under the radar report
BLUE CHIP

ISSUE ETF 2024
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THE ETF REPORT

ETFs are a building block for your core portfolio

Diversification is the key to successful investing because it prevents knee-jerk reactions to negative events. Exchange Traded Funds (ETFs) form one of the two bedrocks in our Building Wealth From Scratch (in the stock market) in the 12-month pathway, we have created for investing.

For a fraction of the cost of any other product, ETFs provide individuals with access to different asset classes, including bonds, equities, emerging markets, developed markets, commodities…

New products are being shipped based on crypto, ESG, Latin America, and Asia Pacific. However, the big money continues to come from the US, which is forecast to reach US$13 trillion under management over the next decade.

The big benefits of investing in an ETF are diversification at a **low cost**, **liquidity or flexibility** to get in and out and **transparency**. You can buy and sell an ETF as easily as buying and selling CBA on the ASX. Hence you pay brokerage, but factored into the price is a management fee, which can vary.

You should move beyond ETFs to enable your portfolio to generate outsized returns through stock picking. But initially, there is no better way of getting on the investment path than through an ETF tracked to a broad Index. As you get more comfortable with your own risk profile you will move beyond this asset class.

From there you can go and take on higher risk by investing directly in a portfolio of individual stocks. For example Under the Radar's **Magnificent Income Seven Portfolio (Blue Chip June 2024)**. You can do this because a portion of your total portfolio will be getting a market-related return.

Stock picking is hard, but intensely enjoyable. There is a case for owning an ETF with exposure to international markets. Put simply, the bigger the ETF, the better; it's about increased liquidity and lower costs. Big is better in this case.

Richard Hemming
Editor

the issue

THE ETF REPORT

BONUS Quarterly Report
In this Special Report we cover off on the big issues to ensure you have all you need to know at your fingertips:
We cover:

- How EFTs Work
- Passive V Active ETFs
- How much an ETF costs
- Fee Comparisons
- The Core/Satellite Approach
- Which ETFs you should buy
- Australian ETFs
- International ETFs
- To Hedge Or Not To Hedge

> **The way to generate big returns is stock picking. There is no other way. An Index-linked ETF gives you a base from which to Build Wealth From Scratch (in the stock market).**

Richard Hemming

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The ETF Report

ETFs are the biggest thing that has happened to the financial markets in the past 30 or 40 years. Although the first ETF was launched in the early 1990s, the industry really only kicked off just over a decade ago and is now worth about US$8.5 trillion (A$12.8 trillion) in Assets under Management.

ETFs offer three big benefits:

- **Diversification**
- **Flexibility**
- **Low cost**

What are ETFs?

ETFs are listed vehicles which are traded on exchanges such as the ASX, the FTSE, the NASDAQ and the NYSE. They can be traded anytime during the exchange's trading hours, using the same tools and strategies associated with shares (market, limit and stop orders, for example).

An ETF is like a basket that holds securities. In many cases, this is an index such as the S&P 500 Index. Another example familiar to people in Australia is the GOLD ETF whose basket is physical gold bars, held in a vault. If you buy A$1,000 of gold, you don't get much gold, about 13 grams, since it's trading at about A$2,363 an ounce. If you buy that gold in an ETF you're buying shares in a big basket of gold.

How they work

The units in an ETF are created by an ETF issuer, such as Blackrock or Vanguard, which issues them in exchange for the underlying basket of assets (usually equity securities). The ETF issuer can only transact with an entity called the authorised participant who is authorised by the ASX and has an agreement with the ETF issuer. The bigger the fund, the more authorised participants, which act to create and redeem shares in order to keep the ETF priced at fair value. These authorised participants are appointed by the issuer and are invisible to individual investors and advisers.

Another participant is the market maker, which is normally a broker.

ETFs are required to have one primary market maker, which is obliged to show quotes for buying and selling units that fall within a narrow range around the value of the ETF's underlying basket of assets or net asset value.

Authorised participants and market makers operate in a sphere which is not visible to individual investors and advisers and play an important role in keeping ETFs closely aligned to their net asset valuation. This means that you cannot bid for a unit in an ETF that is 10% below its net asset backing.

The ASX offers a market-making incentive scheme in order that market makers maintain prices and liquidity (the ability to easily buy and sell units). The market only functions effectively if the price quoted for these ETFs are close to their net asset valuation.

The ability to create and redeem shares gives big investors and market makers an incentive to arbitrage the price of the ETF with the fair value of the stocks in the basket. This continuous arbitrage is why an ETF's price on the exchange is typically very close to the value of the securities in the basket.

To create ETF units the authorised participant will transfer the basket of assets underlying the ETF to the ETF issuer. The issuer creates the ETF units that the market maker will acquire via the authorised participant. Redemptions of ETF units will follow the opposite process.

Diversification is important because it reduces stock-specific risk. For instance, BHP's shares have been weaker over the past few months and the other commodities producers on the ASX aren't faring much better. If half your portfolio is in resources you're going to be in the red.

The ETF Report

What are the Risks?

Index-tracking ETFs are relatively safe, but there are definite risks in the fast-growing market for various, more focussed, iterations that investors need to be aware of.

We prefer the large broadly diversified ETFs as a foundation for the $500 Strategy in *Building Wealth From Scratch*, to enable you to achieving portfolio diversification at the lowest possible cost.

Passive ETFs

ETFs are predominantly passive, which means they track an index using the same criteria as the index, and they are not funded by debt so there is no leverage involved. In contrast, being "actively" managed means that a fund manager is often trying to "beat" an index, in terms of performance.

Active ETFs

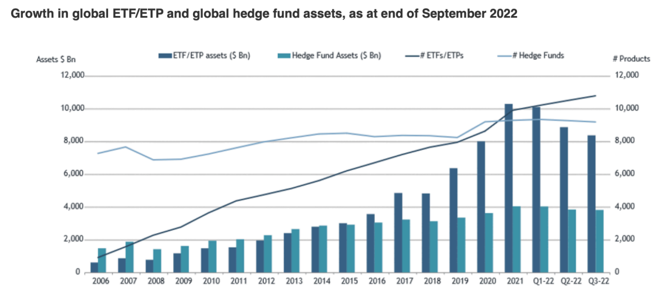
Actively managed ETFs are mutual funds by another name. An active ETF is an investment product that trades on the share market and holds a basket of securities. So far it's the same as the index tracking version. The difference is that the fees charged are higher because the manager is aiming to beat the index by actively managing the basket of stocks in the ETF.

Investor take-up has been limited because of the relatively high costs and the risk of a fund shutting down, which is not good on a number of levels. They also trade at a bid-offer spread of more than 1% from the underlying investment, which increases as more esoteric criteria form basis of the fund.

Ultimately if the underlying asset is risky, the ETF will replicate that risk. If you can't get out of the underlying asset easily as an individual investor, it's easy to appreciate that the ETF will find it just as difficult, probably more so. In investment markets, there is no magic (but there is the miracle of compound interest).

CONCLUSION:

ETFs are Fantastic BUT NOT once you get off the main road.



Source: ETFGI data sourced from ETF/ETP sponsors, exchanges, regulatory filings, Thomson Reuters/Lipper, Bloomberg, publicly available sources and data generated in-house.Note: This report is based on the most recent data available at the time of publication. Asset and flow data may change slightly as additional data becomes available.

Investor inflows into ETFs outstrips hedge funds

Demand for ETFs has skyrocketed in the past decade as investors move into low-cost funds that track an index, and out of traditional actively managed funds deemed as being inconsistent in performance and charging high fees.

Global ETF Assets under Management almost tripled from US$3.3 trillion in 2016 to over US$10 trillion in November 2021 and is still growing as investors seek low-cost access to investment markets.

For Australian investors ETFs are particularly relevant for reducing the risk inherent in the ASX market. Given the local bourse represents less than 2% of the global stock market, there's a huge concentration risk. In fact, the Big Four banks and the resource majors comprise half the total market!

The ETF Report

How much does an ETF cost?

Fees can vary, with many providers taking advantage of the perceived low cost. ETFs carry a brokerage and a management fee. The brokerage is when you buy and sell units in an ETF and are generally flat, but can increase at larger sizes.

Management fees are charged annually by the fund providers. From surveying a number of providers the average fee was 0.50%, but these varied by market, region & industry.

A rule of thumb is that the more traded a market, the lower the cost of the ETF that tracks that market. The crucial variable is the management expense ratio or MER, which is simply thee that is paid by shareholders of investment funds, including ETFs. It is simply the fees paid by the fund to the managers for individuals who run the fund, plus legal fees, accounting services etc as a percentage of the invested assets. As you would appreciate, size matters in this consideration.

Fee Comparison

ETFs providers charge much lower fees than competitive mutual funds, which means that clients have flocked to them like never before.

An Australian-listed ETF which tracks the S&P500 is Blackrock's iShares (ASX code IVV).

It charges management expenses of 3 basis points, or 0.034% of its funds under management go into paying the managers of that fund. You need to be aware of the currency affect, which is an additional consideration and which we discuss below,

The State Street product (SPDR) which replicates the S&P/ASX 200 Index (ASX code STW) charges 13 basis points, or 0.13%.

Compare these figures to what the actively managed Platinum International charges: 1.48% of its funds under management for running the fund.

The BT Future Goals Fund estimates that its total fees are 133 basis points or 1.33%.

These are the percentages by which these funds have to outperform before an investor gets a cent. Active ETFs sit somewhere in between, but have not had a strong track record.

Here is a table on the ETFs that cover Australian equities, which are both active and passive. This highlights the differing management fees and **indirect cost ratio**, which includes an estimate of the costs for investing in a managed fund or ETF and comes from the product disclosure statement. This includes fees deducted from the fund's assets rather than paid directly by the fund and can include performance fees.

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Australian ETFs, Passive or Active?

AUSTRALIAN ETFS: PASSIVE OR ACTIVE?

ETF NAME	ASX Code	Active or Passive	Fund Size*	1yr	3y	5y	Mgmt Fee	Indirect Cost Ratio (ICR)
Airlie Australian Share	AASF	ACTIVE	$597.4m	14.3	8.4	**11.5**	0.78%	0.78%
BetaShares Australia 200 ETF	A200	PASSIVE	$5130.0m	13.1	6.9	**8.0**	0.04%	0.07%
BetaShares Australian Equities Bear Hedge	BEAR	ACTIVE	$43.2m	-6.0	-4.8	**-8.3**	1.19%	1.48%
BetaShares Australian Ex-20 Portfolio Diversifier ETF	EX20	ACTIVE	$265.1m	8.5	5.0	**6.0**	0.20%	0.25%
BetaShares Australian Quality ETF	AQLT	ACTIVE	$95.2m	22.0 -	-		0.35%	0.00%
BetaShares Australian Sustainability Leaders ETF	FAIR	ACTIVE	$1178.0m	7.7	3.8	**5.0**	0.39%	0.49%
BetaShares FTSE Rafi Australia 200 ETF	QOZ	ACTIVE	$530.5m	16.1	8.3	**8.4**	0.30%	0.40%
BetaShares Managed Risk Australian Share	AUST	ACTIVE	$31.0m	9.4	3.0	**3.7**	0.39%	0.49%
BlackRock IShares Core MSCI Australia ESG Leaders ETF	IESG	PASSIVE	$212.1m	12.9 -	-		0.09%	0.09%
BlackRock iShares Core S&P/ASX 200 ETF	IOZ	PASSIVE	$2131.6m	12.8	6.7	**7.7**	0.05%	0.07%
BlackRock iShares Edge MSCI Australia Minimum Volatility ETF	MVOL	ACTIVE	$66.5m	7.7	5.8	**5.7**	0.30%	0.30%
BlackRock iShares Edge MSCI Australia Multifactor ETF	AUMF	ACTIVE	$21.1m	13.6	5.0	**6.3**	0.30%	0.30%
BlackRock iShares S&P/ASX 20 ETF	ILC	PASSIVE	$317.6m	14.9	7.0	**8.2**	0.24%	0.24%
State Street Global SPDR S&P/ASX 200	STW	PASSIVE	$5064.5m	12.9	6.7	**7.8**	0.05%	0.05%
State Street Global SPDR S&P/ASX 200 ESG	E200	PASSIVE	$48.4m	11.7 -	-		0.05%	0.05%
Van Eck MSCI Australian Sustainable Equity ETF	GRNV	ACTIVE	$163.9m	10.9	6.0	**6.6**	0.35%	0.35%
VanEck Australian Equal Weight ETF	MVW	ACTIVE	$2309.4m	10.2	7.8	**7.7**	0.35%	0.35%
Vanguard Australian Shares Index ETF	VAS	PASSIVE	$14952.8m	12.8	6.6	**7.8**	0.07%	0.10%
Vanguard Ethically Conscious Australian Shares ETF	VETH	ACTIVE	$423.5m	13.7	5.5 -		0.16%	0.17%
Vanguard MSCI Australian Large Companies Index ETF	VLC	ACTIVE	$235.9m	15.5	7.7	**8.8**	0.20%	0.20%

*@ 24 June 2024 Source, Bell Potter

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The ETF Report

The Core/Satellite Approach

Why ETFs are important for your portfolio
The core of your portfolio represents your exposure to market factors, which is what the industry calls "beta". The market is represented by indexes. In Australia's case, the benchmark is most often the S&P/ASX 200 Index. An example of a "core" approach is investing in some 60 stocks, or investing in an index-linked ETF or a Vanguard fund, which replicates the index. Doing the latter means you achieve diversification at a low cost.

Under the Radar has two portfolios:
1. Magnificent Income Seven Portfolio (Blue Chip June 2024)

2. Small Cap portfolio which currently has 18 stocks in it, plus an ETF replicating the price of gold (GOLD.ASX).

These highly concentrated funds are designed to add what the industry terms "alpha" which means performance above that experienced by the market.

Concentrating on the core
How much core you need in your portfolio depends on your risk appetite. If you can tolerate high volatility in the search for bigger profits, you would put more money into growth assets like small caps. The more conservative you are, the more you put into core or diversified element of your portfolio. Of course this is after you have established how much cash you are happy with holding.

What are core assets? These are index funds and ETFs that are passively managed and track the performance of the broader market; low-cost low fee and you get what the market return is. You get nice neat diversification.

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The ETF Market

Which ETFs do I buy?

In Building Wealth From Scratch (in the stock market) we advise buying an ETF tracking the domestic benchmark, the S&P/ASX 200 Index because this is the first step, as well as the cheapest option, in achieving diversification for an Australian investor.

The main ETF providers, which are all reputable:

1. Betashares Australia 200 ETF (A200.ASX)
2. Vanguard Australia Shares Index ETF (VAS.ASX)
3. iShares Core S&P/ASX 200 ETF (IOZ.ASX)
4. SPDR S&P/ASX 200 ETF (STW.ASX)

Bigger is Better

Bigger is better when choosing an ETF provider.

The BIG Providers: Vanguard, Blackrock & State Street
The ETF industry has attracted close to US$8 trillion in new business since the start of 2008. Like almost everything else in financial markets, scale delivers the biggest profits.

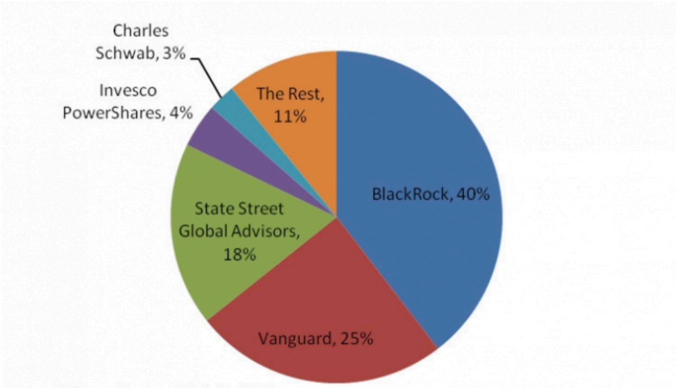
Given the concentration of EFT providers, the US giants Vanguard, BlackRock and State Street account for almost 70% of the global market.

As you can see above, Aussie-based **BetaShares Australia 200 ETF (A200:ASX)** competes when it comes to fees, which is why it makes the cut.

Vanguard has a definite competitive edge because of its unique structure. The company is owned by its clients, so it is effectively a mutual, which allows it to constantly cut fees as it gets bigger. Most of its competition need the fees to boost profits and fund payouts to shareholders.

Battle Of the ETF Giants

Market share of ETF Providers



BlackRock's iShare. Vanguard and State Street put the other ETF providers in the shade. BlackRock's bitcoin ETF reached US$10bn in less than two months this year, faster than any US ETF in history, fuelled by a rally in the cryptocurrency. The Securities Exchange Commission only gave the green light to bitcoin ETFs in January, which sent bitcoin to record levels. The leverage effect of these big ETFs rivals derivatives.

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The ETF Report

What about international shares?

Stock picking is hard, but enjoyable. It's much hard to add value in the only direct international investing that you would do – Big Caps. There is nothing wrong with owning Telsa, Apple, Alphabet, Nvidia and in the past few years they have done very well.

But the benefits of international investing through an ETF is much greater than investing in any single stock. This gives you both international and stock diversification that most investors require for a major portfolio.

Within global shares, are they currency hedged or currency unhedged?
By purchasing assets located offshore via an unhedged global ETF, you are taking a short position in the Australian dollar and a long position in the US dollar and/or other currencies.

Your offshore investments benefit when those foreign currencies appreciate against the Aussie; but you suffer when those offshore currencies are depreciating against the Australian dollar. Alternatively, your offshore investment suffers when the Australian dollar is appreciating.

Three years ago one Aussie dollar was worth almost 80 US cents; now it's level now at 66 US cents. Consequently, in the over this period any investment priced in US dollars and not hedged for currency movements would have been boosted by over 20% in value had that the underlying price stayed the same (in US dollars). Conversely, if the Australian dollar appreciates from current levels i.e. goes from 66 US cents to 75 US cents, you would lose about 12% on the basis of currency alone, without including transaction costs.

Ultimately you need to make a choice whether you buy an ETF that is currency hedged or non-currency hedged.

If you believe that the Australian dollar will continue to appreciate, you will choose the currency-hedged version. If you believe the Australian dollar will decrease, you'll choose the unhedged version.

CONCLUSION:

We prefer unhedged index linked ETFs from big providers.

It's worth noting that the hedged version will be more costly because the ETF provider is using currency tools to achieve this position and this costs money, which eats into returns. If you do want to hedge, use a currency fund.

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The ETF Report

International ETFs

US MARKET

iShares S&P 500 ETF (IVV.ASX)
Managed by Blackrock and tracks the S&P500 Index, with management fees of 0.04%. Unhedged.

Vanguard US Total Market Shares Index ETF (VTS:ASX)
Exposure to the mega-caps listed in the United States. The fund tracks the CRSP US Total Market Index. Unhedged. Quarterly distributions.

INTERNATIONAL

Vanguard MSCI Index International Shares ETF (VGS:ASX)
Exposure to some of the world's largest companies listed in developed economies, tracking the MSCI World ex-Australia Index (with net dividends reinvested). Quarterly distributions.

Vanguard All-World Ex-US Shares Index ETF (VEU:ASX)
Exposure to some of the world's largest listed companies in developed and emerging economies outside the United States. Tracks the FTSE All World Ex-US Index. Distributions are made quarterly and management fees are 0.09% per annum.

EMERGING MARKETS

iShares MSCI Emerging Markets ETF (IEM:ASX)
Exposure to 800 plus large and mid-size companies in emerging markets, tracking the MSCI Emerging Markets Index. Semi-annual distributions and management fees are 0.67%.

Vanguard FTSE Emerging Markets Shares ETF (VGE:ASX)
Exposure to more than 5,000 companies in emerging economies, tracking the FTSE Emerging Markets All Cap China A Inclusion Index (dividends reinvested) in Australian dollars. Unhedged.

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99% of all financial news relates to the 40 to 50 biggest companies.
So what about the rest? They're Under the Radar.

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