Module 1: Introduction to ETFs

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Topic 1: Big picture investing

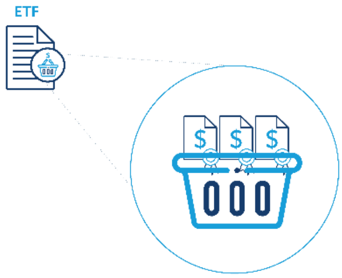
Which stock to buy?

Investors spend many hours trying to answer this question.

The goal is to find stocks that will provide good returns. Analysis often includes comparison with other stocks - reflected in judgements such as 'outperform' or 'underperform'.

An alternative approach is to look at the 'big picture' - instead of trying to pick individual stocks, you can invest in the market as a whole.

In the big picture approach, your returns depend on the performance of the broad sharemarket, rather than on a few stocks in particular.



Exchange Traded Funds (ETFs) are big picture investments.

ETFs enable you to invest in a broad range of shares in one trade. They allow you to take a view on the market rather than on particular shares.

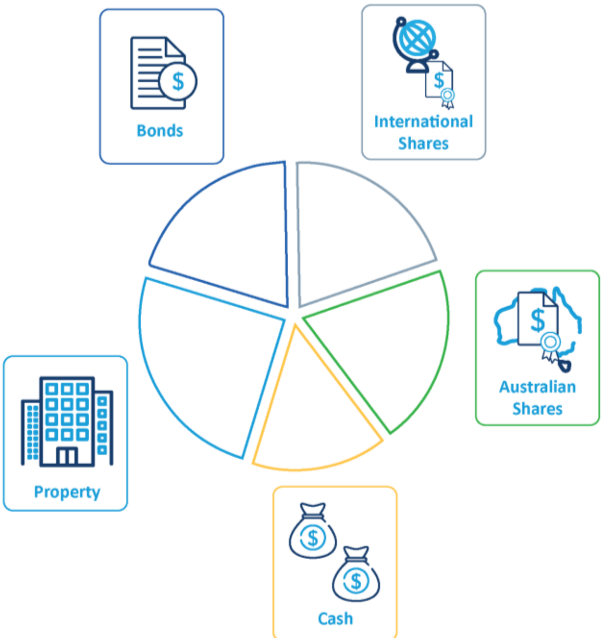
An ETF gives you instant exposure to the Australian sharemarket as a whole or a segment of it.

Why take a big picture approach?

Research suggests that your most important investment decision is how you spread your money between asset classes such as:

- Australian shares
- international shares
- property
- bonds, and
- cash.

The way you divide your funds between these asset classes is called asset allocation.

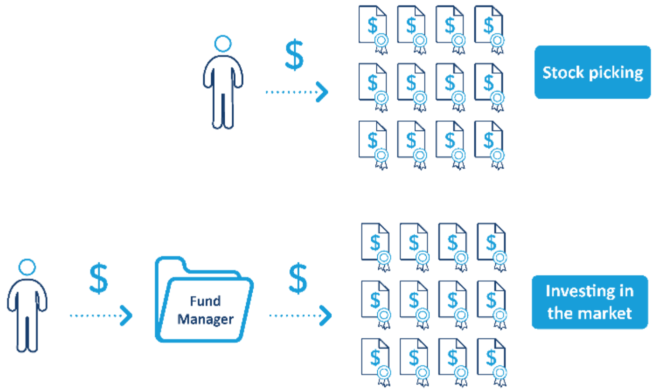


How can you invest in the market?

Investors who want to invest in the sharemarket, but don't want to pick stocks, often invest in managed funds.

When you buy units in a managed fund, the fund manager invests your money according to the fund's investment goals. The fund may perform better or worse than the market as a whole.

An ETF is a type of managed fund, but with some important differences from traditional managed funds.

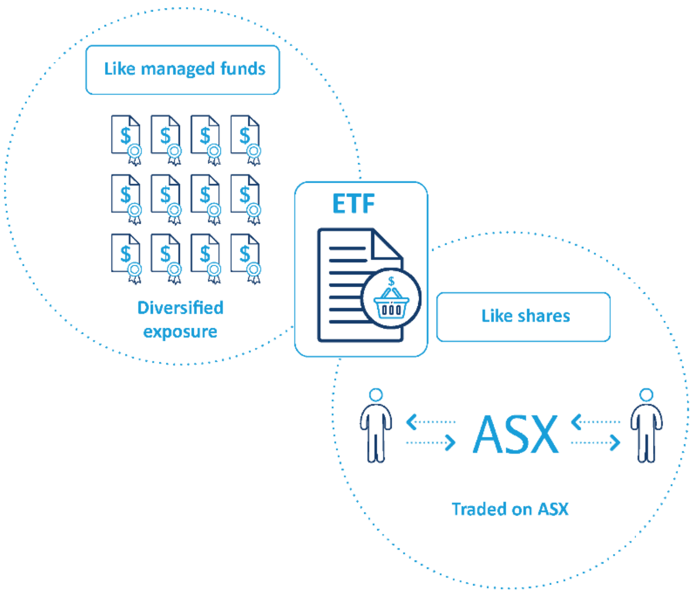


Topic 2: What are ETFs?

An ETF is a type of fund traded on market.

An ETF can give you exposure to a wide range of assets in a single trade.

Like shares, you buy and sell ETFs on market through your stockbroker.

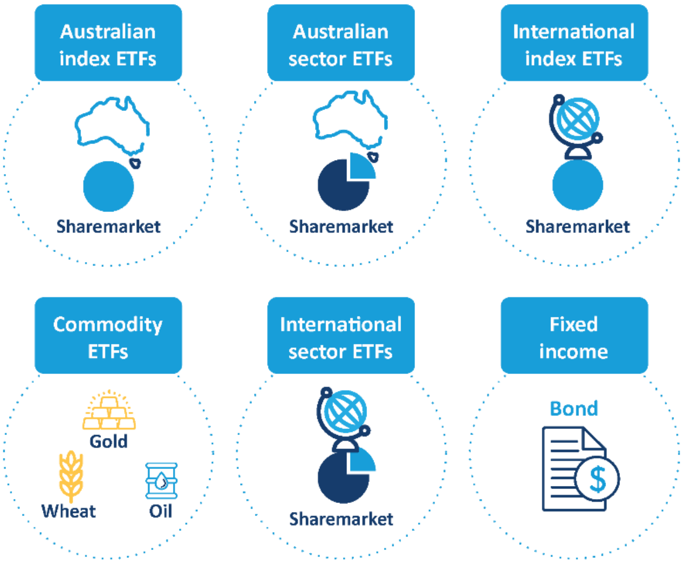


A range of markets and assets

ETFs offer exposure to a range of markets and assets, both domestic and international.

These include:

- the Australian sharemarket
- sectors of the Australian sharemarket
- overseas sharemarkets
- sectors of overseas sharemarkets
- fixed income
- foreign currencies, and
- commodities.



Accurate price tracking

Each ETF will typically track an underlying index. The ETF is designed to closely follow the performance of that index.

Another way of saying this is that the ETF 'tracks' the underlying index.

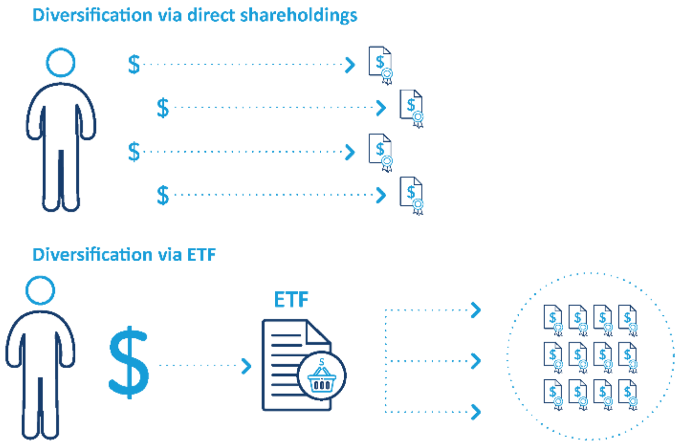
If your ETF is over the S&P/ASX200 index, for example, percentage movements in the index will be mirrored by percentage changes in the price of the ETF.

The ability of an ETF to closely track the underlying index is due to the way ETFs are structured. The way ETFs work is explained in detail in Module 2 'What are ETFs?'.

Topic 3: Why buy ETFs?

Diversification

Spreading your money across a range of asset classes can decrease your overall risk, as it reduces the impact on your portfolio if one or two of your investments perform poorly.



ETFs give you access to a range of markets and assets, both domestic and international.

ETFs offer diversification in one trade. For example you can get exposure to all the stocks in the index an ETF tracks, which may number several hundred. You pay brokerage on only one transaction.

In contrast, attaining diversification by direct shareholdings can be time-consuming and costly. You pay brokerage on each share purchase, and if your funds are limited, you may end up spreading them too thinly.

Income and growth

ETFs can offer returns in the form of income and capital growth.

Distributions are made either quarterly or half yearly depending on the ETF. For ETFs over the sharemarket, the fund receives dividends on the shares in the index, and passes through your portion, including any franking credits. The fund also passes on any capital gains it has made from selling shares.

There is also the potential for capital growth. If the sharemarket performs well, the value of your ETF will increase in line with the rise in the index. Of course if the index falls, your ETF will decrease in value.

Traded on ASX

ETFs are traded on ASX (and other market venues where available), making the purchase and sale process straightforward.

You buy and sell through your broker at any time during ASX trading hours, just as you buy and sell ordinary shares. Throughout the trading day you can check on the current price of your ETF.

The time of day you trade an ETF is important. Module 3 covers this in detail.

You also have the security of knowing you are trading on a market that is supervised and regulated.

Pay/receive close to net asset value

ETFs are structured so that the price of the ETF should be at or very close to the net asset value (NAV) - it will generally not trade at a significant premium or discount to the NAV.

The NAV reflects the market value of the underlying portfolio of shares (or other assets), adjusted for the fund's fees and expenses. It is calculated by dividing the value of the assets in the ETF (adjusted for fees and expenses), by the number of issued units.

This means the market price of your ETF is determined almost entirely by the NAV, and is not influenced by demand for and supply of the ETFs themselves.

Note that deviations from NAV are possible, so it can be wise to research the NAV and current price before trading.

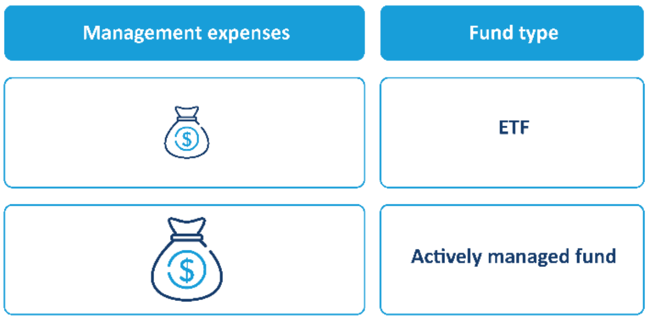
Low management expenses

ETFs are index funds, so are 'passively' managed. The securities the ETF holds are determined generally by the composition of the relevant index.

ETF management expenses are generally low.

Many other managed funds are 'actively' managed. The fund manager attempts to outperform a benchmark, and therefore makes decisions about the assets the fund holds.

The costs of actively managed funds are typically higher than those of ETFs.



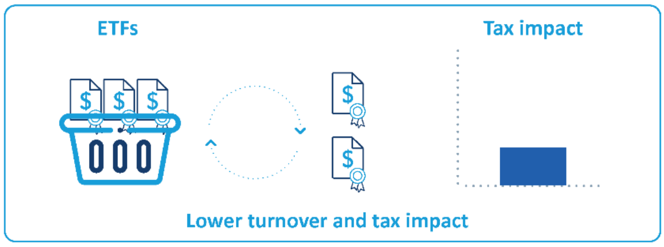
Tax efficient

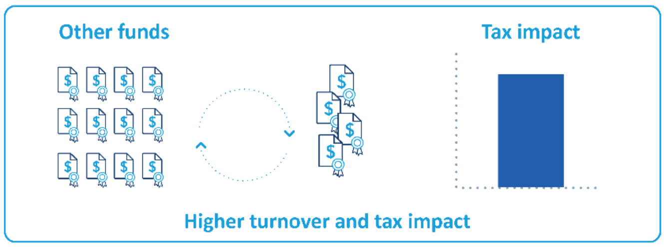
ETFs operate in a tax efficient way.

There is typically very low turnover in the portfolio, as securities are usually bought and sold only when the composition of the relevant index changes.

As a result, the fund itself realises few capital gains or losses, minimising the tax impact on investors in the fund.

Capital gains/losses made by the fund are separate from any capital gain or loss you make when you sell your ETFs.





Topic 4: Risks of ETFs

Like all investments, ETFs involve risk. They offer exposure to a diverse range of assets, so risk profiles may vary significantly between different ETFs.

The main risks are that:

- the value of the portfolio falls (market risk)
- fluctuations in the value of the Australian dollar affect the value of ETFs over international assets (currency risk)
- you may not be able to sell your ETFs for a fair price (liquidity risk)
- ETFs can experience mispricing and divergence from NAV

Let's look at these risks in more detail.

Market risk

The portfolio underlying an ETF comprises many securities, protecting you against the specific risk of an individual security performing poorly.

However, you are still exposed to market risk.

For example, if the broad Australian sharemarket falls, an ETF that tracks the S&P/ASX 200 index will fall in value. This is called market risk.

Similarly, an ETF that tracks a sector index such as a resources index will fall in value if the resources sector performs poorly. This is called sector risk.

Currency risk

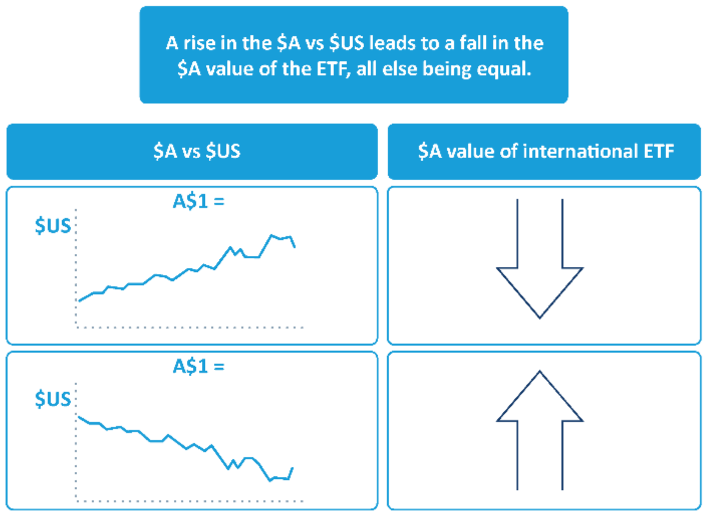
ETFs such as international ETFs and some commodity ETFs expose you to currency risk.

In the case of international ETFs, the underlying portfolio comprises assets, such as shares, listed on overseas markets. Those assets are priced in the currency of the overseas market.

The foreign currency value must be converted into Australian dollars before the ETF can be traded on ASX. A rise in the value of the Australian dollar against the currency of the country you have exposure to can lead to a fall in the value of your ETF.

Currency risk is covered in detail in Module 5, 'International ETFs'.

You may also be exposed to currency risk if you invest in commodity ETFs as commodities are priced in US dollars. Currency risk in commodity ETFs is covered in Module 7.



Liquidity risk

This is the risk you may not be able to sell your ETFs for a fair price. There may be insufficient orders to buy or the price may be too low.

Liquidity can vary between different ETFs. Some are actively traded. Others have relatively low turnover, which can make buying and selling at a fair price more difficult.

In the absence of natural buyers and sellers you may trade with a market maker. There is more on market makers in Module 3.

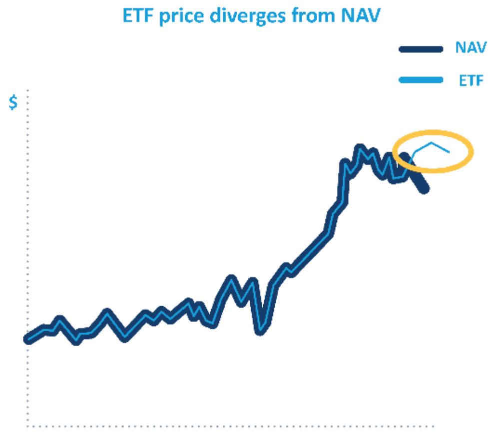
Tracking/pricing errors

There may be times when an ETF's price does not exactly follow the price of the index or investments it is designed to track.

This may be because the portfolio of assets the ETF holds does not move exactly in line with the index being tracked.

Or it may be that the price of the ETF temporarily moves away from the NAV of the fund.

The risk of divergence from the NAV is higher at certain times of the trading day. This is discussed in more detail in Module 3.



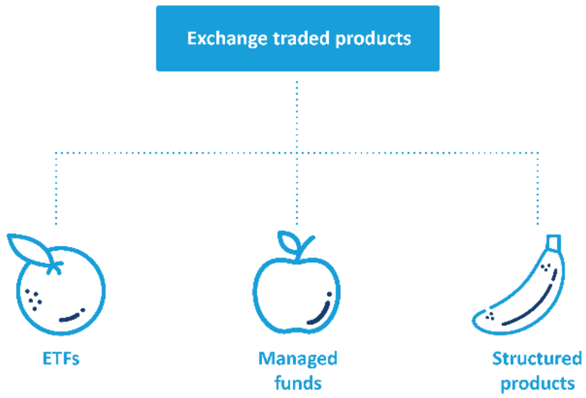
Avoiding confusion with similar but different products

There are products that have similar characteristics to ETFs but which may be a managed fund or a type of structured product.

While these products may be grouped on websites with ETFs, they have their own features, benefits and risks. It is important to know what product you are trading, and to understand the risks involved. Take note of the name of any product you are looking to trade.

The ASX website contains information about ETFs, structured products and managed funds, which are collectively referred to as exchange traded products (ETPs).

The Australian Securities and Investments Commission (ASIC) has published useful information on ETFs on their MoneySmart website.



Topic 5: ETF strategies

You can use ETFs in a number of ways, including:

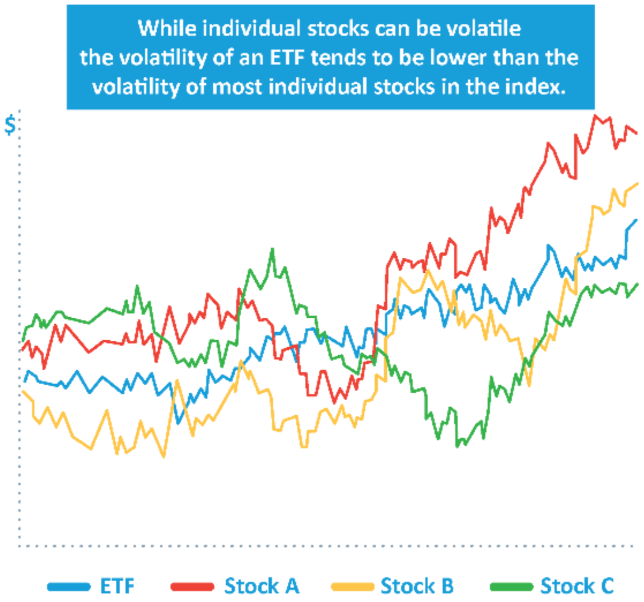
- instant diversification
- core plus satellite
- geared exposure through margin lending
- adjust asset allocation.

Let's take a look at these applications in detail.

Instant diversification

For example, an ETF provides exposure to all the stocks in the underlying index, giving you instant diversification, no matter how small your investment.

Having your money spread across a range of shares can decrease your overall risk, as it reduces the impact on your portfolio if one or two companies perform poorly.



Core plus satellite

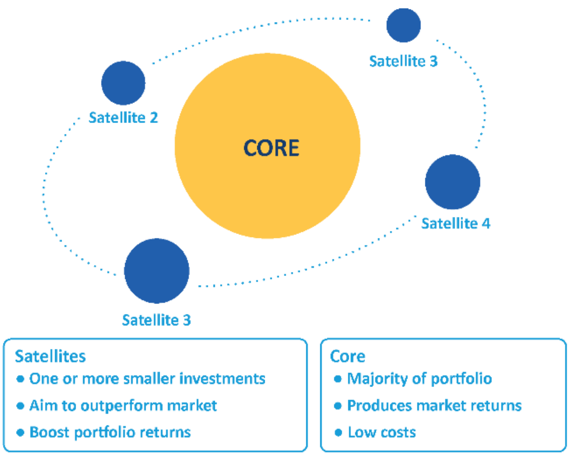
The core plus satellite approach has two elements:

- a core portfolio that produces returns in line with the market, and
- one or more investments the investor thinks will outperform the market (satellites).

The investor looks to the satellites to boost overall returns by taking advantage of opportunities, but relies on the core to generate market returns.

An important consideration in this approach is that you achieve your core returns at low cost - you don't want to pay high costs simply to achieve market returns.

ETFs typically serve as the 'core' investment.



For example, you could buy ETFs that track the performance of the S&P/ASX 200 index as the core of your portfolio, producing market returns at low cost.

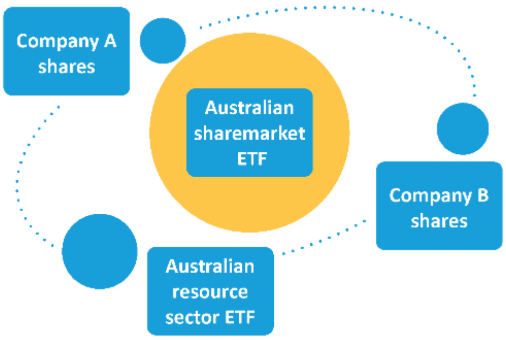
The satellites could be individual shares you think will outperform the market, or actively managed funds.

You can also use ETFs as satellites.

If you think a particular sector will do well, you could buy ETFs that give you exposure to that sector.

Or you might have a view that an overseas market will perform strongly, and buy ETFs that track the overseas market's index.

Construct a core plus satellite portfolio in which:
- The core is an ETF that tracks the broad Australian sharemarket.
- Satellites are:
  - an ETF that tracks the Australian resource sector index
  - shares in company A
  - shares in company B



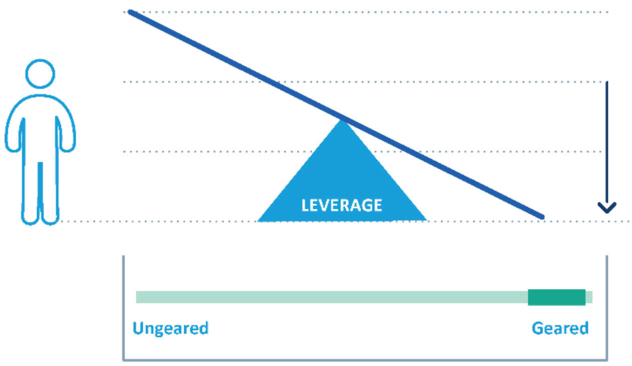
Using gearing increases your potential for profit and loss.

Geared exposure

You can use ETFs as part of a geared investing strategy such as margin lending.

ETFs are generally on the list of 'approved products' against which margin lenders will lend you money.

Using borrowed funds to invest in ETFs can increase your returns if the ETF performs well. However, you will suffer increased losses if the ETF performs badly.



Adjust asset allocation

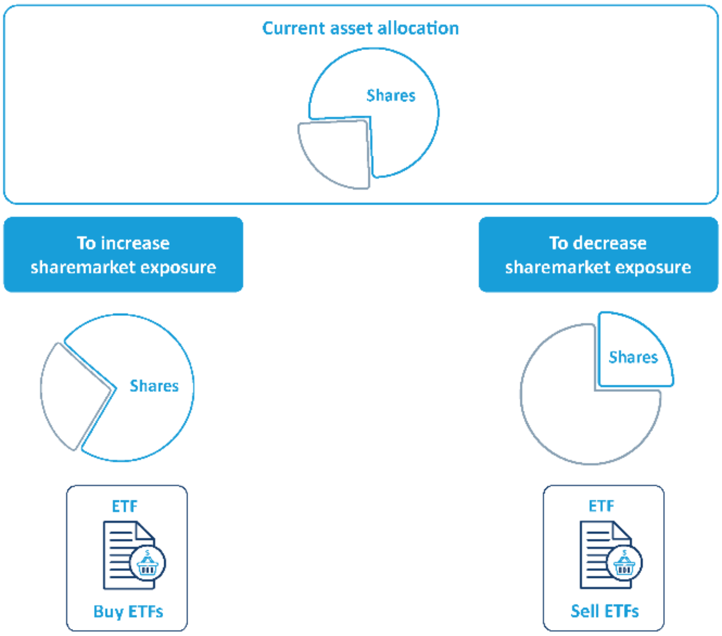
In Topic 1 we looked at the importance of asset allocation - the way you spread your money between asset classes such as:

- Australian shares
- international shares
- property
- bonds, and
- cash.

Your asset allocation has a significant impact on your investment returns.

From time to time you may want to adjust your asset allocation - for example changing your exposure to shares.

ETFs enable you to easily adjust your weighting to the sharemarket, or a sector of it, in one transaction - buying ETFs to increase your exposure, selling to decrease it.



Summary

- ETFs are big picture investments, enabling you to trade a view on the sharemarket as a whole. For example in one trade you can get diversified exposure to the Australian sharemarket or a market sector, or to an overseas sharemarket or sector. You have leveraged exposure to price movements in the underlying asset.
- Benefits of ETFs include:
  - potential returns in the form of income and capital growth
  - low management fees
  - trading at or close to their net asset value.
- ETFs are traded on ASX.
- You buy or sell ETFs through a stockbroker, just as you would buy or sell shares. Live prices are available throughout the trading day.
- The main risks of ETFs are that:
  - the value of the underlying asset falls
  - exchange rate movements affect the value of ETFs over international assets and commodities
  - the ETF's price may diverge from the value of the underlying index or assets.
- You can use ETFs in a number of ways, including:
  - To achieve instant diversification
  - as part of a 'core plus satellite' approach
  - as part of a geared investing strategy
  - to adjust your asset allocation.