Learn the basics

EXCHANGE TRADED FUNDS (ETFs).

An introductory guide for first time investors

Exchange Traded Funds (ETFs) are managed index funds that trade on the stock exchange. They combine liquidity of shares with the diversification and efficiency benefits of managed funds.

Essentially, ETFs provide access to a diversified portfolio of underlying assets in one quick and simple transaction. ETFs are constructed and managed by professional fund managers.

They are generally passive vehicles, which means an ETF will aim to replicate the returns of a specific index/benchmark. For example, a 2% rise or fall in the index would result in approximately a 2% rise or fall for an ETF which tracked that index (all other things being equal).

Depending on the index/benchmark the ETF is tracking, an ETF can offer exposures to domestic equities, international equities, fixed income, currencies and commodities.

BELL POTTER

How an ETF works

1. The Primary Market

ETFs are structured as open-ended funds, which means an ETF does not have a fixed amount of shares on issue. This unique capability of continually offering shares is done through a process of daily creation and redemption. An ETF provider employs Market Makers and Authorised Participants (AP) to manage this process.

The AP are tasked to manage the creation and redemption function of an ETF. To create new units for sale in the secondary market, the AP delivers a basket of securities, which is determined by the ETF Sponsor. In return, ETF units of equal value are delivered to the AP. The AP then sells the ETF units to the public on the exchange to meet investor demand.

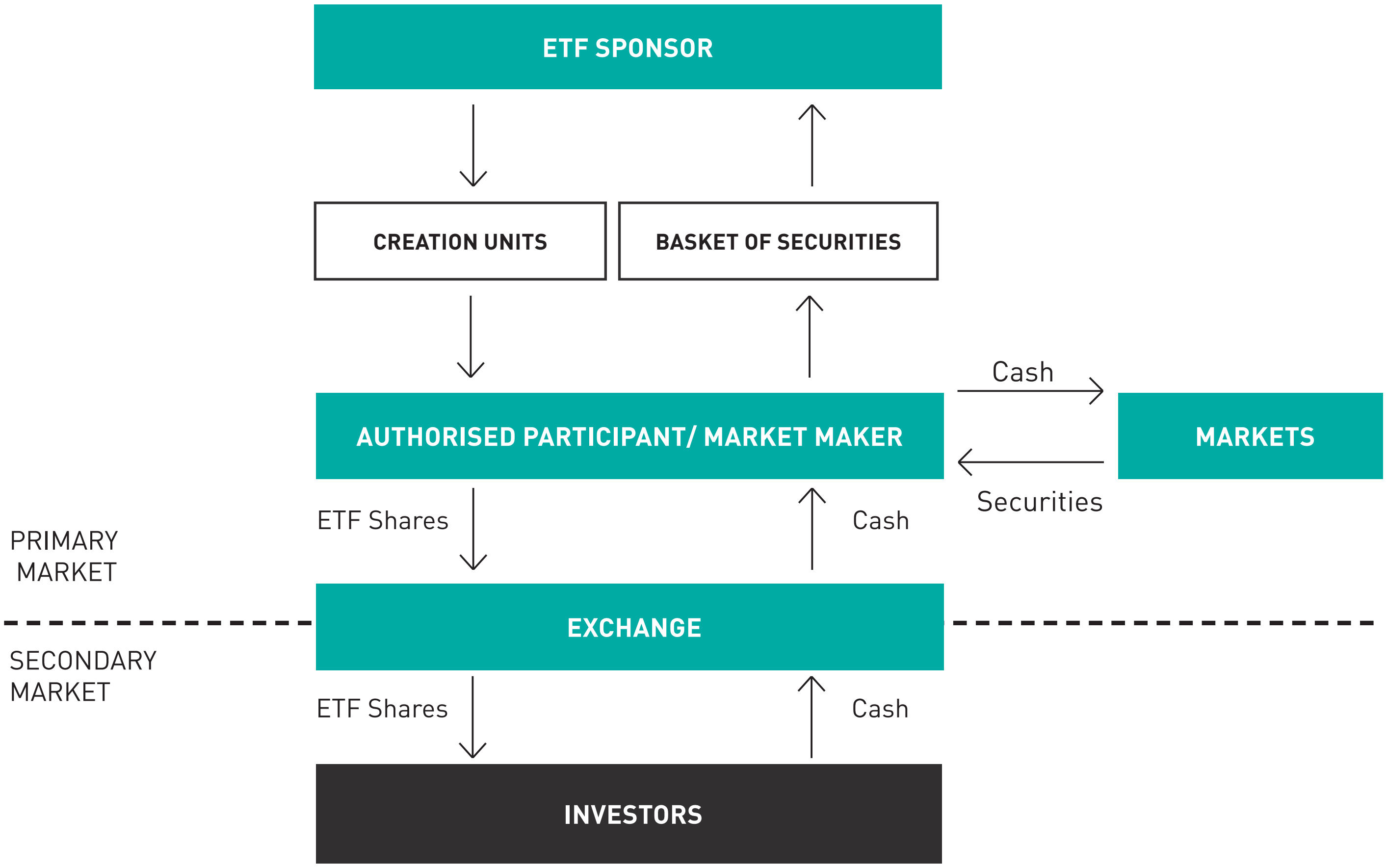
Market Makers meanwhile, ensure the liquidity in the market by quoting Buy and Sell prices during the trading day. These prices are continuously updated to reflect the changes in underlying securities the ETF holds.

2. The Secondary Market

In the secondary market, buyers and sellers transact on the stock exchange – units are bought from/sold to another investor without any involvement of the ETF sponsor. These transactions are processed throughout the trading day at market price.

Essentially, the AP/Market Maker will pick up a trade and create/redeem the ETF (Primary Market) if an investor can't find a buyer/seller on the ASX (Secondary Market) - given it is at a reasonable price.

FIGURE 1 - THE PRIMARY AND SECONDARY MARKET



How you can use an ETF in your portfolio

Building an investment portfolio
ETFs covering different asset classes and markets can be used as building blocks to build a diversified portfolio that operates at a low cost.

Core solutions
ETFs can be used to create a 'core' of an investment portfolio and can potentially seek returns above its benchmark if layered with other investments like actively managed funds.

Portfolio rebalancing
Can provide a simple and cost efficient way to rebalance the exposure in your portfolio. Rebalancing your portfolio helps ensure your investment portfolio reflects your investment objective.

Access specific asset classes
ETFs can be used to instantly invest in specific market sectors, countries or regions that are often difficult to access by investors.

Key benefits and risks

KEY BENEFITS

Diversification

ETFs can provide a quick and simple way for investors to gain exposure to a diversified portfolio with one transaction on the ASX.

Low cost

Annual management fees of an ETF are generally lower than many traditional managed funds.

Accessibility

ETFs have dramatically increased access to all major asset classes that can sometimes be difficult for investors to access.

Flexibility

ETFs are designed to be just like shares so ETFs can be traded during market hours.

Liquidity

The listed nature of ETFs provides investors with the liquidity to react to changing market conditions.

Transparency

ETF providers publicly disclose its portfolio holdings of each ETF, as often as daily.

Distribution and franking credits

ETFs generally distribute dividends and franking credits it receives from its underlying portfolio to Unit Holders.

RISKS

Tracking error
Imperfect correlation between the ETF and its underlying index is referred to Tracking Error. This may occur due to index methodology, rounding errors and reconstitution of the index. This risk may increase at times of market instability.

Bid offer spread
The possibility of price discrepancy between the ETF and the price of shares that it holds. Therefore, it is suggested to hold off trading an ETF until the market is open. For instance, if you are trading an Asian ETF, try placing the order when the Asian Market opens.

Currency risk
International ETFs are subjected to fluctuations in the Australian dollars against other currencies, which may erode or magnify returns.

Passive management
ETFs are not actively managed and do not attempt to take defensive positions in any market conditions, including declining markets. These are passive vehicles used to gain a low cost exposure.

Four deciding factors

1. **INVESTMENT STRATEGY**
   Determining the correct investment strategy will assist you to pick the most effective ETF.

2. **INVESTMENT HORIZON**
   Determine if the ETF you are seeking is for a short-term or long term investment.

3. **ETF ASSETS**
   Have a good understanding of your chosen ETF and all its holdings.

4. **FEES**
   You might find multiple ETFs offering similar investment strategies. Often, choosing the cheaper ETF might be the best strategy.

Know the difference

	SHARES	BONDS	MANAGED FUNDS	ETFs
INTRA DAY PRICING	Yes	Yes	No	Yes
LIQUIDITY	High	Low	Varied	High
ACCESSIBILITY	High	Varied	Varied	High
FEES				
TRANSACTION COST	Standard Brokerage	Varied	Varied	Standard Brokerage
MANAGEMENT FEE	N/A	N/A	High MER	Low MER
TRANSPARENCY	N/A	N/A	Varied	Disclose as often as daily
DIVERSIFICATION	Low	Low	High	High