The benefits of ETFs

And how to use them in your portfolio

What are ETFs?

ETFs are a type of managed investment fund that are traded on a stock exchange. This means they are bought and sold in exactly the same way as shares, allowing investors to enter or exit a position any time the market is open.

ETFs often track major local and overseas indices such as the ASX200 or S&P500, or sub-sectors such as listed property or smaller companies. Some track more specific indices, for example the MSCI Australia ex-Tobacco ex-Controversial Weapons Index. There are also ETFs that track bond (fixed interest) indices, currencies, and commodities such as oil and gold.

Most ETFs are 'index funds', which simply means that they seek to match the performance of a particular index. They usually do this by investing in the same shares in the same proportions that make up the specified index. As with other managed funds, the dividends earned and franking credits received are passed through to investors in the form of distributions.

Benefits of ETFs

ETFs provide investors with a number of benefits that can simplify their portfolios and potentially increase returns.

Lower costs
As ETFs track an index made up of known securities there's no need to employ expensive analysts to pick shares. The cost of managing an ETF is therefore much lower than is the case for actively managed funds. This has a greater bearing on the long-term performance of a fund than many people realise.

Take, for example, an investment fund that is currently worth $200,000 and receives new contributions of $10,000 each year. With a return of 6% per annum after fees and tax the fund would be expected to grow to $1,009,283 in 20 years' time. However, if higher fees of 1%, reduce that annual return to 5%, the fund might only be worth $861,319, a difference of $147,964 less.

Diversification
ETFs are a simple way to achieve a high level of diversification in one trade. Increasing diversification can also reduce the overall risk of a portfolio. Exchange traded funds allow investors to gain broad based market exposure across a variety of asset classes, including domestic and international equities, fixed income, cash and commodities.

Tax efficiency
Active funds constantly buy and sell shares in pursuit of higher performance, often realising capital gains along the way. These are taxable each year. If a super fund is in its tax-free phase this isn't a problem, but in the accumulation phase these gains are taxed at 15%, or 10% if the assets were held for more than 12 months. While this may not seem much, it still creates a drag on the long-term performance of the portfolio.

The traditional low turnover of investments provided by an indexing approach to investing minimises the capital gains distribution impact of investing in an ETF. This improves performance and tax efficiency over the longer term. An ETF usually only buys or sells shares when companies enter or leave its index. As most indices have a low turnover, ETFs realise little in the way of capital gains each year. This effectively puts off tax until the units are sold, helping to boost long-term performance.

Transparency
Whether it's for ethical, thematic or other reasons, many investors want to either gain exposure to some economic sectors or avoid others. ETFs provide a high level of transparency regarding the individual securities that make up the portfolios.

Often the list of shares held is available on the manager's website and is updated daily, allowing investors to make an informed choice when deciding between different investment options. Unlisted managed funds may only update their investment lists every few months, if at all.

How can investors use ETFs?

From effective portfolio construction and helping to manage risk through to reducing paperwork, ETFs simplify many aspects of managing a portfolio.

Asset allocation and the core-satellite approach to investing

Any investment strategy needs to be designed with an eye on risk, and one of the most important methods of managing investment risk is diversification. This is primarily achieved through asset allocation, the process of spreading money across the main asset classes of Australian shares, international shares, property, fixed interest and cash. Shares and property are more 'risky' investments, offering potentially higher returns, but also the possibility of greater losses. Fixed interest and cash are lower risk, but are also expected to generate lower returns over the long term.

Asset allocation is the largest contributor to the performance of a portfolio. If a portfolio is heavily weighted towards shares, and if the share market performs well, the portfolio will perform well. The opposite applies too, of course. In fact, for a share portfolio, over 75% of overall performance is due to market performance, with the choice of individual shares making a relatively small contribution.

This dominant influence of the share market as a whole has given rise to the concept of core-satellite investing. This sees most of the share component of a portfolio, the 'core', invested in ETFs, to capture market and sector returns at relatively low cost. Remaining funds are then used to buy 'satellite' investments. These may be more specialised funds or individual shares. Investors get to enjoy the thrill of backing their personal interests or hunches while market performance is largely captured and risk is managed.

Global access with ETFs

ETFs are a simple, low cost tool to access global equity markets through the ASX. There are over 70 international exchange traded funds on the ASX providing exposure to broad based global equity markets and sectors.

For example, the UBS IQ MSCI World ex Australia Ethical ETF (ASX code: UBW) provides core exposure to approximately 1550 securities listed on 22 global exchanges of the world's major economies (excluding Australia) in one trade.

Between 2012 and 2017 Australian ETFs more than tripled their funds under management, evidence that investors are warming to the benefits of ETFs.

For long-term investors, low costs, instant diversification, tax efficiency and reduced paperwork are arguably the most compelling of these benefits. More active investors are attracted by the ability to buy and sell any time markets are open, allowing them to rapidly adjust sector exposure and to seize opportunities as they arise.

ETFs popularity is only likely to increase and the amount of money invested to grow further. Not only that, fund managers can be expected to seek out new opportunities to establish ETFs covering a wider range of more specialised investments.

Controlling cash

ETFs have a couple of roles to play in helping investors manage their cash position.

One example is when an investor wants to rearrange a satellite component of a portfolio, perhaps to take a profit on an asset that has performed well, but doesn't wish to be right out of the market while deciding on the purchase of another asset. Due to the liquid and flexible nature of ETFs, funds can be invested in an ETF for a short period of time to allow market exposure to be maintained until the next satellite investment is chosen. Or an investor may want to pivot from, say, small cap shares to unlisted property. Exposure to property can be quickly gained via an ETF while the unlisted vehicle is being selected.

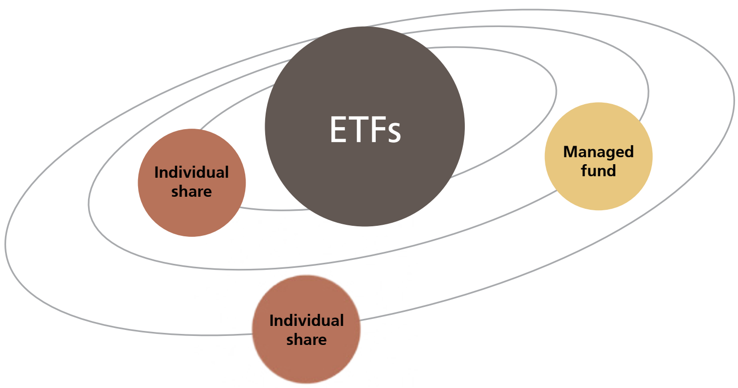
Managing the cash component of a portfolio over the longer term can also be aided by ETFs. High interest cash ETFs, such as the UBS IQ Cash ETF, are available that can provide an attractive alternative to bank accounts.

Tax credits

In addition to the capital gains tax benefits mentioned earlier, the franking credits received by ETFs are passed through to investors. For SMSFs, and depending on the asset allocation, these franking credits can offset tax payable by the fund and even lead to a refund of excess franking credits.

Rebalancing the portfolio

After a period of strong share market returns a portfolio may become too highly weighted towards shares, increasing its level of risk. Or after a dip in the market, it might be a good time to top up on shares at bargain prices. Or as retirement nears and SMSF trustees prepare to establish pensions, it may be wise to shift the focus of the portfolio from capital growth to income generation.



There are a variety of reasons as to why it may be necessary to rebalance the asset allocation of a portfolio. For a portfolio built on large, direct investments or conventional managed funds this can be a complex task that may involve significant tax issues. However, for a portfolio built around a core of ETFs, rebalancing can be achieved with a few quick trades.

Choice and direct access

Investors are spoiled for choice when it comes to ETFs. They span a range of asset classes across different regions, providing investors with direct access to a world of opportunities. While ideally suited to a 'buy and hold' investment approach, they also provide investors with the ability to quickly trade into and out of the market sectors tracked by individual ETFs, providing an important tool for risk management.

Comparison of ETFs and other financial products

	ETFs	Managed Funds	Shares	Listed Investment Companies (LICs)
Pricing	Intra-day / continuous	Priced at the end of the day. Bought and sold at next price	Continuously changes during trading hours	Continuously changes during trading hours. May trade at more or less than the value of the underlying assets
Ease of sale and purchase	Buy and sell online at any time during trading hours	Varies	Buy and sell online at any time during trading hours	Buy and sell online at any time during trading hours
Liquidity	High	Varies. Usually high for share funds	High for larger companies; can be low for small companies	High
Transparency	Most ETFs update holdings list daily	Varies. Many funds update quarterly	Fully transparent	Main holdings and net asset values usually updated monthly
Management Fees	Generally low	Medium to high	Not applicable	Low
Brokerage	One brokerage payment buys a diversified portfolio	Brokerage costs covered by buy/sell spread	Brokerage payable on each trade	One brokerage payment buys a diversified portfolio
Tax issues	Control over timing of sale. Capital gains tax only payable after sale	Active management creates regular capital gains tax events	Control over timing of sale. Capital gains tax only payable after sale	Depends on level of portfolio turnover. Dividends usually contain a capital gains component

UBS Exchange Traded Funds

The UBS Australian ETF platform was established in 2012. UBS Asset Management has a long-term track record of providing index-based investment solutions to clients. The first UBS ETF was launched in Europe in 2001. Since then UBS has launched over 250 ETFs globally, with funds under management in excess of AUD 59 billion as of 30 September 2017. UBS ETFs are managed by an experienced asset manager, UBS Asset Management, with a 30 year heritage managing passive investments.

Exposure	Name	ASX code
Australian-quality	UBS IQ Morningstar Australia Quality ETF	ETF
Australian-income	UBS IQ Morningstar Australia Dividend Yield ETF	DIV
Australia	UBS IQ MSCI Australia Ethical ETF	UBA
Cash	UBS IQ Cash ETF	MONY
World	UBS IQ MSCI World ex Australia Ethical ETF	UBW
Europe	UBS IQ MSCI Europe Ethical ETF	UBE
US	UBS IQ MSCI USA Ethical ETF	UBU
Japan	UBS IQ MSCI Japan Ethical ETF	UBJ
Asia ex Japan	UBS IQ MSCI Asia APEX 50 Ethical ETF	UBP

Find out more

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