

Separating ETF Myths from Realities

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 4,300 options available and US\$1.49 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 STOCKS.

REALITY: A stock 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 stock can be bought and sold on the major stock exchanges throughout the day at the market price. A stock’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 stocks, 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; optimization-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.

* Active ETFs are not currently listed on the Australian Securities Exchange

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

- **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.
- **OPTIMIZATION-BASED.** Designed to control trading costs and promote liquidity, this strategy uses a sampling process to create a representative or optimized 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 market-place, 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 stock, 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 stocks, 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 stocks. 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 stocks.

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. In addition, many funds charge ongoing fees to compensate brokers, record keepers, transfer agents and other entities for marketing and servicing costs. Indeed, depending on the amount invested, the commissions an investor may pay for trading shares of a particular ETF may actually be less than the sales charges and management fees they would be charged by investing the same amount in a managed fund with a similar strategy.

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.

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.

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 stock 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 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 which are generally taxable in the hands of investors.

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: ETFS' 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).

As an example at 31 December 2010, STW distributed \$0.78 per share in dividends, 79% of which were franked at a rate of 31.5%.² Using the formulas for grossing up dividends, we can see that the dividend may also be accompanied by \$0.28 cents per share of franking credits. We also know that the \$0.78 partially franked dividend may be equivalent to a \$1.06 in unfranked dividends.

MYTH: ETFS ARE AS LIQUID AS THE UNDERLYING ISSUER

REALITY: Physical ETFs do not have debts outstanding against the constituent stocks 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 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 18 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 neutralize the negative performance of others. Diversification does not ensure a profit or guarantee against a loss.

BID ASK SPREAD

The different between the highest price a buyer is willing to pay for an asset and the lowest price for which a seller is willing to sell it.

INDEX DEFINITIONS

S&P®/ASX 200 INDEX

The S&P/ASX 200 Index is recognised as one of the leading investment benchmarks for the Australian equity market. The index represents the 200 largest and most liquid publicly listed entities in Australia. The S&P/ASX 200 Index provides investors and fund managers with an effective benchmark for Australian equity performance as it offers a broader representation of the Australian market.



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ABOUT SPDR® ETFs

Offered by State Street Global Advisors, SPDR ETFs are a family of ETFs that provide investors with the flexibility to select investments that are precisely aligned to their investment strategy. Recognised as an industry pioneer, State Street Global Advisors created the first ever ETF in 1993—the SPDR S&P 500, which is currently the world’s largest ETF.³ In 2001, SSgA introduced ETFs in Australia when it launched the SPDR S&P/ASX 200 Fund and the SPDR S&P/ASX 50 Fund. Currently, State Street Global Advisors manages approximately US\$244 billion of ETF assets worldwide.⁴

For more information about our ETFs or how to invest, please call +612 9240 7600 or email info@spdrs.com.au.

IMPORTANT RISK INFORMATION

¹ Bloomberg, SSgA Global ETF Strategy & Research, as of 30 September, 2011

² As the ETFs are unit trusts, it may offset expenses against the cash amount of franked dividends which can result in franking credits in excess of the 30% corporate tax rate.

³ Bloomberg, as of 30 September, 2011.

⁴ As of 30 September 2011. This AUM includes the assets of the SPDR Gold Trust (approx. US\$64 billion as of 30 September 2011), for which State Street Global Markets, LLC, an affiliate of State Street Global Advisors serves as the marketing agent.

The issuer of units in SPDR S&P/ASX 200 Fund (ARSN 097 712 377) SPDR S&P/ASX 50 Fund (ARSN 097 712 420) and SPDR S&P/ASX Small Ordinaries Fund (ARSN 149 869 992) (“the Funds”) is State Street Global Advisors, Australia Services Limited (“SSgA, ASL”) (ABN 16 108 671 441, Australian Financial Services Licence “AFSL” number 274900). A Product Disclosure (“PDS”) statement for units in each of the funds is available at www.spdrs.com.au. Investors should consider the PDS in deciding whether to acquire, or continue to hold, units in an ETF. An investment in the Funds does not represent a deposit with or a liability of any company in the State Street Corporation group of companies including State Street Bank and Trust Company (ABN 70 062 819 630, AFSL 238276) and is subject to investment risk including possible delays in repayment and loss of income and principal invested.

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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 ETFs net asset value. Brokerage commissions and ETF expenses will reduce returns.

These investments may have difficulty in liquidating an investment position without taking a significant discount from current market value, which can be a significant problem with certain lightly traded securities.

Diversification does not ensure a profit or guarantee against loss.

Passive management and the creation/redemption process can help minimise capital gains distributions. Frequent trading of ETFs could significantly increase commissions and other costs such that they may offset any savings from low fees or costs.

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