "The difference in costs could range from 1% to 3%. This can be especially significant when compounded over a longer investment horizon."

ETFs also have more transparency. The ETF investor is privy to the full content of the ETF. "An investor can go to our website or Bursa Malaysia's and see the stocks that the fund has in its holdings. With a unit trust, you will only know post-event, usually via their reports," says Zainal Izlan Zainal Abidin, CEO and director of i-VCAP Management Sdn Bhd.

Maznah concurs, saying that at all times, the investor knows the composition of the fund. She adds that tradability is another benefit as the ETF is priced continually in real-time throughout the day. "An ETF can be bought and sold at current market prices, unlike unit trusts, which can only be traded at the end of the trading day." ■

ETFs also come with minimal costs and access to up-to-the-minute trading times, which means that investors can also be more nimble.

However, note that they also come with their fair share of risks. For one, there is investment risk in its underlying securities. Soon gives an example. "A financial-sector ETF would be totally exposed to the sell-off in banks and financials. Even a well-diversified index like the S&P would have suffered versus an active manager who may have decided to underweight financials and overweight defensive sectors like consumer staples during a recession."

Tracking errors happen when the performance of the ETF does not mimic the performance of the benchmark index it is tracking. "Even if the index is down 50%, the ETFs should also be down 50%. Tracking error happens when the benchmark is down 50% but the ETFs are down 60% instead. Something is wrong," says Zainal. "It could be the manager's fault or something else. In any case, that is the risk. Tracking errors will occur — but the job of the manager is to minimise them," he adds.

As the ETFs are openly traded on an exchange as opposed to being valued at the end of the day as with unit trust funds, says Soon, they can suffer or benefit from investor sentiment as the traded price differs from their actual net asset value (NAV).

Investing in ETFs

While there are only three listed ETFs on the local stock market, investing in international ETFs is possible. You can ask a local broker for its overseas counterpart, who would be able to perform the trading and transactions, says Zainal. "Investors will still need to open a local version of the CDS account - it's just like trading on Bursa Malaysia. But there are [other] things [to consider], like settlement issues. For instance, if you're buying a Hong Kong ETF, you would have to settle in HK dollars and if your funds are in Malaysia, you have to arrange for a remittance or transfer from there.

"For smaller retail investors, it might be too cumbersome, but for those who have international investments to start with, it can be part and parcel of their investments."

Before you buy an ETF, there are some things you need to note. Eric Wong, head of research, Hong Kong at Thomson Reuters Lipper, says retail investors will need to look at, among other things, the assets (stocks, bonds or commodities) the ETFs hold or the indices they track; the investment management style of the ETFs (active or passive); the track record of the financial institutions in designing and developing the ETFs, which includes evaluating the academic qualification and experience of the personnel; and the turnover of investment personnel at the financial institutions, which could result in insufficient supervision and subject them to a higher probability of loose management.

"Compare the historical and forward fundamental parameters such as price-to-earnings and price-to-book ratios and study the technical trading parameters such as price behaviour pattern, moving averages or Relative Strength Index of the ETFs to determine their entry and exit," says Wong.

The ETF's liquidity is also important in order to speed up transactions. Wong says the liquidity of an ETF is not only reflected by its trading volume and bid-ask spread (a narrower spread usually means higher liquidity) at the stock exchange, it is also judged by the liquidity of its underlying securities or the securities that make up the index the ETF tracks.

"This is because ETFs sometimes allow their investors, usually institutional investors, to redeem large blocks of the ETF units for a basket of the underlying assets [securities] of the ETFs, or alternately, exchange the underlying securities for the ETF units.

"Thus, the liquidity of these underlying securities also determines the liquidity of the ETF and needs to be considered," he adds.

Lastly, watch out for those fees. Just like unit trust funds, management fees vary for different types of ETFs. "Some underlying securities are easier to access than others. If you want those that are more difficult to access, be prepared to pay more," says Zainal. ■

What are ETNs?

THOUGH SIMILAR TO ETFs, an exchange-traded note (ETN) adopts a very different structure, explains Datin Maznah Mahbob, CEO, funds management division, at AmInvestment Bank Group. "Issued generally by global debt issuers and/or underwriting banks, an ETN is a structured product issued as debt notes. When held to maturity, the investor will receive a cash payout linked to the performance of the underlying index during the period starting from the trade day and ending at maturity. "An ETN does not have tracking risk, unlike an ETF, which may not perform as closely per the index due to fees, expenses, dividends, and so on. An ETN can be liquidated before maturity by selling back on the exchange."

It comes with risks. Christopher Soon, an institutional consulting director with a major bank in Singapore, says as it's a contract between the issuer and holder, there is a credit risk. "If the issuer becomes bankrupt, there is a possibility of total loss [of the investor's investment]. Also, if the credit rating of the issuer is downgraded, the value of the ETN may drop even though there is no change in the index. This is because an ETN is like a structured product and relies on the ability of the issuer to make good on its promise." ■