# 5 Questions Every Australian Investor Should Ask Before Investing in an ETF

With the use of ETFs by investors continuing to gain momentum, it is important that investors take the time to understand this rapidly growing category. Here, we answer five simple questions designed to help guide and deepen your understanding of ETFs.

What kind of ETFs are available?

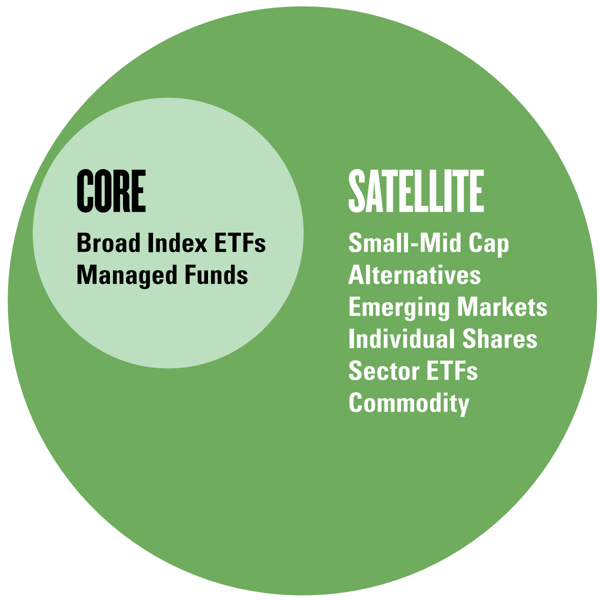
What are the investment objectives and risks?

How do investors use EFTs?

When can I trade ETFs?

How can an ETF be evaluated?

**A Core-Satellite Strategy**




### 1. What Kind of ETFs Are Available?

There are ETFs available in nearly every possible asset class, including Australian shares, international shares, fixed income, real estate and commodities. Within these broad categories are a number of sub-categories including geographic restrictions, capitalisation ranges, industry sectors, and style based. ETFs may be broadly diversified or narrowly focused.

In Australia, the majority of ETFs are currently index-based (or passively managed), i.e., they are designed to track the performance of a designated index. In other parts of the world, some index based ETFs are "geared" — that is, they seek to track the multiple or inverse (or multiple inverse) of an index. There are also ETFs that are actively managed, i.e., their investment adviser selects investments to meet a particular investment objective or policy, which is typically to outperform a selected benchmark. Finally, there is also a growing range of 'smart beta' ETFs. These are ETFs that seek active investment exposures with the efficiency of passive investment management and include income focused and quality focused ETFs.

### 2. What Are the Investment Objectives and Risks?

ETFs follow a wide range of investment strategies and objectives. In addition to the stated objective of an ETF, you should consider how the ETF provider is attempting to achieve that objective and how the ETF seeks to track the respective Index. While a number of ETFs might cover the same market segment, they may do so in different ways. For example, an Index may have a range of securities (varying to a few thousand), and it may follow a market capitalisation strategy or dividend strategy, amongst others.

Any investment strategy needs to take into account the risks associated with the investment. The principal risks are typically those associated with the ETF's investment objective i.e., adverse developments in the securities or market segments in which the ETF invests, or related developments such as interest rate or currency fluctuations.

Information on investment objectives and risks are available in an ETFs Product Disclosure Statement ("PDS"), and on the respective website.

### 3. How do Investors Use ETFs?

The most common use is to help investors gain low cost access to a new asset class in a single trade or to further diversify an existing asset allocation to minimise stock specific risk. Another popular approach is to use ETFs to achieve a core-satellite strategy. This means an investor holds a relatively stable and diversified investment as a "core" holding, adding "satellite" positions around this core in the hope of generating additional returns.

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## 4. When Can I Trade ETFs?

ETFs trade during normal ASX market hours. It is recommended that investors refrain from trading before 10.15am or 10.30am. This gives the institutional liquidity providers additional time to ensure ETF prices more accurately reflect the true value of the ETF. Many investors also avoid trading at the market close, as the closing auction can result in additional price volatility.

## 5. How Can An ETF Be Evaluated?

Assessing critical factors such as market exposure, performance, overall cost, liquidity, tracking difference and ETF provider are important in order to best determine whether the ETF fits the desired risk/return profile of your investment objective.

### Market Exposure

Understanding how much of the market or asset class an ETF's underlying benchmark covers is an important factor in ensuring you're getting the desired coverage you're after. For example, as investors tend to already have strong allocations to domestic equities, a broad international equity ETF that doesn't include Australian equities, ensures that your international exposure is truly global.

### Performance

While past performance is not an indication of how an ETF may perform in the future, an investor may wish to evaluate an ETF's performance against its stated objective or benchmark.

### Cost

There are a number of costs associated with investing in an ETF, including fees charged by the ETF provider and brokerage commissions. Investors may also consider indirect costs, including those stemming from the bid/ask spread and any premium/discount volatility.

### Liquidity

Liquidity refers to how easily an ETF can be bought or sold. ETF liquidity should be considered with respect to both the ETF and the underlying securities the ETF holds. Highly liquid ETFs and ETFs that have highly liquid underlying securities (even if the ETF does not have high trading volumes) typically have narrower bid/ask spreads than ETFs that trade less or hold less liquid securities.

### Tracking Difference

Tracking difference is the extent to which the ETF's return deviates from the return of its benchmark index and is influenced by a number of factors, such as how an ETF seeks to track the index and the ETF's operating expenses.

### ETF Provider

Considering an ETF provider with a strong indexing history, deep portfolio management expertise and dedicated client service and support to help investors evaluate their options is an important factor in evaluating overall suitability.

**Figure 1: ETF Cost of Ownership**

Expense Ratio + Commission + Spread (+ Tracking Error) = Total Cost of Ownership

Source: State Street Global Advisors (SSGA).

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**State Street Global Advisors Australia Services Limited** Level 17, 420 George Street, Sydney, NSW 2000. 1300 665 385.

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ETFs trade like stocks, are subject to investment risk, fluctuate in market value and may trade at prices above or below the ETF's net asset value. ETFs typically invest by sampling an index, holding a range of securities that, in the aggregate, approximates the full Index in terms of key risk factors and other characteristics. This may cause the fund to experience tracking errors relative to performance of the index.

Diversification does not ensure a profit or guarantee against loss. Sector ETFs products are also subject to sector risk and non-diversification risk, which generally results in greater price fluctuations than the overall market. Brokerage commissions and ETF expenses will reduce returns and transaction costs will also be incurred when buying or selling units of an ETF on ASX markets. ETF units may only be redeemed directly by persons called "Authorised Participants".

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