# Module 0
# Where do ETFs fit in?

ASX

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# Topic 1: Creating a diversified portfolio

## Diversification

A widely accepted fundamental of investing is that investors should be exposed to a range of different assets.

Spreading your investment funds among asset classes such as Australian and international shares, property, fixed interest and commodities means you don't have 'all your eggs in one basket'.

Diversification reduces your risk, and can improve your investment returns.

## More than just shares

Most investors are familiar with the idea of buying shares on ASX. Shares give you an ownership stake in a company, providing you with exposure to the performance of that company.

However ASX's range of products extends further than shares.

Other products provide different investment outcomes, or access to other assets.

## Why are there different product structures?

The range of products available on ASX increases your investment options.

You can:

- get exposure to an asset class that is difficult to invest in directly, such as commodities, commercial property, or emerging markets
- achieve a range of different investment outcomes, such as the leveraged exposure provided by options and warrants
- achieve exposure to multiple underlying assets in one trade, via products such as managed funds or exchange traded funds (ETFs).

The different product types have their own features, benefits and risks.

It is important to have a general understanding of the key differences between the various products quoted on ASX, and of the risks involved.

# Topic 2: Product type and ASX rules

## Listing Rules and AQUA Rules

The majority of products quoted on ASX, including shares, real estate investment trusts (REITs) and listed investment companies (LICs) are governed by the ASX Listing Rules.

The AQUA Rules were added to the ASX Rules framework in 2008 to accommodate products that did not fit easily under the Listing Rules. They govern three broad types of product:

- managed funds
- ETFs, and
- structured products.

The PDS will tell you which set of rules a product is listed under.

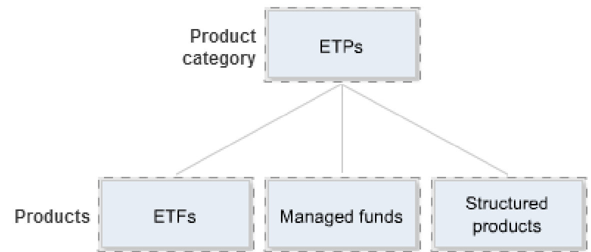
While it is useful background information, you don't need to know the details of the rules framework under which a product is listed in order to make successful investments.

| Product | Rules framework |
| --- | --- |
| • ETFs<br>• Managed funds<br>• Structured products | AQUA Rules |
| • Shares<br>• REITs<br>• LICs | Listing Rules |

# Topic 3: Structured products & managed funds

## Exchange traded products

Products traded under the AQUA rules are referred to collectively as 'exchange traded products' (ETPs) (The term 'ETP' is not formalised in the AQUA Rules but is a term preferred by the financial regulator ASIC.)




The ETP family comprises:

- exchange traded funds (ETFs)
- structured products, and
- managed funds

All ETPs have certain features in common, but there are also some important differences. You should read the PDS to ensure you understand the features and risks of the product you are considering investing in.

## What makes these products similar?

ETFs, structured products and managed funds give you convenient, cost-effective exposure to assets or investment outcomes that may be difficult to access in other ways.

For example, exposure to commodities, currencies or emerging markets.

They can also provide exposure to a diversified portfolio of shares or bonds that would require many trades and high transaction costs to construct directly.

| Exchange traded products | |
|---|---|
| Portfolio of assets in one trade | ✓ |
| Exposure to markets that are difficult to access | ✓ |
| Can be cost-effective | ✓ |
| Range of different investment styles | ✓ |

## What makes these products different?

The key distinctions between the different products in the ETP family have to do with:

- investment style
- product backing, and
- counterparty risk.

***Investment style***

ETFs are passively managed, and typically track an index. The ETF manager's job is to replicate the performance of the index.

| Product | Management style | |
|---|---|---|
| | Passive | Active |
| ETF | ✓ | ✗ |
| Managed fund | ✓ | ✓ |

A managed fund may be either passively managed like an ETF, or actively managed. If it is actively managed, the fund manager attempts to outperform a benchmark.

### *Product backing*

Physical ETFs hold a portfolio of the assets in the index that they are tracking. Each unit in the ETF represents an interest in the portfolio.

For each product, indicate whether you are exposed to the performance of:
• the underlying assets
• the product issuer.

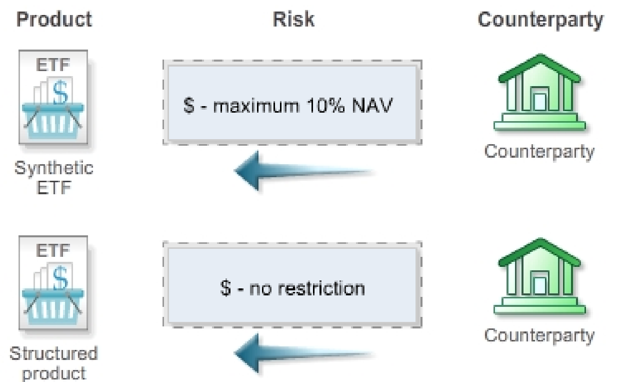
| Product | Exposure to performance of: | |
|---|---|---|
| | Underlying assets? | Product issuer? |
| ETF | Yes | No |
| Structured product | Yes | Yes |

In contrast, most structured products are not physically backed. Instead the product is a promise (which may be secured or unsecured) by the issuer to provide you with the performance of a specified index. As well as being exposed to the performance of the underlying assets, you also rely on the issuer fulfilling their obligations under the terms of issue of the product.

Most structured products have '(structured products)' included in their name.

### *Counterparty risk*

Counterparty risk is the risk that the third party fails to meet some or all of its obligations, with consequent loss for the ETP.




ASX has requirements designed to minimise counterparty risk for ETFs. Under ASX rules, counterparties can owe an ETF no more than 10% of the fund's net asset value (NAV). If that limit is breached, the ETF must take action immediately to reduce the exposure.

This rule does not apply to structured products. An investor in a synthetic structured product may be exposed to a much higher level of counterparty risk. (A synthetic structure may involve the product issuer entering a derivative contract, such as a swap, with a third party.)

ETPs that use a synthetic structure must have the word '(synthetic)' in their name. You should read the PDS to ensure you understand the risks involved.