Exchange traded funds (ETFs)

Opening new opportunities for financial advisers

Growth in the retail ETF industry, as well as the ability of ETFs to complement unit trust investments, provides financial advisers with additional tools to build better investment portfolios for their clients.

Large institutional investors were the first to recognise the cost benefits of ETFs, but individual investors and financial advisers are also recognising their appeal in the quest to keep fees as low as possible. This has contributed to the recent growth of ETFs, both in the number of offerings and in the number of assets under management.

In fact, as of June 2010, investors have poured more than R70 billion into ETFs and the market continues to expand, with more than 46 listed ETFs already available to investors. Growth in the retail ETF industry is also opening up areas of the market that were previously inaccessible or prohibitively expensive, such as institutional grade products.

The recent launch of iTransact, South Africa's leading independent ETF investment platform for financial advisers and investors, also reflects the growing popularity of ETFs.

Tracking an index

Like most unit trusts, most ETFs are registered collective investment schemes (unit trusts) that offer investors a whole share in a professionally managed portfolio of securities, such as shares and bonds. All ETFs are thus low-cost index tracking unit trusts, listed on the stock exchange, which replicate an index's performance.

An index is a statistical measure of a compilation of several shares, for example the FTSE/JSE Top 40 Companies Index which picks and then tracks only the best performing 40 companies out of the hundreds of listed companies so that investors are only offered the best and don't have to worry about the others.

Best of both worlds

There is a strong argument in favour of combining ETFs and unit trusts into an investor's investment portfolio. A portfolio composed entirely of passively managed ETFs typically means low costs, low manager risk and consistent performance relative to markets. However, it also means giving up any opportunity for outperforming the market. Actively managed unit trusts purport to provide this opportunity, but in South Africa more than 75 per cent of these active managers don't beat the market despite the huge fees they charge investors to do so.

In fact, active managers exploit our natural human behaviour that makes us have an above average belief in the human ability to forecast the future based on events affecting us at the time.

Lance Solms, head of iTransact says, "ETFs and unit trusts are complementary to each other and moderate the swings between the extremes of relative performance." Solms also states that a combined strategy using both ETFs (passive) and unit trusts (active) can help avoid the pangs of regret investors experience when one approach trumps the other, offering investors the best of both worlds.

Role of financial advisers

In Europe and the UK, around 90 per cent of ETF users are institutions and professional investors who do not make use of financial advisers. In contrast, in the US, where ETFs are largely sold by financial advisers using distribution platforms, retail investors account for around 50 per cent of the US ETF market.

Andrew Arenberg, director of marketing for iShares – one of the world's largest ETF firms, once stated that investors into retail ETFs mostly come through financial advisers and account for about two-thirds of new money flowing into ETFs. He added that new money from individuals investing without financial advisers only accounted for about 10 per cent of overall inflows.

South African financial advisers will no doubt also play an important role in the growth of the ETF industry as they begin understanding the benefits of using ETFs as an additional investment tool to help their clients achieve their long-term investment objectives.