Debunking Myths and Misconceptions

Even as ETFs have grown in popularity, there is still a great deal of misunderstanding about how they are structured and regulated, how they trade, and how their performance compares to other kinds of investments.

For nearly twenty years, since State Street launched the first exchange traded fund ("ETF") in 1993, SPDR® S&P 500®, ETFs have grown to become an extremely popular investment vehicle globally for both individual and institutional investors, with over 6,000 options available and US$2.9 trillion in assets.[1] ETFs offer an easy, cost-efficient way for investors to incorporate various asset classes, investment styles, industry sectors and even commodities to their portfolios. Because most ETFs are passively managed, they generally have low management fees and operating expenses. Like individual stocks, ETFs give investors the flexibility to buy and sell on the major stock exchanges throughout the day, at the market price. It's important to keep in mind that frequent ETF trading, which typically occurs through a broker, can significantly increase brokerage commissions potentially washing away any savings from low fees or costs. But even as ETFs have grown in popularity, there is still a great deal of misunderstanding about how they are structured and regulated, how they trade, and how their performance compares to other kinds of investments. Increased disclosure, greater transparency and improved investor education are vital to helping investors decide which financial products, including ETFs, are most appropriate for their investment needs. This article is designed to provide the facts behind some common ETF myths that persist today.

Myth: ETFs Are the Same as Individual Shares

Reality A share is a type of security that signifies ownership in a corporation and represents a claim on part of the corporation's assets and earnings. A share can be bought and sold on the major stock exchanges throughout the day at the market price. A share's price will generally reflect the market's supply and demand for its shares.

An ETF is a commingled investment vehicle comprised of a collection or 'basket' of securities that tracks, and is intended to represent, the performance of a broad or specific segment of the market, such as Australian equities, small cap stocks or emerging markets. Most ETFs offer the combined benefits of unit trusts and individual securities. Like unit trusts, ETFs allow investors to track the returns a range of domestic and international indexes. Like individual shares, ETFs give investors the flexibility to buy and sell units at market prices on the major stock exchanges throughout the day.

Myth: All ETFs Replicate Their Underlying Indexes

Reality Most, but not all, ETFs are designed to provide investment results that generally track the price and yield performance of an underlying benchmark index (such as the S&P®/ASX 200 Index) by holding a portfolio of securities that seeks to mirror this performance. The majority of ETFs around the world use one of three techniques to achieve this goal: full replication; optimisation-based tracking; and synthetic replication. However, not all ETFs are replication-based; within the past few years a growing number of actively managed ETFs have been launched that leverage the expertise of portfolio managers to execute security selection and trading decisions.

Let's examine each of these approaches in greater depth.

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Full Replication

In this approach, an ETF holds all the securities in the same weightings as its associated index. Over time, the manager adjusts the portfolio to reflect changes in the index (such as the replacement of one security with another) and manages cash flow from dividends or income generation. This strategy tends to provide very close tracking with the underlying index.

Optimisation-Based

Designed to control trading costs and promote liquidity, this strategy uses a sampling process to create a representative or optimised portfolio of securities that closely matches the characteristics of the underlying index. While this approach may be more cost- efficient, it tends to carry a higher potential for tracking error than ETFs that use the full replication method.

Synthetic Replication

A recent introduction to the marketplace, these funds (also known as 'synthetic' funds) attempt to replicate index returns by purchasing derivatives such as swap agreements with one of more counterparties, such as a bank. Typically, the counterparty will agree to deliver the performance of the associated index (minus a small spread), including capital gains and dividends, in exchange for the value of the performance generated by a pool of physical securities held by the ETF (these securities are not necessarily the same as those comprising the ETF's index). This allows the ETF to mirror the performance of an index without having to own the actual securities, which can be advantageous when it is difficult or expensive to trade in certain markets or sectors. Synthetic ETFs can be riskier than other kinds of ETFs because a counterparty could default on its obligations. However, financial regulators in most countries limit the amount of assets that can be invested in derivatives and require these ETFs to provide adequate liquidity to protect investors against default-related losses.

Actively Managed

This relatively new category of ETFs allows managers to apply their own expertise in overseeing portfolio construction and trading decisions, similar to actively managed funds. While the ETF will have a benchmark index, its managers will generally attempt to outperform that index's returns rather than simply match it. The main difference between ETFs and managed funds is that ETFs are priced and traded intraday, while managed funds can only be purchased or sold at their net asset value after the market closes. Generally, actively managed ETFs have higher expenses than replication-based ETFs. In general, while there are benefits and risks to each approach, understanding the product structure is vital to helping investors decide which financial products are most appropriate for their investment needs.

Myth: Individual Stocks, Bonds and Managed Funds Generally Outperform ETFs

Reality Any short-term or long-term analysis of the markets will demonstrate that no particular investment category or type can consistently outperform another. Performance of any security, whether it's a share, bond, managed fund or ETF, is determined by any number of factors, including the economy, monetary policy, market conditions, or issues affecting a particular security's asset class or industry sector. For individual shares, fundamentals such as earnings, valuations and financial stability will also affect share prices. For bonds, factors such as short term interest rates, inflation and credit ratings will influence their yields.

The advantage of commingled vehicles such as managed funds and ETFs is that they offer the benefits of diversification, which may help to reduce the overall risk of a portfolio, as the decline in the price of any one security may be offset by the rise in price of another.

Myth: ETFs Are Riskier Investments Than Unlisted Managed Funds

Reality There's no significant investment research that proves that all ETFs carry significantly higher risk than unlisted managed funds. Because most ETFs are designed to replicate the performance of an associated index, their overall risk level should not be significantly higher or lower than that of the index itself. Investors should evaluate their level of comfort with the unique risk and volatility characteristics of a given index, industry sector or asset class of interest before investing in an associated ETF.

Further, the risk and volatility level of any commingled investment vehicle, whether it is an ETF or an unlisted managed fund, is determined by a number of factors, including:

- The performance characteristics of the fund's underlying holdings;
- The inherent volatility and risk of the markets or sectors in which the vehicles invests;
- The investment style the fund uses;
- In the case of actively managed funds, the manager's bets on individual securities or sectors.

Myth: ETFs May Have Lower Expenses, but They Cost More to Own Because You Have to Pay a Brokerage Commission When You Trade Them

Reality It is true that investors pay commissions to their broker when they buy or sell shares of an ETF, as they do when they trade individual shares. It is also true that frequent trading of ETFs could significantly increase commissions and other costs. However, the same thing can be said for trading individual shares.

While investors don't pay brokerage commissions when purchasing or redeeming units in traditional managed funds, units in certain funds may have either an up-front entry fee or back-end redemption charge which incorporates a commission element paid to those investment advisers for placing investors in the fund.

It's important for investors to consider both immediate and future costs — commissions, sales charges, management fees, and tax implications — when evaluating the suitability of any kind of investment.

Managed funds may incur additional costs that may not be readily apparent to investors. For example, some managed funds can raise their investment management fees if their managers outperform their benchmarks. Also, managed funds with high turnover rates may declare higher capital gains distributions, which can increase an investor's tax burden, whereas most passively managed ETFs have lower turnover rates, which generally result in lower capital gains where applicable.

Myth: ETFs Carry Unreasonable Bid/Ask Spreads

Reality The bid is the price at which a buyer is willing to purchase ETF units, and the ask is the price at which a seller is willing to sell ETF units. The difference between the bid and the ask is the spread, which indicates the overall cost of trading in any security (plus any applicable brokerage commission costs). Like anything sold in a public marketplace, the bid/ask spread for any exchange traded security, whether it's a share or ETF, is governed largely by supply and demand, the availability of information about the securities, and investors' reactions to geopolitical or market and economic events.

Larger, highly liquid ETFs like the SPDR S&P/ASX 200 Fund (ticker: STW) tend to have tighter spreads than ETFs that invest in less-liquid asset classes or are thinly traded like the SPDR S&P/ASX Small Ordinaries Fund (ticker: SSO). As trading volume in an ETF rises, competition reduces spreads and allows investors to buy and sell units in a more cost-efficient manner. ETFs that trade in international securities often have wider spreads because many overseas markets are closed when these ETFs are trading, making it difficult for Australian investors to access updated information on the securities in which the ETF invests. Generally, bid/ask spreads are of less concern to long-term investors. However, those who are concerned about spreads may wish to use stop or limit orders when purchasing or selling units of ETFs or any other security, particularly in periods of high market volatility.

Myth: ETFs Are Only for Day Traders and Short-Term Investors

Reality ETFs are effective investment tools for all types of investors, from short-term traders to those investing for long-term financial goals such as retirement or their children's education. Their unique structure as commingled investment vehicles that can be bought and sold at market prices gives ETFs the flexibility to be used to execute a variety of investment strategies, without the added expenses of active management.

Myth: ETFs Encourage Excessive Trading

Reality The broad universe of asset classes, investment styles and industry sectors represented by ETFs have made them attractive vehicles for executing strategies designed to capitalise on pricing efficiencies in a given market. However, investors were engaging in short-term trading long before ETFs were introduced to the market.

While ETFs have become a tool that investors use to execute decisions, the average trading volume of ETFs represents only a fraction of all securities transactions on any given day in the market.

Myth: Actively Managed Funds Deliver Superior Performance Over Passive ETFs

Reality If the last decade has proven anything about investing, it's that the only thing you can predict about the market is that it will be unpredictable. Any given asset class, investment style, or active or passive vehicle may outperform any other during a given timeframe. Yet, as all managed fund and ETF investors are told time and time again, past performance is no guarantee of future results. In any case, performance alone should not be the sole criteria for determining whether an actively managed or passively managed fund is an appropriate choice for you. Other factors should also be considered, such as:

Manager Discretion

While most passive ETFs limit investments to securities representing its associated index, an actively managed fund may have a wider degree of latitude to invest across asset classes, investment styles and sectors. This allows the fund to focus on delivering higher total returns, rather than mirroring index performance.

Alpha Generation

Through effective portfolio management and trading decisions, an active fund manager may be able to outperform a benchmark in rising markets or mitigate losses in a declining market more effectively than passively managed funds. Of course, it's also possible that an active manager's decisions may result in higher volatility or greater losses.

Costs

The price of active management is generally higher in costs. Portfolio manager compensation and higher trading costs generally result in higher expense ratios for investors. In addition, actively managed funds tend to have higher turnover rates, which can result in higher capital gains. And, of course, the most important consideration when evaluating any investment option is whether it is a suitable choice, given your own investment goals, timeframe and risk tolerance.

Myth: ETF Tax Consequences On Capital Gains Erode Fund Returns

Reality Although ETFs are tax efficient vehicles that allow investors to time tax consequences of capital gains, they can also be utilised to help SMSFs in accumulation mode minimise their tax bills in other ways. ETFs are able to do this by passing through franking credits from the dividends it receives from constituent companies. Investors holding the STW ETF on and around the two distribution dates (June and December) could receive valuable franking credits along with the dividends. Franking credits represent company taxes already paid on corporate profits and can be passed along to shareholders with normal dividends as an "IOU" from the tax office. This credit in essence eliminates the double taxation of profits at both the corporate and personal level. Eligible shareholders are those who can demonstrate they have held the security for a continuous period of 45 days or who have less than $5,000 in franking credits for the current tax year (the small investor exemption).

Let's illustrate this with an example. An ETF with a franking rate of 25% across its constituent's dividends pays a franked dividend of $0.75 plus a $0.25 franking credit. The $0.25 franking credit represents the taxes corporations have already paid and that do not need to be paid again by eligible investors. This combination of dividend and credit is exactly equivalent to an unfranked dividend of $1.00. Although an unfranked $0.75 dividend would normally result in a $0.11 per share tax bill (at an SMSF's 15% financial year tax rate), due to the $0.25 franking credit the SMSFs will actually receive a $0.10 rebate making the franking credit act very much like a negative tax. As at 31 December 2015, the STW ETF distributed $1.19 per share in dividends, 86.87% of which were franked at a rate of 31.11%. This amounted to a $0.47 per share franking credit or a $0.15 per share rebate to an SMSF investor in the 15% tax bracket of a financial year.[2]

Myth: ETFs Are as Liquid as the Underlying Issuer

Reality Physical ETFs do not have debts outstanding against the constituent shares held in the portfolio and are fully equitised. Units of SPDR ETFs (all physically-backed) are owned by the single party in possession of the units at a given time. The owner of the shares is the party in possession of those units. Since an investor is investing in the ETF itself and not the assets of the issuer, the investor is not exposed to the potential risks of issuer insolvency.

SPDR ETFs have operational procedures for share creation and redemption that are designed to protect the interest of the fund's shareholders by contractually requiring the fund's Authorised Participants (i.e. approved institutional trader or market maker authorised by the relevant exchange known as an "AP") to represent that units being tendered for redemption are settled units in the possession of the AP or the client they represent. As such, when an ETF is liquidated, it sells out of its holdings and distributes the cash to ETF investors at the NAV. Also, an ETF cannot be redeemed for more than its actual units issued.

SPDR ETFs in Australia are passive instruments that do not on their own attempt to influence the market rather they seek to track the performance of market indices. The in-kind exchange mechanism inherent in ETFs ensures that it does not have to sell securities to meet a redemption request. To point, every creation or redemption request is fulfilled by an AP by either receiving or delivering a pro-rata basket of securities in exchange for SPDR ETF shares. While a SPDR ETF will tend to trade in concert with the intrinsic value of the underlying securities, it does not buy or sell portfolio securities to meet creation or redemption requests.

Conclusion

Over the past 23 years, ETFs have globally grown to become an extremely popular choice for investors seeking a cost effective option for executing both short and long term investment strategies. Understanding their unique characteristics is an important step toward determining whether ETFs can be an appropriate choice for your portfolio and the role they may play in helping you achieve your own investment objectives.

Definitions

Alpha

A measure of performance on a risk-adjusted basis. Alpha takes the volatility (price risk) of a mutual fund and compares its risk adjusted performance to a benchmark index. The excess return of the fund relative to the return of the benchmark index is a fund's alpha.

Transparency

Defined as the accessibility of information on the order flow for a particular stock, allowing knowledge of the quantities of stock being offered and the bids at the various price levels.

Diversification

A risk-management technique that mixes a wide variety of investments within a portfolio. The rationale contends that a portfolio of different kinds of investments will, on average, yield higher returns and pose a lower risk than any individual investment found within the portfolio. It strives to smooth out events in a portfolio so that the positive performance of some investments will neutralise the negative performance of others. Diversification does not ensure a profit or guarantee against a loss.

Bid Ask Spread

Defined as a percentage of ETF price. Average & spread = (offer–bid/midpoint as measure from 10.30am–3:45pm)

20 Day Average volume = The average share volume traded over the last 20 trading days multiplied by the month end closing price.

Index Definitions

S&P®/ASX 200 Index

The S&P/ASX 200 is recognised as the primary investable benchmark in Australia. The index covers approximately 80% of Australian equity market capitalisation.[3] Index constituents are drawn from eligible companies listed on the Australian Stock Exchange. This index is designed to address investment managers' needs to benchmark against a portfolio characterised by sufficient size and liquidity.

1 Morningstar, State Street Global Advisors (SSGA), as of 31 December 2015.

2 The outcome will vary according to an investor's marginal taxation rate. SSGA as of 1 March 2016.

3 S&P Dow Jones Indices as at 1 March 2016.

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