

# E T F

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## demand surges

**Low cost and low risk, exchange-traded funds track indices and can be bought like stocks**



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If you think an exchange-traded fund (ETF) sounds like another hard-to-understand investment product that is best avoided, think again.

ETFs are actually fairly simple to grasp and have, in fact, grown in popularity among retail investors who are embracing them as a low cost, low risk way to diversify.

The surge in demand is partly due to a rapid increase in the availability of ETFs.

They appeal to investors because they provide exposure to a myriad of investments ranging from equities, sectors, investing themes and commodities to fixed income.

Another reason for the strong rise of ETFs is the shift to a more risk averse mindset among investors, in the wake of the global financial crisis.

An ETF combines the features of a unit trust with those of a stock. Listed on a stock exchange, an ETF invests in a basket of stocks that aims, for instance, to track the performance of an underlying index.

That means an ETF that tracks the Straits Times Index (STI), for example,

will rise and fall in value in tandem with the STI.

Investors like the fact that ETFs allow them to focus on a particular market or asset class without having to be overly concerned with individual stock picking.

So if you are interested in a foreign market, say China, but do not know which stock to select, you can consider an ETF that tracks the market benchmark of the country. An example is the United SSE 50 China ETF which offers access to China's A-shares market. Trading in those actual shares is currently restricted to Chinese nationals and approved foreign investors.

Launched last November, the Singapore-dollar denominated ETF offers exposure to the 50 largest A-shares firms listed on the Shanghai stock exchange. The assets under management of the ETF have doubled recently to about US\$130 million (S\$174 million) and it is among the top five most actively traded ETFs on the Singapore Exchange (SGX) in terms of volume and value.

Another advantage of ETFs is the lower cost. Generally, they have zero sales charges and lower management fees of less than 1 per cent. In fact, it is three times cheaper to own an ETF than a unit trust, said OCBC Securities' head of products group, Mr Tan Shen-Lin.

According to investment research house Morningstar, the average expense ratio of an ETF is currently 0.55 per cent compared with average fund management fees of 1.44 per cent for actively managed unit trusts.

As ETFs are listed on exchanges, you can buy and sell an ETF just like any stock during trading hours. This ensures trading flexibility and liquidity.

Mr Tan noted that so far this year alone, the average daily trading volume for ETFs has increased 132 per cent to US\$117.1 billion.

"Today, the global ETF industry has more than 2,200 ETFs with assets in excess of US\$1.04 trillion, listed across 42 exchanges. Of these, about 400 were launched only this year," he said.

Closer to home, the number of ETFs listed on the SGX has nearly doubled to 74 from 38 this time last year. According to an SGX spokesman, ETF trading value grew 33 per cent to \$3.95 billion in the first eight months of this year compared to the same period last year.

"The most actively traded ETFs are those offering exposure to gold, India-based markets and China A-shares," said SGX.

Some financial advisory firms such as Provident and New Independent have used ETFs liberally in their asset allocation strategy. This refers to spreading your investments in different asset classes and in different geographic regions.

Provident's chief executive Christopher Tan believes using ETFs is one of the best ways to execute one's asset allocation strategies.

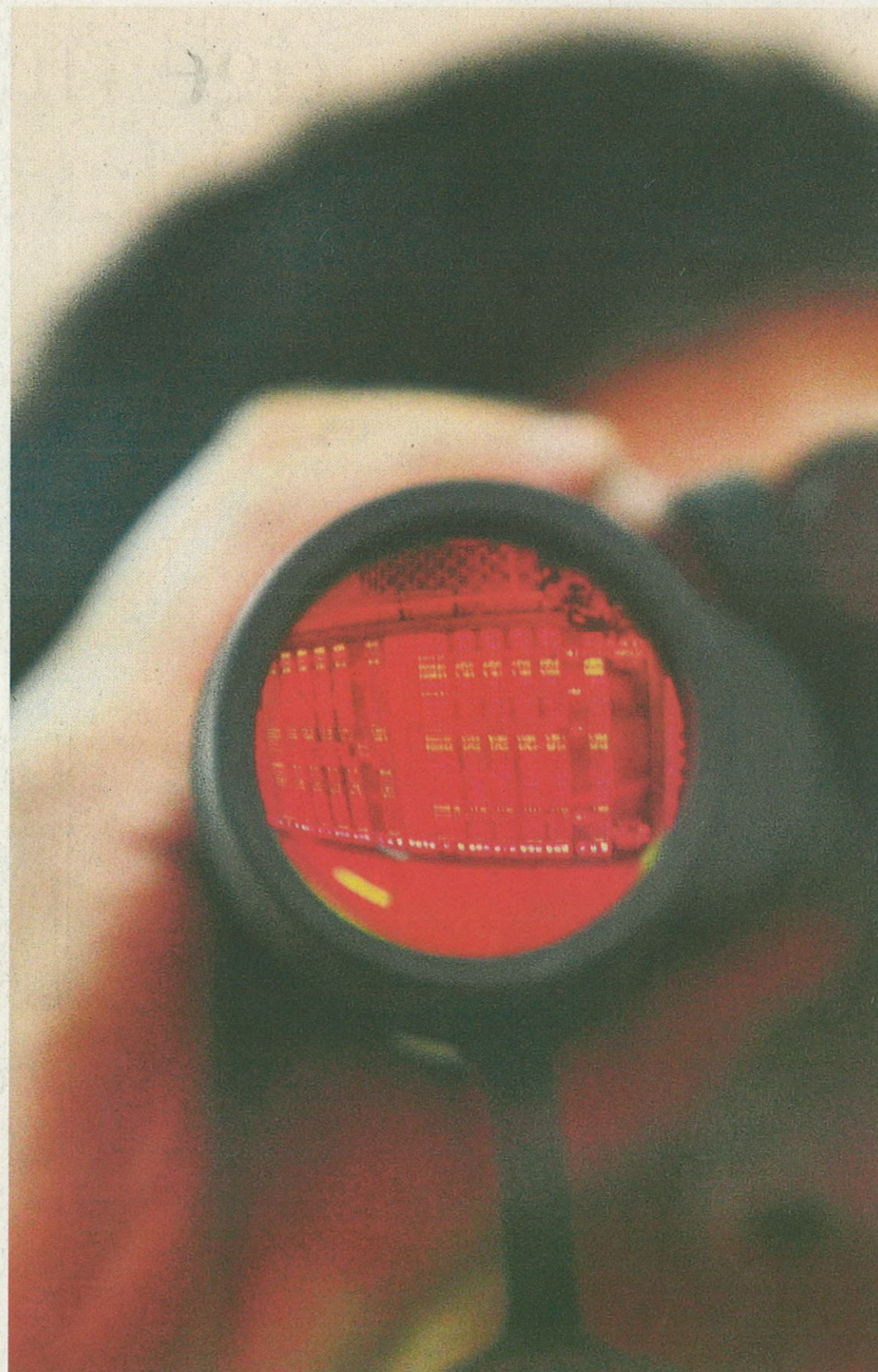
"We believe that most active (fund) managers cannot beat the market and for those who can, they cannot beat it consistently. So the better way to execute your asset allocation is not by unit trusts but by ETFs," he said.

This means choosing markets and asset classes that will rise in the long run, and staying invested. That is the key to successful investing, he added.

Launched in late 2008 for accredited investors, the targeted gross returns of Provident Global Portfolios - which comprise mainly ETFs - range from 8 per cent to 10 per cent. The annual management fee is 1.2 per cent.

In May, the Phillip-Provident Pi Global Portfolios, which invests mainly into ETFs, was launched for retail

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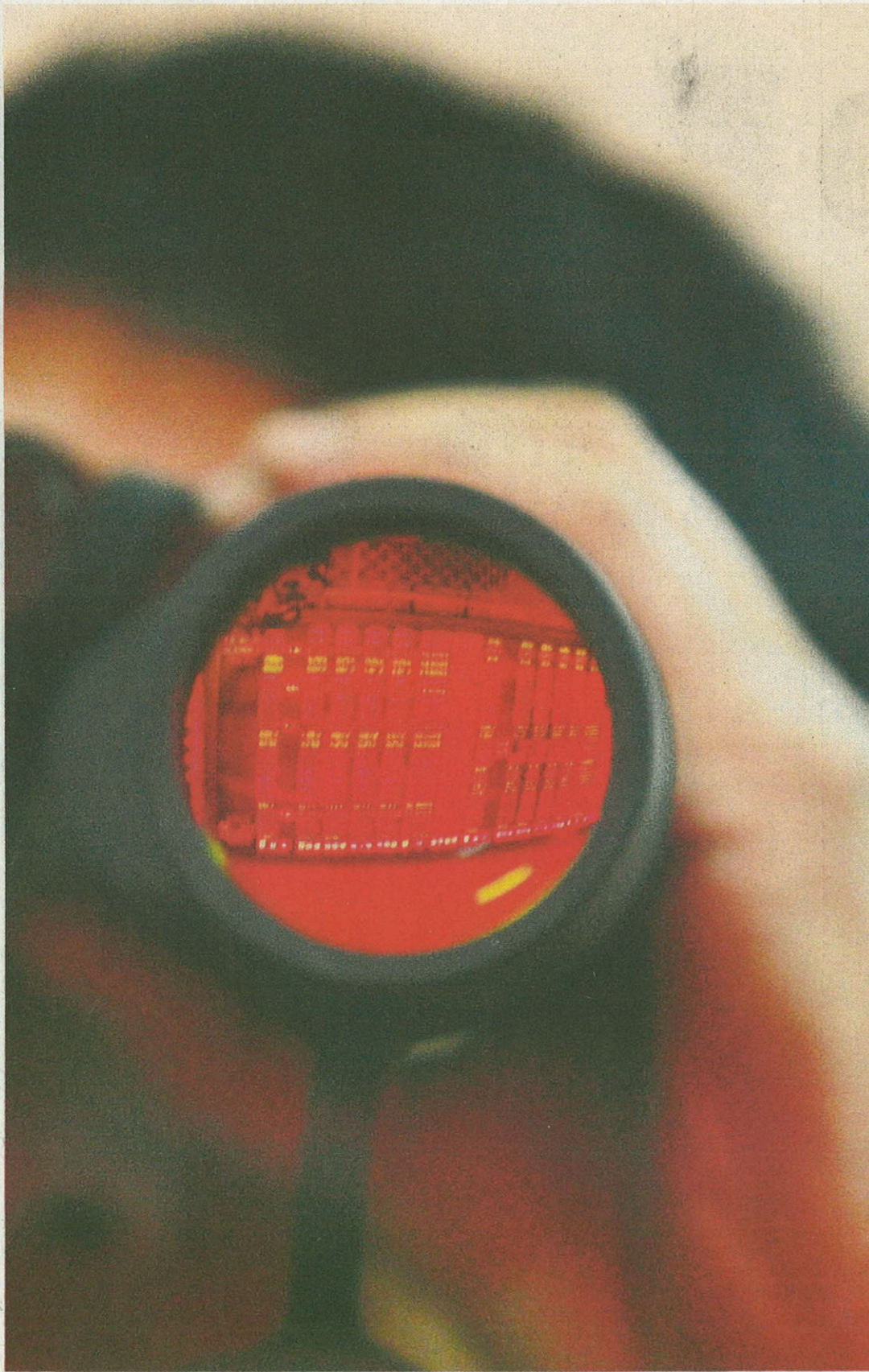


PHOTO: REUTERS

# What to look for in ETFs

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investors.

Mr Chong Jiun Yeh, executive director, head of structured investments at UOB Asset Management, said that because ETFs are straightforward, flexible and cost efficient, it is possible to construct an individual's entire portfolio comprising only ETFs.

But before you rush in, do note that ETFs come with some risks and have different levels of complexity. The more complex ones are unsuitable for the average retail investor.

Here are eight things to consider when buying ETFs.

**1 Understand what the ETF tracks**  
Like any investment tool, each ETF is created with a different set of investment objectives. While it aims to track the movement of a specified index or asset class, the extent of diversification of each ETF depends on the underlying index or asset class.

For instance, by investing in the StreetTRACKS Straits Times Index (STI) Fund, you gain exposure to all the 30 stocks, such as Singapore Press Holdings, SingTel and Singapore Airlines, which make up the STI. The ETF invests in the STI component stocks in proportion to their respective index weights. This means investors can diversify their portfolios without having to buy each of the stocks directly.

ETFs can also be theme-driven, focusing on market sectors such as real estate and energy, as well as certain asset classes or commodities such as gold.

It is prudent to read the prospectus and research reports to understand the investment objectives and the expected returns and volatility.

**2 How is the ETF constructed?**  
You should understand how the ETF is constructed and whether it fits into the overall portfolio diversification that you want to achieve, said Mr Chong.

Here are three ways that an ETF could be constructed:

■ **Full replication:** This is the ideal, simple type of construction where the ETF is replicated exactly with the component stocks of the underlying index.

■ **Representative sampling:** In situations where it may not be cost efficient to replicate exactly, some ETFs replicate

the index by investing only in a representative sample of stocks from the index it aims to track.

For example, one of the Hong Kong-listed iShares CSI300 Index ETFs – designed to replicate the performance of 300 stocks traded in the Shanghai and Shenzhen stock exchanges – owns about 140 stocks, and not 300.

■ **Use of swaps:** Instead of buying underlying securities, an ETF may use more sophisticated instruments such as swaps to provide the index return. As the swap is provided by a counterparty, you will be exposed to the risk of the counterparty going bankrupt and not honouring the return.

To acquaint yourselves with the risk potential, refer to the "investment approach" and "risks" portions of the prospectus. Do not invest if you are not comfortable or do not understand the structure.

**3 Tracking errors**  
There are a variety of reasons an ETF may be unable to replicate the performance of the underlying index exactly, resulting in tracking errors. The reasons include differences in timing, constraints in investing, costs and other factors.

This explains why the changes in net asset value (NAV) of the ETF may not mirror the price changes in the underlying index precisely.

**4 Check net asset value (NAV) of the ETF**

The NAV of the ETF may be different from the market price which is af-

ected by demand and supply.

So before buying into an ETF, you also need to know how much premium or discount the ETF is trading to the current NAV of the index, added Mr Chong.

**5 Market risks**  
While an ETF provides exposure to a specific market via the underlying index or asset, do bear in mind that it will be directly affected by the performance of its constituent securities. So if the global equity market falls owing to the European sovereign debt crisis, it is only logical that an ETF tracking the FTSE 100 Index – a share index of the 100 most highly capitalised British firms listed on the London Stock Exchange – will deliver a poor return, said OCBC's Mr Tan.

**6 Trading hours**  
Another tip from Provident's Mr Tan is to go for ETFs listed in markets which are open during Singapore office hours as it helps in placing buy and sell orders in a cost effective way.

**7 Credibility of ETF provider**  
Check out the track record of the ETF issuer and manager. You should be concerned with how long they have been in the ETF market and their past performance. Established players include iShares, Lyxor and Deutsche Bank, said Provident.

**8 Education**  
Since April, the SGX has worked closely with product providers, partner brokers, the Securities Investors Association of Singapore (Sias) to run a six-month marketing programme to provide weekly investor product research and product commentaries on ETFs in local newspapers and the websites of SGX, brokers and Sias Research.

OCBC Securities will be running a retail investor seminar on ETFs on Saturday. It is also launching a one-stop online portal, ETF IQ, in the coming weeks. The portal will offer global ETF-related materials such as market news, research reports and an online screening tool to retail investors.

ETF IQ is designed to track ETFs listed on three key markets – Singapore, the United States and Hong Kong.

## ETFs LISTED IN SINGAPORE

The 74 Singapore-listed ETFs comprise:

- 57 single or regional indices' equity ETFs covering Asia, Europe, the United States and Latin America;
- Seven fixed income ETFs;
- Six money market ETFs covering Singapore, Australia, Europe and the US; and
- Four commodity ETFs, including gold.

Source: SGX

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