

Exchange Traded Funds

The Beginner's Guide



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The beginner's guide to exchange traded funds

Exchange traded funds offer instant diversification at low cost. With almost 100 ETFs clamouring for your attention, in this special report we narrow down the list to the ones you might actually buy.

INTRODUCTION

One per cent doesn't sound like much. You probably wouldn't drive a few extra kilometres for petrol that was one per cent cheaper, would you? Yet when it comes to investing costs, it can make a huge difference.

Consider John and Olivia. Ten years ago John invested \$100,000 in a managed fund that charged a management fee of 1.5% every year. Olivia invested the same amount in an index fund (don't worry, we'll explain the difference shortly) that charged 0.5%. Both funds generated the same performance of 9% a year, about the same as the All Ordinaries index, before costs.

Table 1 shows the difference after costs. Yesterday John owned an investment worth \$206,000. Olivia, by contrast, has ended up with almost \$226,000. A 1% difference in annual costs has amounted to almost \$20,000 of investment value over the decade. Olivia's already booked her round-the-world holiday and can't wait to visit New York, Paris and Istanbul.

TABLE 1: WHICH ONE DO YOU WANT?

	JOHN	OLIVIA
FUND TYPE	Managed fund	Index fund
STARTING CAPITAL – 2004	\$100,000	\$100,000
RETURN (% P.A.)	9.00%	9.00%
MANAGEMENT FEE (% P.A.)	1.50%	0.50%
ENDING CAPITAL – 2014	\$206,103	\$226,098
DIFFERENCE	\$19,995 less than Olivia	\$19,995 more than John

Expenses matter. It wouldn't be so bad if you received better performance for your management fee. But studies show that – on average – investment managers underperform the market over long periods. And if you're thinking individual investors do better, think again. On average 'Mum and Dad' investors perform even worse than the professionals because they tend to buy on wild optimism and sell during tough times.

SHOPTALK 1

Outperform: Investment managers generally manage money with the intention of 'outperforming'. This means they aim to exceed the return produced by some benchmark, such as the All Ordinaries index or the S&P/ASX 200 index.

Warren Buffett has said as much. In fact, he suggests that most investors shouldn't even try to outperform (see Shoptalk 1). In the 1993 Berkshire Hathaway letter to shareholders, Buffett stated:

'By periodically investing in an index fund ... the know-nothing investor can actually outperform most investment professionals. Paradoxically, when "dumb" money acknowledges its limitations, it ceases to be dumb.'

Buffett has here appropriated Wall Street's derogatory term for retail investors, so he was not deriding them himself. He was simply stating that outperformance is difficult, and many people spend more time and money attempting it than is justified. His solution is the same one he has recommended to his wife after he dies: Buy a low-cost index fund.

INDEX FUNDS VS ETFS

What, then, is an index fund? It's similar to a managed fund – because it pools investor money to buy a diversified portfolio of assets – except that you're not paying for investment 'expertise'. An index fund buys assets to mirror a particular benchmark, such as the S&P/ASX 200 index. So an investor in an S&P/ASX 200 index fund would own a stake in the 200 stocks in that index. The idea is that you get the market return, less costs (but more on those later).

But this special report, as you may have gathered from the title, is about exchange traded funds. So what do index funds have to do with exchange traded funds?

SHOPTALK 2

Exchange traded fund (ETF): A fund, usually structured as a unit trust, which holds assets similar to a managed fund. Unlike a managed fund, the units in an ETF are listed on a securities exchange, enabling investors to buy and sell in a similar manner to shares. ETFs are commonly, although not always, low-cost funds that track an index closely.

Well an exchange traded fund – or ETF for short – is usually an index fund that is listed on a securities exchange such as the ASX. They're more accurately called 'exchange traded products' because they're not all funds (and, to complicate things further, they don't all mirror indices either). But for simplicity's sake let's use the term 'ETF' and deal with any exceptions as they arise.

A 1% difference in annual costs has amounted to almost \$20,000 of investment value over the decade.

ETF PROFILE: VTS

NAME: Vanguard US Total Market Shares Index ETF

ASX CODE: VTS

INDEX TRACKED: CRSP US Total Market index in AUD

LISTED ON ASX: 2009

MER (%): 0.05

UNDERLYING ASSET: 3,500 stocks listed on the NYSE and NASDAQ

DISTRIBUTIONS: Quarterly

CROSS-LISTED: Yes

CURRENCY HEDGED: No

SUITABLE FOR: Investors who want the broadest possible exposure to the US stock market.

WHAT WE LIKE: Significant diversification at an extremely low cost.

WHAT WE DON'T LIKE: Cross-listing may cause tax complications.

ALTERNATIVES: IVV (S&P 500)

ETF PROFILE: USD

NAME: BetaShares US Dollar ETF

ASX CODE: USD

INDEX TRACKED: n/a

LISTED ON ASX: 2011

MER (%): 0.45

UNDERLYING ASSET: US dollars

DISTRIBUTIONS: Semi-annual

CROSS-LISTED: No

CURRENCY HEDGED: n/a

SUITABLE FOR: Investors or travellers who wish to hedge against the Australian dollar falling.

WHAT WE LIKE: A low-cost way of 'buying' US dollars. Underlying asset is US dollars held in an interest-earning bank account.

WHAT WE DON'T LIKE: Australian dollar has already fallen more than 20% against the US dollar since 2011.

ALTERNATIVES: POU (British Pound), EEU (Euro)

TABLE 2: TYPES OF POOLED INVESTMENT VEHICLE (RETAIL)

	MANAGED FUND	INVESTMENT LISTED COMPANY (LIC)	INDEX FUND	EXCHANGE TRADED FUND (ETF)
STRUCTURE	Unit trust (fund)	Company (shares)	Unit trust (fund)	Unit trust (fund) – (generally)
LISTED?	No	Yes	No	Yes
COST P.A. (APPROX.)	1%–2.5%	0.2%–1.5%	0.7%–1.0%	0.1%–1.0%
CAN BUY/SELL AT NET ASSET VALUE?	Yes	Can be above or below	Yes	Yes (approximately)
MANAGEMENT STYLE	Active	Active	Passive	Passive (generally)
RANGE OF UNDERLYING INVESTMENTS?	Most types	Usually shares	Some types	Extensive range

So how are ETFs different from the alternatives?

We've already seen that an ETF is different from an index fund because it's listed, so it's arguably easier to buy. An ETF should also be lower cost than a managed fund because it doesn't have to pay as much for investment expertise. In exchange you give up the potential for outperformance and, more importantly, underperformance.

Another type of pooled investment vehicle you might know is a listed investment company (or LIC). While some – such as Argo Investments and Australian Foundation Investment Company – have costs even lower than most ETFs, they can trade above net asset value (see Shoptalk 3). ETFs, by contrast, are structured to trade in line with asset value so you won't pay \$1.10 for a dollar's worth of assets. ETFs, being funds rather than companies, also pass tax benefits – such as franking credits – through to their investors.

SHOPTALK 3

Net Asset Value (NAV): Net asset value (NAV) is calculated as the value of an investment entity's assets minus its liabilities (and is effectively the same as net tangible assets, or NTA). It's usually presented on a per unit or per share basis. For example, NAV of \$1.47 per unit.

As an easy and low-cost way to obtain instant diversification without paying a premium to asset value, then, ETFs have much to recommend them.

SHOULD YOU BUY ETFS?

So who should buy ETFs? Before answering that question, let's take a detour down the bumpy road called 'asset allocation'. The term refers to how a portfolio should be divided between different asset categories. Without the appropriate division – also known as diversification – your portfolio is less likely to achieve your personal goals.

You might already know a well-diversified portfolio should consist of cash, fixed interest, property, Australian shares and international shares. How much you allocate to each of these asset classes will depend on your personal goals and risk tolerance.

The topic of asset allocation could fill another special report (or a publication like [Super Advisor](#)). But what's

important here is that ETFs – like managed funds – can help you with it.

As a member of *Intelligent Investor Share Advisor*, you're probably already buying shares directly on the ASX (also known as 'direct share' investing). So you are – or at least think you can be – a 'know-something investor' to use Buffett's lexicon.

But you might be a know-nothing investor in other asset classes, such as international shares. Buying ETFs can get you exposure to international shares, or even a particular region's shares, quickly and easily. In the Meet the Investors section on [page 7](#) you'll find some specific ETF examples.

SHOPTALK 4

Active vs passive investment: An active management style of investing aims to produce returns that exceed a particular index (through stock selection, for example). Passive investing aims to replicate the returns of the index (through owning all or most of the stocks in that index). Investors can adopt active or passive management approaches – or a combination of both – in their own portfolios. Both approaches incur costs which will reduce the returns earned.

Returning to the original question, who should buy ETFs? Well there are three classes of investors they may be suitable for:

- 1. Completely passive:** Investors who don't have the time or the inclination to manage their own portfolios, and who don't believe investment managers can consistently outperform. Their portfolio – including the Australian and international share portions – is invested passively. People with busy careers or who want 'no-fuss' sharemarket exposure would fall into this category.
- 2. Combination of active and passive:** Investors who own a combination of direct shares, managed funds and ETFs. They invest actively themselves and might own some managed funds, but use ETFs for passive exposure to some asset classes, such as international shares. This category probably describes many members of *Intelligent Investor Share Advisor*.
- 3. Opportunistic/hedging:** Investors who use ETFs opportunistically or for hedging purposes. These investors, who are usually more aggressive,

opportunistically buy regional share ETFs or similar when they perceive the underlying market to be underpriced. Alternatively, they might buy ETFs that allow them to hedge against particular events (such as currency movements).

SHOPTALK 5

Hedging: A hedge is a risk management strategy designed to limit a loss or offset price movements in a stock, currency, or commodity market. If you intend to travel to the United States next year, for example, you could hedge against the risk of the Australian dollar declining by buying US dollars now (or you could buy a US dollar ETF). An international ETF that hedges against currency movements has undertaken agreements with other parties (known as counterparties) that limit the effect of those movements.

You probably fall into one of these categories, so there may be an ETF to suit you – which brings us to the next section.

TYPES OF ETFs

There are almost 100 ETFs listed on the ASX. Unlike overseas, where all sorts of weird and wonderful ETFs have emerged, the ASX and Australian Securities and Investments Commission have kept a firm hand on the regulatory wheel in Australia. So the ETFs listed here are more 'vanilla' than some overseas – and that's a good thing.

TABLE 3: TYPES OF ETFs

1. Australian large capitalisation ETFs
2. Australian small capitalisation ETFs
3. Australian sector ETFs
4. International ETFs
5. Strategy-based ETFs
6. Cash and fixed-interest ETFs
7. Currency ETFs
8. Commodity ETFs

The ASX-listed ETFs can be categorised as follows (our categories are slightly different to the [ASX's](#) but are easily reconciled):

1. **Australian large capitalisation:** ETFs that mirror an Australian large capitalisation index, such as the S&P/ASX 200 or the S&P/ASX 50.
2. **Australian small capitalisation:** ETFs that mirror an Australian small capitalisation index, such as the S&P/ASX Small Ordinaries.
3. **Australian sector:** ETFs that mirror an Australian sector index, such as the S&P/ASX 200 Resources or the S&P/ASX 300 A-REITS (property trust) indices.
4. **International:** ETFs that mirror an international index, such as the S&P 500 or the MSCI Japan.

The majority of investors will probably only select from ETFs within these first four categories. In particular, if you already 'do it yourself' buying Australian shares, you

might only consider the international ones (category 4). But there are other types of ETFs, and it's here that their investment approaches diverge from conventional index funds. The remaining categories are:

5. **Strategy-based:** ETFs that buy Australian or international stocks based on certain quantitative criteria, such as 'high dividends', or 'value', or that use other investment or hedging strategies. In 'The ETF worry list' on [page 7](#), you'll see why most of these are of limited appeal.
6. **Cash and fixed-interest:** ETFs that buy portfolios of cash deposits or bonds. These may appeal to some investors.
7. **Currency exposure:** ETFs that invest in certain currencies, such as US dollars or Euros. These may appeal to some investors (or even travellers).
8. **Commodity exposure:** ETFs that reflect price movements in particular commodities, such as gold, crude oil, or wheat. With one or two exceptions these are probably too high risk for most investors.

So they're the eight types of ETFs. But wait, there's more to know yet.

WHAT ELSE IS THERE TO KNOW?

The good stuff – where we tell you which ETFs you might want to buy – isn't far away. But you're not fully informed quite yet. Here we answer your burning questions.

HOW LOW IS 'LOW COST'?

The direct cost of an ETF is measured using a management expense ratio, or MER (see Shoptalk 6). In Australia, MERs for exchanged traded funds range from 0.05% to 1.3% a year. The lower the better, and you should probably aim for less than 0.5% in some cases – although you might consider going a little higher for some specialist international ETFs.

SHOPTALK 6

Management expense ratio (MER): Management expenses are the operating costs incurred in running a fund. In percentage terms, these are expressed as a percentage of fund assets. A \$100m fund that incurs expenses of \$1m a year has a MER of 1.0%.

But there are a couple of 'hidden' costs to remember. As ETFs are listed you'll pay brokerage, which makes them somewhat unsuitable for investors who wish – very sensibly – to make regular additional contributions. If this is important to you, then an unlisted index fund might be more appropriate.

Also, when you trade you should consider the spread between buy and sell prices on the market (known as the 'bid/ask spread'). We'll say more about this in *The ETF buyer's checklist* on [page 6](#).

ETF PROFILE: GOLD

NAME: ETFS Physical Gold

ASX CODE: GOLD

INDEX TRACKED: n/a

LISTED ON ASX: 2003

MER (%): 0.4

UNDERLYING ASSET: Gold bullion

DISTRIBUTIONS: n/a

CROSS-LISTED: No

CURRENCY HEDGED: No

SUITABLE FOR: Aggressive investors who want exposure to gold.

WHAT WE LIKE: This security, structured as a redeemable preference share, is physically backed by gold bullion held in a London vault.

WHAT WE DON'T LIKE: Gold is a speculative asset that pays no income.

ALTERNATIVES: n/a

ETF PROFILE: IZZ

NAME: iShares China Large-cap ETF

ASX CODE: IZZ

INDEX TRACKED: FTSE China 50

LISTED ON ASX: 2007

MER (%): 0.73

UNDERLYING ASSET: The 50 largest Chinese stocks that trade in Hong Kong.

DISTRIBUTIONS: Semi-annual

CROSS-LISTED: Yes

CURRENCY HEDGED: No

SUITABLE FOR: Investors who want exposure to the Chinese market.

WHAT WE LIKE: Chinese stocks are arguably inexpensive, although whether that applies to the top 50 stocks is hard to say.

WHAT WE DON'T LIKE: Relatively high cost. High exposure to financials. Cross-listing may cause tax complications.

ALTERNATIVES: IAA (for broader Asian exposure)

ETF PROFILE: STW**NAME:** SPDR S&P/ASX 200 Fund**ASX CODE:** STW**INDEX TRACKED:** S&P/ASX 200**LISTED ON ASX:** 2001**MER (%):** 0.29**UNDERLYING ASSET:** Top 200 Australian stocks**DISTRIBUTIONS:** Semi-annually**CROSS-LISTED:** No**CURRENCY HEDGED:** n/a**SUITABLE FOR:** Investors who want broad exposure to the largest Australian stocks.**WHAT WE LIKE:** The largest, longest-listed Australian ETF with fairly low costs.**WHAT WE DON'T LIKE:** There are a couple of lower-cost ETFs that track similar indices (e.g. VAS, IOZ). The Australian sharemarket is weighted to banks and resources.**ALTERNATIVES:** VAS, IOZ**ETF PROFILE: BEAR****NAME:** BetaShares Australian Equities Bear Hedge Fund**ASX CODE:** BEAR**INDEX TRACKED:** Negative correlation to S&P/ASX 200 index**LISTED ON ASX:** 2012**MER (%):** 1.19**UNDERLYING ASSET:** Sells ASX SPI 200 futures.**DISTRIBUTIONS:** Annually**CROSS-LISTED:** No**CURRENCY HEDGED:** No**SUITABLE FOR:** Aggressive investors who want to profit from the Australian sharemarket falling (or hedge against it).**WHAT WE LIKE:** Easy way to go 'short' the Australian market.**WHAT WE DON'T LIKE:** Relatively high cost. The Australian sharemarket tends to rise over time.**ALTERNATIVES:** n/a**IS AVERAGE GOOD ENOUGH?**

If you own an ETF that mirrors an index, you will by definition get the average return (less costs). Some people dislike the idea of average and feel they should do better. Only you can answer this question, but human beings are notoriously overconfident about their ability to beat the market.

HEDGED OR UNHEDGED?

This question applies to ETFs that own international assets, or assets priced in a non-Australian currency. Almost all are unhedged, which means your return will also be influenced by how currencies move. If the Australian dollar rises, then the value of your ETF will fall, all else being equal (and vice versa). Generally our view is that currency diversification is one of the benefits of owning international assets, so unhedged currency exposure is desirable. That's certainly been true in recent years because the Australian dollar has been historically high although, having fallen more than 20% against the US dollar since 2011, it's becoming less desirable. If you want to remove the effect of currency fluctuations, there are a small number of hedged ETFs.

WHAT ABOUT DISTRIBUTIONS?

ETFs pay distributions in the same way as managed funds (assuming the underlying assets produce income). Depending on the ETF, distributions might be made monthly, quarterly, semi-annually or annually.

Any franking credits will be passed through to you. You'll generally receive a tax statement after the end of the financial year that you'll need to complete your income tax return.

WHAT ARE THE TAX IMPLICATIONS?

One advantage of ETFs is that the underlying portfolio requires relatively few changes (for example, only when a stock is added to or removed from an index). Less portfolio turnover means fewer capital gains will be realised, so ETFs are usually more tax efficient than their managed fund counterparts (where portfolio turnover can exceed 100% a year or more).

As with any investment, you'll be subject to capital gains tax when you sell.

TAX ISSUES

If you buy an ETF that invests in international shares, check whether it is cross-listed in the USA (most are). If it is, you'll need to complete the W8-BEN form the registry will send you to reduce US withholding tax. You could also be subject to US estate tax on your international ETFs should you die. Seek advice.

So far, so simple. But international ETFs might have a sting in the tax tail. Many of them are cross-listed in the US, having their domicile there and trading on the ASX as Chess Depositary Interests (CDIs). As a US financial product, the registry will send you a form known as a W8-BEN. This will reduce the rate of US withholding tax from 30% to 15% for Australian residents.

More concerning, the product prospectuses refer to the possibility that you might become subject to US estate taxes. This is clearly a tricky area where you should seek advice.

ARE ETFs SAFE?

The key thing to remember is that an ETF will reflect the value of the underlying assets. So if you buy the iShares MSCI Japan ETF, for example, you'll be exposed to the performance of Japanese shares as well as currency movements. The primary risks for international ETFs are therefore market and currency risk. You should understand what assets your ETF owns, as these assets will determine your risks and your returns.

Australian regulators have been careful to ensure local ETFs are structured carefully, so they're usually backed by physical assets (for example, shares). Those that aren't – known as 'synthetic' ETFs – depend on entering contracts with counterparties. Even here the regulators have put in place restrictions to reduce risks, but few investors should need to buy synthetic ETFs (which can be identified because they use the word 'synthetic' in their name). Many commodity-based ETFs are synthetic.

While physical ETFs are as safe as the assets they invest in, they are still a relatively new product. In market meltdowns, for example, they may behave differently to the underlying assets, although the way they are structured means pricing discrepancies should not persist for long.

THE ETF BUYER'S CHECKLIST

So how do you buy ETFs? While they're listed on the ASX, the way you buy an exchange traded fund varies slightly from the way you would buy a stock. Here's how you go about buying.

1. Read the product disclosure statement (or prospectus, depending on the type of ETF). The product disclosure statement will – as its name suggests – disclose important information about the product. Understand the assets you are buying, the risks and potential tax issues.
2. Check the product issuer's website for up-to-date information. Ideally you want to buy as close to net asset value (NAV) as possible so you should check this figure (remember to take overnight movements in the underlying market into account). You might also want to check other information, such as the underlying stocks the ETF owns.
3. Try to buy while the underlying market is open. This might be difficult, but you're more likely to get a price that reflects NAV (for example, wait for the Japanese market to open if you are trying to buy the iShares MSCI Japan ETF).
4. Avoid trading in the 30 minutes after opening and before close. You're more likely to get a price closer to NAV. 'Market-makers', whose job it is to provide liquidity in ETF markets, may not be as active in these periods.

- Use limit orders. Unless the bid/ask spread is very narrow, you might want to sit between the buy and sell prices and let the market makers fulfil your order.
- Beware volatile days. You're less likely to get a price close to NAV as the price of the underlying stocks might temporarily detach from the ETF price (or the bid/ask spread may widen).

So that's how you go about buying. In the next section we'll outline the specific ETFs you might want to consider.

WHICH ETFS SHOULD YOU BUY?

Earlier, we saw that ETFs are an asset allocation tool. So exactly which ones you buy will depend on your existing portfolio, investment goals and risk tolerance. You may even disagree with our choices.

But here – and in the next section – we'll narrow down the product list to the ones we think you should consider. Let's start with the ETF issuers.

As ETFs remain a relatively new investment product, we suggest you stick with the larger issuers, the ones that have been around the longest, and those with the most conventional range of products. These include BlackRock's [iShares](#), [BetaShares](#), [SPDR ETFs](#) (from State Street), [Vanguard](#) and [ETF Securities](#). Other providers, such as Russell, Market Vectors and UBS are relatively new entrants and/or they provide more specialist products.

Here's the list of the products we suggest you choose from:

- Most iShares ETFs, namely some Australian and most international share ones.
- Most SPDR ETFs, namely some Australian and most international share ones.
- Most Vanguard ETFs, namely some Australian and most international share ones.
- Some Beta Shares ETFs, specifically its currency ETFs, its high-interest cash ETF and (perhaps) its Bear Hedge Fund.
- The ETF Securities precious metal ETFs (structured as redeemable preference shares) that are backed by physical metal (specifically its gold ETF).

Most investors should probably stick to the first three issuers' ETFs (and generally only those based on conventional stock market indices). More aggressive investors might consider the remaining two. We'll look at some examples in Meet the Investors on [page 8](#).

So which ETFs do you need to watch out for? Start worrying in the following section.

THE ETF WORRY LIST

Being conservative, *Intelligent Investor Share Advisor* is inclined to steer clear of less conventional ETFs. Our macroeconomic views mean that even some conventional ETFs should be treated with caution. Here are the ETFs that give us cause for concern at the moment:

- Australian large capitalisation ETFs** (see *Types of ETFs* on [page 5](#)). While these have a place in the portfolios of some passive investors, remember the Australian indices are heavily weighted to banks and resources. For example, an investor in the SPDR S&P/ASX 200 Fund will have a 30% weighting to the big four banks (well above our suggested maximum limit of 20%).
- Strategy-based ETFs** (see also *Types of ETFs* on [page 5](#)). 'High dividend' ETFs are particularly common in Australia and, as you might guess, invest in high yielding stocks. But the underlying portfolios can be dangerously unbalanced. The SPDR High Dividend Yield Fund, for example, has a 36% exposure to the big four banks. While the number of 'smart beta' ETFs that are based on unconventional indices or quantitative stock selection strategies is likely to increase, we recommend caution.
- Bond and fixed interest ETFs**. While these might be suitable for some investors, rising interest rates would be bad news for bond funds. Also, ETFs that invest in corporate bonds would likely suffer in a repeat of the global financial crisis as liquidity dried up.
- Gearred ETFs**. These are ETFs that borrow to buy shares. Need we say more?
- Synthetic commodity ETFs**. Unless you have specialist knowledge or need to hedge for some reason, we suggest you avoid speculating on commodity prices.

Of course, all investors are different. Perhaps you're less conservative or prefer not to worry about strategic or macroeconomic concerns. Whatever the case, make sure you understand the underlying assets that will drive your investment returns.

“
The underlying portfolios can be dangerously unbalanced. The SPDR High Dividend Yield Fund, for example, has a 36% exposure to the big four banks.
”

BEFORE YOU BUY

- Read the Product Disclosure Statement
- Check the net asset value per unit (NAV)
- Buy while the underlying market is open, if possible
- Avoid trading in the 30 minutes before open and close
- Use a limit order
- Beware volatile days

Meet the Investors

Here's where we get down to business. This section contains three portfolios that contain examples of ETFs you could consider using the selection criteria in this report. First, a caveat: these are example portfolios for hypothetical investors rather than suggested portfolios. In other words, asset allocation has not been considered.

With that warning out of the way, let's meet our investors: Peter, Paul and Mary. The three friends are a decade away from retirement but have very different views about investment. Let's begin.

Peter's ETF portfolio won't set the world alight, but it's reasonably conservative and highly diversified. It has cash available for any market downturns and, importantly, has costs that average only 0.14% a year.

PETER'S PORTFOLIO

Peter's always been the sensible one. He knows he must invest, but could never really be bothered learning about stocks. It all just seemed too hard, particularly as his public relations business, 'Puff Piece', takes up so much of his time.

TABLE 4: PETER'S ETF PORTFOLIO

ETF	ASSET CLASS/ INDEX	ASX CODE	MER (%)	AMOUNT INVESTED (\$)
BETASHARES AUSTRALIAN HIGH INTEREST CASH ETF	Bank deposits (Aust)	AAA	0.18	25,000
VANGUARD AUSTRALIAN SHARES ETF	S&P/ASX 300 index	VAS	0.15	35,000
ISHARES CORE S&P 500 ETF	S&P 500	IVV	0.07	20,000
VANGUARD ALL-WORLD EX-US SHARES ETF	FTSE All-World ex-US index	VEU	0.15	20,000
TOTAL				100,000

But Peter's done his research and spoken to a few investors he respects. They told him to keep his portfolio simple, and his costs as low as possible. ETFs seemed like a great choice for the Australian and international stocks part of his portfolio. His portfolio is completely passively invested.

Peter thinks he might eventually retire to Europe or North America, so he wants a decent chunk of his portfolio in international shares. But he also has an opportunistic streak, and he wants funds available should stock markets take a dive in the future.

For this part of his portfolio, he's chosen the BetaShares Australian High Interest Cash ETF. He likes that it owns a portfolio of Australian bank deposits, and is currently yielding 3.2%, with interest paid on a monthly basis.

For the Australian shares portion, he's chosen the Vanguard Australian Shares ETF. It's low cost, and he favours it because it owns the top 300 stocks, so it's slightly more diversified than a fund based on the top 200. He's worried the Australian market is overweight banks and resources

but figures it's something he'll have to live with.

Internationally, he chooses the iShares Core S&P 500 ETF for the largest American stocks. It's complemented nicely by the Vanguard All-World ex-US Shares index ETF, which invests in a global portfolio of about 2,400 non-US stocks.

Peter's ETF portfolio won't set the world alight, but it's reasonably conservative and highly diversified. It has cash available for any market downturns and, importantly, has costs that average only 0.14% a year.

PAUL'S PORTFOLIO

Paul's a more experienced investor than Peter, and he's also willing to take on a little more risk. In fact, he already actively manages an Australian share portfolio through his company, Windy Enterprises. (As an *Intelligent Investor Share Advisor* member, he's been selling down his bank stocks). So Paul is adopting a combination of active and passive strategies.

TABLE 5: PAUL'S ETF PORTFOLIO

ETF	ASSET CLASS/ INDEX	ASX CODE	MER (%)	AMOUNT INVESTED (\$)
SPDR S&P/ASX SMALL ORDINARIES FUND	Aust. small companies	SSO	0.50	20,000
ISHARES EUROPE ETF	S&P Europe 350	IEU	0.60	30,000
ISHARES CHINA LARGE-CAP ETF	FTSE China 50	IZZ	0.73	30,000
VANGUARD US TOTAL MARKET SHARES ETF	CRSP US Broad Market index	VTS	0.05	20,000
TOTAL				100,000

Paul's been burnt by small company stocks in the past and thinks outsourcing this area of his portfolio makes sense. He likes the fact that small stocks have underperformed for a few years now, and believes the trend might reverse at some point. So he selects the SPDR S&P/ASX Small Ordinaries Fund for this part of his portfolio.

Paul reads widely about international investing, and thinks the US market looks a little expensive. While he wants some exposure to US shares, he's hoping for a broader range of companies than he'd get with an S&P 500 ETF. So instead he selects the Vanguard US Total Market Shares ETF, which owns a whopping 3,500 stocks in the US.

Elsewhere, his reading tells him European and Chinese markets look significantly less expensive than other markets. So he buys the iShares Europe ETF and iShares China Large-cap ETF to provide that exposure. He expects to hold these ETFs for many years, but is prepared to switch into other markets down the track, depending on valuation.

Paul pays a little more because of the specialist nature of his portfolio, with an average cost of 0.51% a year.

MARY'S PORTFOLIO

Mary's also an experienced investor but she's increasingly concerned about events in Australia. The iron ore price has been plummeting and she thinks a deep recession is inevitable. She's so worried that she has recently sold her upmarket floristry business, as well as her Australian share portfolio, and is wondering what to do with the money.

(If truth be told, Peter and Paul are a little concerned. She's been spending a lot of time at her property three hours out of Melbourne, and what's with all those solar panels?).

Mary opts for a defensive strategy, to protect against any fallout from a serious decline in Australian markets. The first investment she buys is the same BetaShares Australian High Interest Cash ETF as Peter, which will give her a small income and some ready cash if she needs to sell it.

a hedge against inflation – has been weak lately, Mary thinks it best to have some exposure and buys some ETFS Physical Gold. Knowing there's some real gold bullion in a London vault behind her investment gives Mary a warm fuzzy feeling every night.

Mary's not so keen on shares these days, but friend Paul reminds her that businesses have created wealth for hundreds of years and she'd be unwise to have no exposure to stocks at all. So he convinces her to buy the iShares Global 100 ETF. If the 100 largest companies in the world can't survive a shakeout, what can?

Having bought her portfolio, Mary retreats to her rural property. The world might be an uncertain place, but she's very comfortable with management fees of just 0.36% a year.

CONCLUSION

With the help of Peter, Paul and Mary, not to mention John and Olivia, we hope you've found this special report on ETFs of interest.

It's easy to forget that a diversified portfolio is about more than a dozen or so Australian stocks. At the click of a mouse you can now own a range of Australian and international share funds as well as many other asset classes. What's more, you can do it at a cost that's lower than ever.

If you haven't considered ETFs, it's time you did. There's a whole world of them waiting.

She feels the Australian dollar is ripe to plummet. Although it's fallen 20% since 2011, it's still higher than its long-term average against the US dollar. So she buys the BetaShares US Dollars ETF, which she particularly likes because it's backed by physical US dollars held in a bank account.

TABLE 6: MARY'S ETF PORTFOLIO

ETF	ASSET CLASS/INDEX	ASX CODE	MER (%)	AMOUNT INVESTED (\$)
BETASHARES AUSTRALIAN HIGH INTEREST CASH ETF	Bank deposits (Aust)	AAA	0.18	25,000
ETFS PHYSICAL GOLD	Gold	GOLD	0.40	25,000
BETASHARES US DOLLAR ETF	Bank deposits (USD)	USD	0.45	25,000
ISHARES GLOBAL 100 ETF	S&P Global 100	I00	0.40	25,000
TOTAL				100,000

She feels the Australian dollar is ripe to plummet. Although it's fallen 20% since 2011, it's still higher than its long-term average against the US dollar. Weakening demand from China can only be bad news for our commodities, she reasons. So she buys the BetaShares US Dollars ETF, which she particularly likes because it's backed by physical US dollars held in a bank account.

Mary's worried about inflation down the track too. With all that money sloshing around in the wake of the global financial crisis, it's hard not to see inflation re-igniting at some point. While the gold price – usually seen as

FURTHER READING

Here are some links to further reading and more information on ETFs:

- [The ASX's ETF product list](#)
- [The Investors Association information on ETFs](#)
- [Morningstar's website section on ETFs](#)
- [ASIC's website on ETFs](#)



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