Module 4 Australian ETFs

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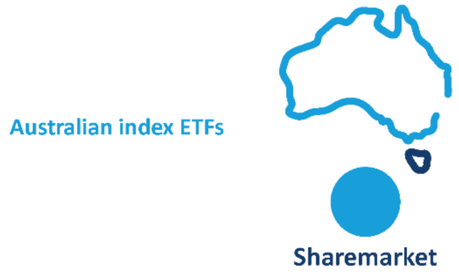
Topic 1: Australian sharemarket exposure

Exchange traded funds (ETFs) are 'big picture' investments, giving you exposure to a broad range of assets in one trade.

Australian ETFs are available over:

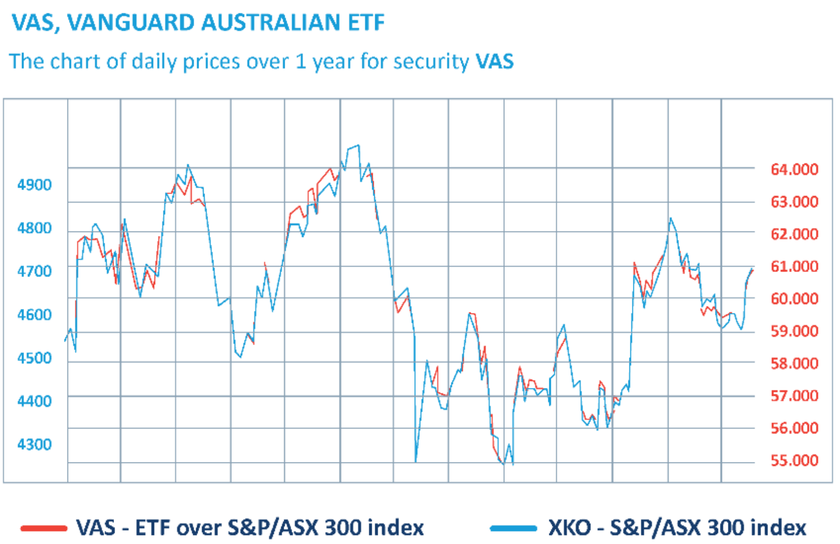
- the Australian sharemarket as a whole,
- sectors of the Australian sharemarket,
- an investment strategy such as enhanced dividend yield, or
- the Australian fixed interest market (covered in Module 6).



Each ETF has 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.

Before we look at domestic ETFs in detail, it's important to understand exactly what a sharemarket index is.



What does an index measure?

A sharemarket index is a measure of the performance of a group of stocks.

Some indices measure the performance of the broad Australian sharemarket, for example the S&P/ASX 200 index, which measures the performance of the top 200 stocks (by size) on ASX.

Other indices measure the performance of a sector of the market, for example the S&P/ASX 200 Energy index and the S&P/ASX 200 Financials index.

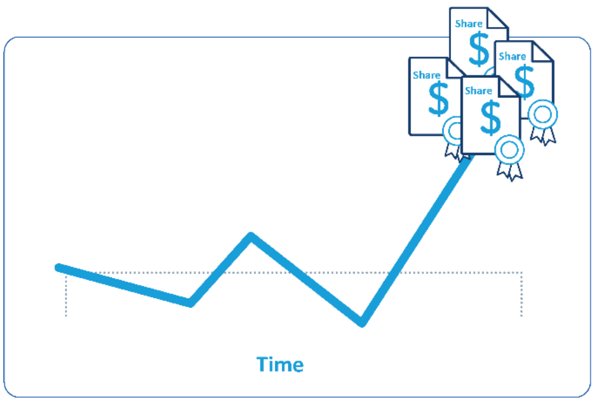
Index	Index type
S&P / ASX 200 Telecommunications	Sector index
S&P / ASX 200	Market index
All Ordinaries	Market index
S&P / ASX 200 Health Care	Sector index
S&P / ASX 300	Market index
S&P / ASX 200 Utilities	Sector index

What makes the level of an index change?

The index level changes as prices of the shares in the index change.

Over a given period, not all stocks move in the same direction, or by the same amount. The index measures the net effect of price movements of the stocks in the index.

You can refer to movements in an index to gauge how the market, or market sector, has performed over time.



Relative influence

Most Australian indices are capitalisation- weighted.

In simple terms, a company's market capitalisation depends not just on its share price, but also on the number of shares on issue.

The larger the company, the greater its weighting in the index, and the greater the impact changes in its share price will have on the value of the index.

For example, a 2% movement in the share price of BHP Billiton, the largest company on ASX, will have a greater effect on the S&P/ASX 200 index than a 2% movement in the price of the stock ranked 150th.

Change in share price	Share price	Number of shares on issue	Market capitalisation	Relative influence on index
5%	$10.00	20 million	$200 million	Medium
5%	$5.00	100 million	$500 million	High
5%	$10.00	10 million	$100 million	Low

Accumulation indices

Two versions of S&P/ASX indices are calculated.

The price return index is a measure of performance that takes into account only the prices of the shares in the index.

The total return (accumulation) index takes into account both the price of shares and the dividends paid by those shares. It assumes that all dividends are reinvested.

Typically Australian ETFs track accumulation indices. When you invest in an ETF over an accumulation index you receive the benefits of those dividends paid by the companies in that index.

Topic 2: How ETFs work for you

Broad market exposure

ETFs track the performance of an index.

Australian broad based index ETFs track indices including:

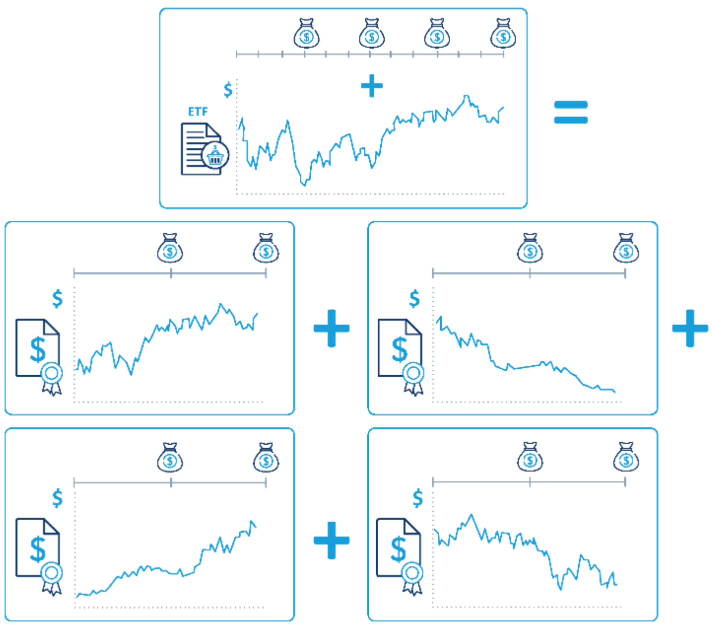
- the S&P/ASX 50 index
- the S&P/ASX 200 index, and
- the S&P/ASX 300 index.

Income and growth

If the sharemarket performs well, the value of your ETFs will increase in line with the rise in the index. If the index falls, your ETFs will decrease in value.

You also receive regular distributions, usually either quarterly or half-yearly.

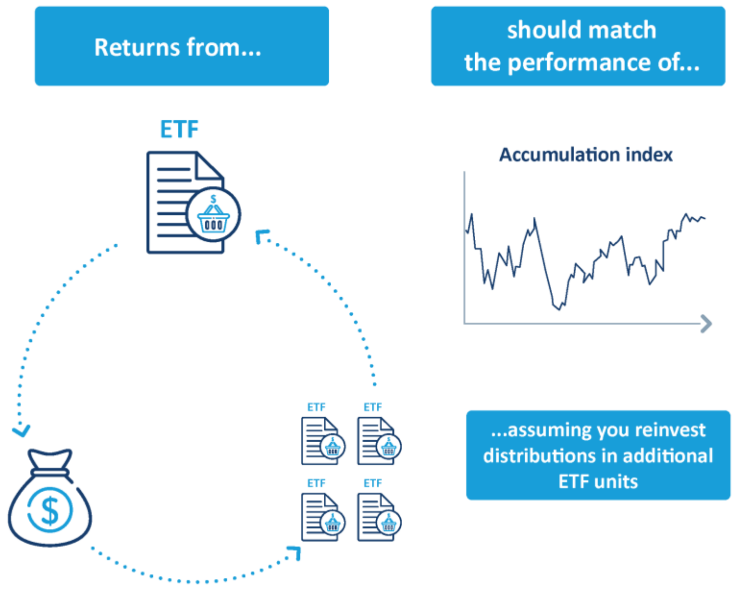
Distributions include your share of dividends and any franking credits received by the fund from shares in the index. They also include your share of any capital gains the fund makes from selling shares.



Investment objective

An investment in an ETF is designed to closely follow the same returns (before fees and expenses) as the relevant index, assuming you reinvest all distributions in additional ETF units.

Most ETFs offer a distribution reinvestment plan (DRP). If you participate in the DRP, your distributions are automatically reinvested.

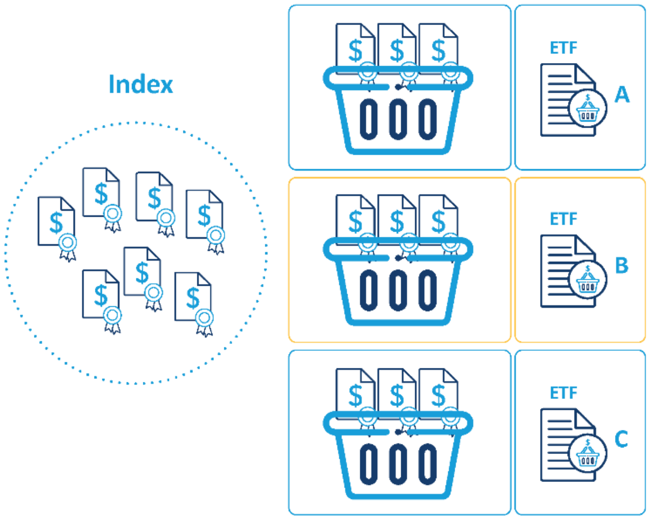


Passive investment

An ETF is a passive investment.

The shares held by the ETF are determined by the composition of the index.

The fund manager's job is to closely track the performance of the index. The fund manager does not attempt to outperform the index by taking overweight or underweight positions in individual stocks.



Market price vs. index level

A common misconception is that the index level will be the price of the ETF. This is not necessarily so.

For example, the S&P/ASX 200 index closed at 4462 points. The SPDR 200 ETF (ASX code: STW), an ETF that tracks the S&P/ASX 200, closed at $42.65.What matters is that in percentage terms, a change in the level of the index will result in a similar percentage change in the price of the ETF.

S&P/ASX 200 Index		SPDR 200 ETF	
Closing level	% change	% change	Closing price
4,686.6			$44.52
4,691.3	0.10%	0.09%	$44.56
4.681.4	-0.21%	-0.27%	$44.44
4,697.5	0.34%	0.32%	$44.58
4,618.2	-1.69%	-1.53%	$43.90
4.619.9	0.04%	0.00%	$43.90
4,699.1	1.71%	1.69%	$44.64

Topic 3: Sector and strategy ETFs

ETFs can focus on a sector of the market

An ETF can track a sector index. These ETFs give you exposure to a particular segment of the Australian sharemarket, rather than to the broad market as a whole.

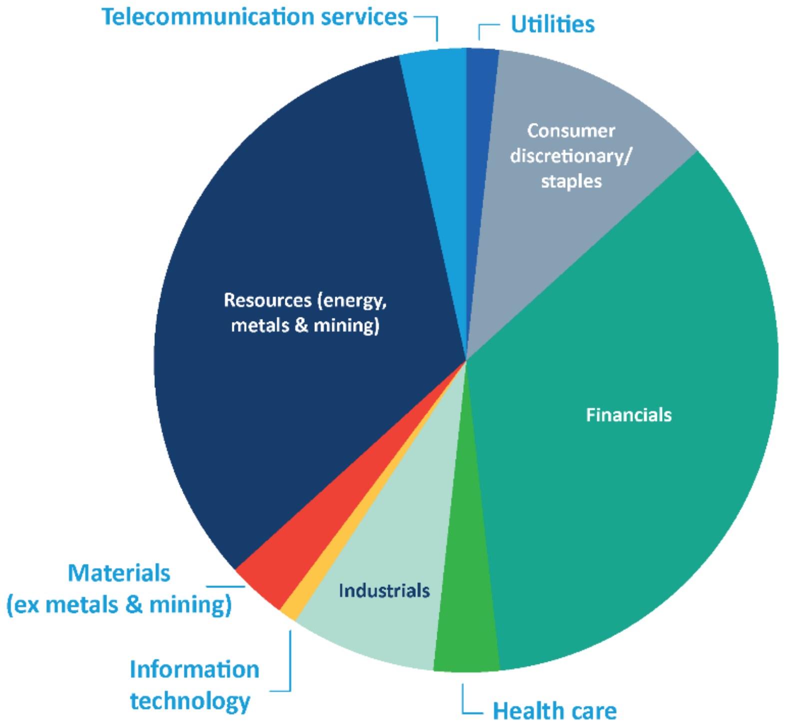
What is a market sector?

A market sector consists of a group of companies from the same or similar industries.

The Australian market uses the Global Industry Classification System (GICS) to classify companies into various sectors and industry groups such as:

- Energy
- Financials
- Industrials, and
- Telecommunication Services.

Please refer to the ASX website for more information on market sectors.



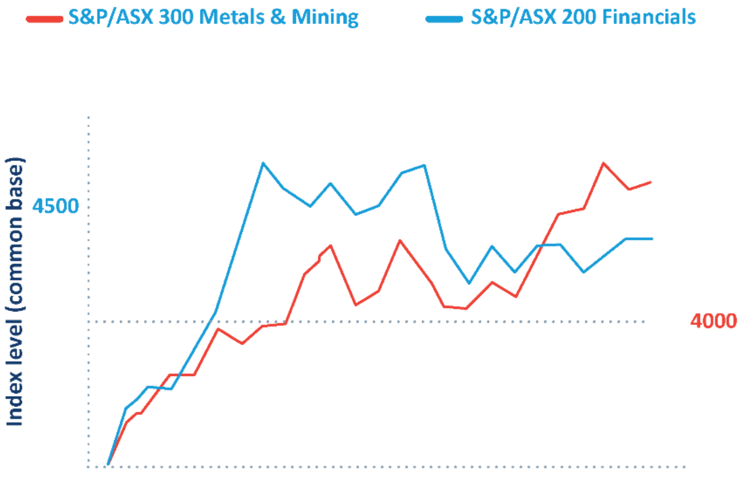
What does a sector index measure?

A sector index measures the performance of the companies that fall into that sector.

For example, the S&P/ASX 200 Financials index measures the performance of the companies within the S&P/ASX 200 index that are classified by GICS into the 'Financials' sector.

Some indices measure the performance of several GICS sectors combined.

For example, the S&P/ASX 200 Resources Index measures the performance of companies within the S&P/ASX 200 index that are classified by GICS into the 'Energy' or 'Metals or Mining' sector.

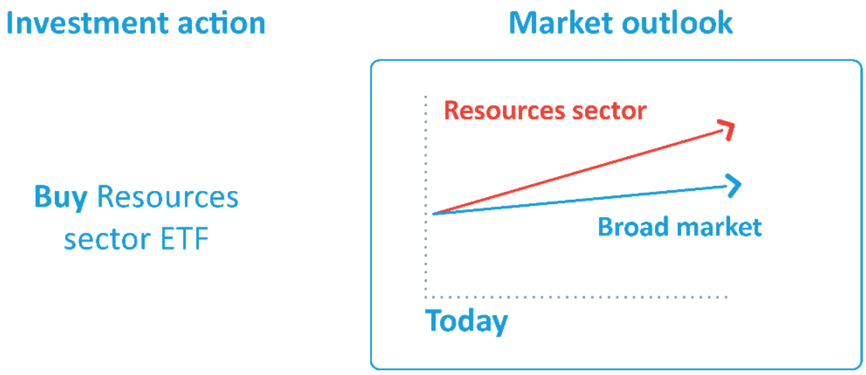


What do ETFs with a sector focus try to achieve?

A sector ETF allows you to trade a view that a particular market sector will perform well.

Buying a sector ETF gives you instant exposure to stocks in that sector. Rather than having to pick stocks, you gain diversified exposure.

For example, if you think the Resources sector will outperform the broad sharemarket, you could buy an ETF that tracks the S&P/ASX 200 Resources index.



Strategy ETFs

Sometimes investors have themes they want to pursue - such as enhanced dividend yield.

A bespoke index may be created to serve as a benchmark against which to measure the performance of that strategy. It is then possible to issue an ETF that tracks that index.

Indices that are created specifically for the purpose of issuing these niche ETFs may be subject to more frequent compositional change than other indices. The PDS for the ETF will contain information about how the index is constructed, and provide details of any relationship that exists between the index provider and the ETF issuer.

Topic 4: Risks

Investing in ETFs involves risk. For more detailed coverage of the risks, please refer to the issuer's website and the ETF's PDS.

Two key risks particularly relevant to domestic ETFs are:

- market risk, and
- portfolio duplication.

For coverage of other risks that apply to all ETFs, please refer to Module 1.

Market risk

The portfolio underlying an ETF is diversified across 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.

Similarly, an ETF that tracks a sector index such as the S&P/ASX 200 Resources Index will fall in value if the resources sector performs poorly. This is called 'sector risk'.

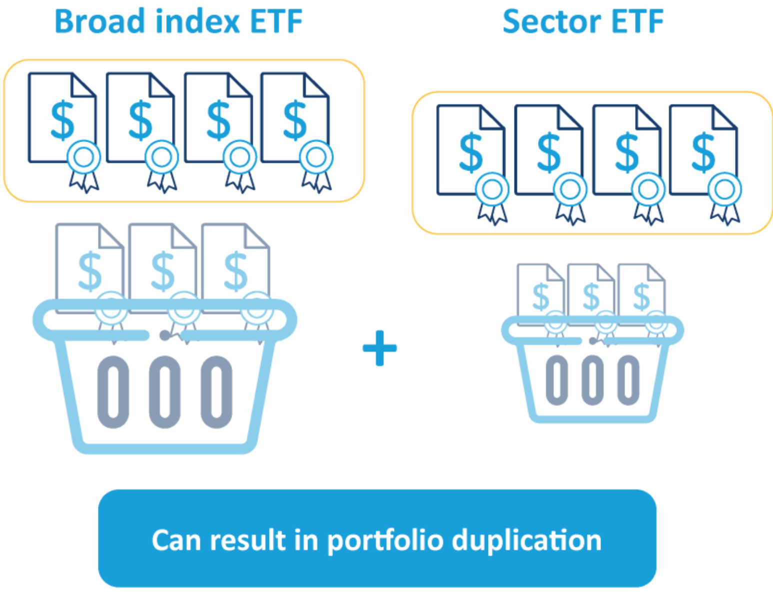
Portfolio duplication

This is a risk associated with sector ETFs.

If you hold a diversified portfolio of shares, or an ETF that tracks the broad sharemarket, adding a sector ETF may duplicate an existing exposure to that market sector.

You should consider your total exposure to a market sector, not just the exposure the sector ETF gives you.

For example, a diversified share portfolio is likely to include stocks in the financial sector. It is wise to take this existing exposure into account if you are considering buying an ETF that tracks the Financials index.


Broad index ETF
Sector ETF
Can result in portfolio duplication

Topic 5: Case study: SPDR S&P/ASX 200 Fund

Let's take a look at a domestic index ETF.

The largest ETF currently traded on ASX is the SPDR S&P/ASX 200 Fund - the 'SPDR 200' with ASX code 'STW'.

The SPDR 200 is issued by State Street Global Advisors (SSGA), and tracks the S&P/ASX 200 index.

The S&P/ASX 200 index measures the performance of the top 200 stocks on ASX, and represents over 80% of the Australian equity market capitalisation. It is regarded as the benchmark index of the Australian sharemarket.

Please refer to the list of ETFs on the ASX website to complete the activity opposite.

ETF	ASX code
SPDR 50	SFY
SPDR 200	STW
Vanguard Australian Shares Index	VAS

What is the fund's investment objective?

The SPDR 200's investment objective is to provide investment returns, before fees and costs that closely correspond to the performance of the S&P/ASX 200 accumulation index, assuming you reinvest distributions in additional units in the ETF.

To complete the activity opposite you will need to go to Company Information on the ASX website, and enter the SPDR's ASX code that you found in the previous activity.

▶ **How often does the SPDR 200 pay distributions?**

○ Once a year ● Twice a year ○ Four times a year

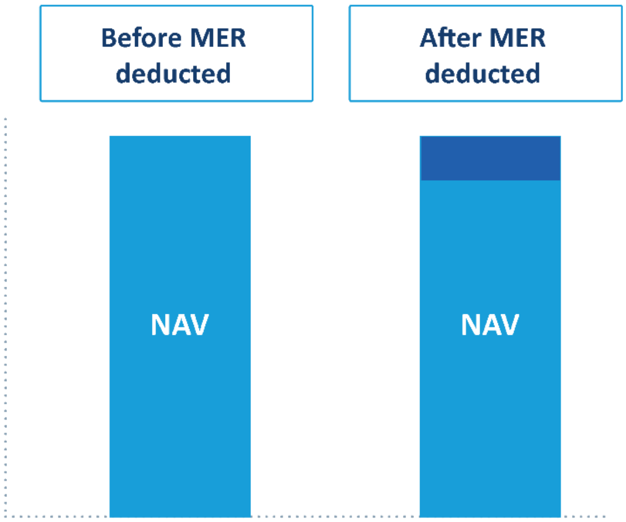
▶ **Do SPDR 200 distributions have franking credits attached?**

○ Once a year ● Twice a year

What are the costs?

As at January 2013 the Management Cost Ratio of the SPDR 200 is 0.286% of the fund's net asset value (NAV).

The management fee is factored into the NAV, so it is reflected in the ETF's price. You do not have to make a separate payment to the issuer.



Information about the NAV and underlying portfolio

Every day, the issuer - SSGA publishes the NAV, and details of the basket of securities underlying the ETF.

You can find NAV information on the issuer's website, and in the case of the SPDR 200, by going to Market Announcements on the ASX website.

There is also an indicative NAV that is continually updated during the trading day. You can find this on your broker's website by typing the code 'YSTW'.

Summary

- Domestic ETFs track an Australian sharemarket index.
- An index is a measure of the performance of a group of assets, and can be:
  - a broad sharemarket index such as the S&P/ASX 200, or
  - a sector index, such as the S&P/ASX 200 Financials.
  - a bespoke or niche index constructed to reflect a particular investment strategy, which allows ETFs to be issued over that index, or
- A total return (accumulation) index takes into account both the price of shares in the index and distributions paid by those shares. It assumes all dividends are reinvested.
- An investment in an ETF is designed to closely follow the same returns (before fees and expenses) as the relevant accumulation index, assuming you reinvest all distributions in additional ETF units.
- A domestic sector ETF gives you exposure to a particular sector of the Australian sharemarket.
- You can use a sector ETF to trade a view on a particular sector, for example buying ETFs if you think the sector will outperform the broad sharemarket.
- A strategy ETF can be used to pursue a particular investment themes, such as enhanced dividend yield.
- The main risk of buying an index ETF is that the market or sector performs poorly, resulting in a fall in the price of your ETF.
- Buying a sector ETF also involves the risk of duplicating an exposure you already have to that market sector.