Exchange traded funds

Plain Talk® Library
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Introducing exchange traded funds

Exchange traded funds, or ETFs, are attracting increasing attention from investors with a growing range of products available.

In this Plain Talk Guide you will find answers to common questions about ETFs. You will also learn how ETFs and traditional managed funds compare and gain a better understanding of how ETFs could benefit your investment portfolio.

Since ETFs were first introduced in the US in 1993, they have become one of the fastest growing investment products in the world.

Along with traditional managed funds, ETFs are another way investors can access Vanguard’s low-cost, high-quality approach to investing.

Growth in ETF assets in Australia

Data as at 31 October 2017

1 Source: Vanguard.
What are ETFs?

An ETF is a managed fund which is traded on the stock exchange. ETFs cover all asset classes, including equities, fixed interest and cash. They can also be broad, covering a full market (or markets), or more specific, covering individual sectors such as property, commodities, gold, oil and banks.

There are now even diversified ETFs that offer low-cost access to thousands of securities across a wide variety of asset classes in a single trade. New ETF products are continually being launched so it’s important to know what you’re investing in.

Index ETFs

ETFs have traditionally used an indexing approach that seeks to track a specific market or sector index. Index ETFs carry all the benefits of traditional index managed funds, such as low operating costs, diversification, tax efficiency and simplicity. They also have some of the benefits of share trading, including continuous pricing, trading flexibility and low execution costs.

The value of an index ETF will move in line with the index it tracks. For example, a 2% rise or fall in the index would result in approximately a 2% rise or fall for an ETF which tracks that index (all other things being equal).

The quoted price of the ETF will replicate changes in price in the underlying holdings throughout the day or the expected change when markets are closed.
Active ETFs

Active ETFs trade on the exchange, just like index ETFs, which means they share many of the same features and benefits. An active ETF doesn’t track an index but rather uses a specific investment approach to achieve a particular outcome such as outperforming an index or minimising the impact of market volatility.

As the ETF market has evolved, investors now have access to a variety of active exchange traded products across the risk spectrum—from factor-based active ETFs that are backed by physical assets all the way through to more leveraged and higher cost inverse ETFs that offer potentially higher returns, albeit with higher risk.

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ETFs — a managed fund traded on an exchange

- **Index Fund**
  - Index fund characteristics
    - Diversification
    - Low fees
    - Low portfolio turnover

- **Active Fund**
  - Active fund characteristics
    - Doesn’t track an index
    - Uses a specific investment approach to achieve particular risk or return outcomes
    - May be higher risk and higher in cost than index funds

- **Individual Share**
  - Individual share characteristics
    - Continuous pricing
    - Trading flexibility
    - Low execution costs
Types of ETFs

**Index**
Designed to track a particular index, like the S&P 500 or ASX 300.

**Commodity**
Designed to track the price of a commodity, such as gold, oil or coffee.

**Inverse**
Designed to profit from a decline in the underlying market or index.

**Actively Managed**
Designed to outperform an index, unlike most ETFs, which are designed to track an index.

**Industry**
Designed to provide exposure to a particular industry, such as pharmaceuticals or technology.

**Factor**
Designed to achieve specific outcomes such as outperforming an index or lowering market volatility by targeting one or more factors (such as value, growth or volatility).
Vanguard’s approach to ETFs

Vanguard offers a range of high-quality ETFs using a variety of strategies to achieve specific outcomes for investors, while keeping costs low.

Vanguard’s index ETFs aim to deliver the index return, before fees, by investing in underlying securities according to their weightings in the benchmark index. This means an ETF’s return, before costs, should closely match the index it tracks, just like a traditional index managed fund.

Vanguard also offers active ETFs that do not track or replicate the performance of a benchmark. Instead, these ETFs use a rules-based approach to achieve specific outcomes for investors, such as lowering portfolio volatility or seeking long-term capital growth through shares offering good value.

Unlike some active ETFs available in Australia which offer concentrated portfolios with a lower number of holdings, Vanguard’s low-cost active ETFs use a transparent and broadly diversified approach, thereby reducing concentration risk.

At Vanguard our ETFs are backed by physical securities, providing investors with transparency about how their money is invested.
How can you invest in ETFs?

ETFs are traded on an exchange like individual securities, but are open-ended like managed funds. So new units can be created and existing units redeemed daily, based on investor demand.

To purchase holdings in an ETF, investors select the ETF they would like to invest in. Using the three or four letter ‘ticker’ applicable to that ETF, they place an order to buy (or sell) the ETF on the exchange through either a full service advisory account or an online broker.

The two most common ways to trade ETF securities are market orders and limit orders. It depends on your needs, but limit orders offer the advantage of price certainty.

1. Market orders

With a market order, the investor places an order in the market to buy or sell ETFs at the best available price.

For example, an investor puts in a market order to buy 100 ETF securities. The order will be automatically matched up with the best available price, which happens to be $51, and the trade will be executed immediately.

Example

- Investor A logs into their brokerage account.
- Investor A puts in a market order to buy 100 ETF securities.
- The order is automatically executed at the best ASX price, which is $51.
- Trade settles 2 days later and investor now owns 100 securities.
The downside of a market order is that you lose control over your maximum/minimum price and you could end up paying a higher price than you intended (see the Limit orders section below for further details on maximum/minimum price).

To increase the likelihood of placing a trade at your preferred price, it could be a good idea to consider using a limit order.

2. Limit orders

With a limit order, the investor places an order in the market to buy a specified quantity of an ETF at or below a specified (or limit) price, or to sell it at or above a specified price.

As the name suggests, a limit order allows you to specify the maximum you are willing to pay when purchasing an ETF and the minimum price you are happy to sell the ETF for.

Using the same example as above, our investor puts in a limit order to buy 100 ETF securities at $50 per security. If later in the trading day the price drops to $50, the order is automatically executed at that price. In this case our investor has invested at the price they wanted by using a limit order. On the downside it may take a long time, if ever, for the price of the ETF to fall or rise to the same price as your limit order. So it may be a good idea to consider setting a reasonable limit.

Even if you are looking to trade at current market prices, you may decide to place a limit price on your order above (for a buy) or below (for a sell) current prices to ensure the trade is placed at a price you are comfortable with.
Fees and costs

ETFs are generally a low-cost investment, and substantially lower in cost than investing in the same exposure of individually purchased shares.

Management fees

An ETF’s management fee comprises the issuer’s responsible entity fee and recoverable expenses including:

- the custodian’s fees (excluding transaction-based fees)
- accounting and audit fees
- any applicable index licence fees
- registry service fees
- listing fees
- any other recoverable expenses under the constitution of the ETF, such as the cost of preparing and amending the constitution, the cost of producing the Product Disclosure Statement (PDS), the cost of investor meetings, postage and other fund administration expenses.

The management fee is calculated daily and deducted from the ETF’s net asset value. There may be other fees and costs charged within the ETF, so check the PDS for more detail before you invest.

Costs involved

Managed fund

Exchange traded fund

Brokerage fees

The broker charges a fee when you buy or sell an ETF, starting from around $10 per transaction.
ETF terms

Bid/Ask spread
The amount by which the ask price exceeds the bid price. This is the difference in price between the highest price that a buyer is willing to pay for a security and the lowest price for which a seller is willing to sell it.

Net Asset Value (NAV)
Ideally an ETF will trade close to its NAV, which is the underlying total value of net assets divided by the number of securities on issue. The NAV is a good indicator of how much the ETF is worth and approximately what price is appropriate to pay.
Benefits of ETFs

Low cost

ETFs typically cost less than traditional managed funds, and substantially less than buying individual shares.

Diversification

ETFs can provide investors with broad exposure to entire markets, asset classes or multi-asset class investments which offer an all-in-one investment solution.

Tax efficiency

Due to their ‘buy and hold’ approach, index ETFs generally have a low turnover, minimising capital gains and improving long-term performance and tax efficiency.

Liquidity

ETFs provide exposure to broad investments in liquid markets. The open-ended structure of an ETF means that it can be as liquid as the underlying securities that it invests in.

Transparency

Most ETFs are highly transparent investments that provide investors full visibility of what they are investing in.

At Vanguard, every day we provide detailed information to the market including:

- the net asset value
- the daily basket of holdings
- the intraday net asset value for domestic equity and fixed income ETFs every 15 seconds throughout the trading day.
ETF Fact—Net Asset Value

Ideally an ETF will trade close to its NAV, which is the underlying total value of net assets divided by the number of securities on issue. The NAV can be used as an indicator of how much the ETF is worth and what sort of price is appropriate to pay.
Risk and return

Index ETFs are designed to provide returns that are similar to the benchmark they track. When investing in an ETF, investors should be aware that the value of the ETF may rise and fall over time, and keep in mind one of the main principles of investing—the higher the potential reward, the higher the risk of losing money.

Risk

Asset classes generally range from low to high risk in the following order—cash, fixed interest, property and shares.

ETF prices can fluctuate within a wide range just like the overall sharemarket, so you should consider your tolerance for market ups and downs and know what the underlying ETF investments are.

Returns

Returns generally come in the form of income and growth.

- Investors can receive income in the form of distributions that are usually paid quarterly or semi-annually based on the amount of ETF securities they hold.

- Growth comes from any increase in the value of the portfolio’s assets and will be reflected in the ETF’s NAV.
Currency risk

Unhedged international ETFs are subject to fluctuations in the value of the Australian dollar against other currencies. Currency movements can impact on your returns because price movements must be converted back into Australian dollars, resulting in gains or losses.

For example, if the value of the Australian dollar (AUD) rises, the value of investments held in foreign assets will fall. Conversely, a weaker Australian dollar increases the AUD value of investments held in foreign assets.

Some international ETFs are currency hedged, offering investors the option to reduce the impact of currency fluctuations.

Vanguard offers currency hedged options for international fixed interest and equity investments.

Should you invest in an ETF or managed fund?

Most of Vanguard’s ETFs and their equivalent managed funds own the same underlying assets. The decision of which vehicle (ETF or managed fund) to invest in will come down to which structure best suits your particular circumstances.

ETFs could suit investors who are looking for an investment option that provides access to broad investment solutions at a single low price. ETFs are particularly beneficial for investors who are comfortable trading on the securities exchange and who want continuous pricing.

Managed funds could be the better investment choice for investors who are looking to continually add to or remove money from their investment through regular contributions or deductions. As brokerage may be paid on every transaction within an ETF, the fees paid in brokerage may make ETFs a more expensive investment option.
Exchange traded funds
Vanguard® Plain Talk Guides
How can you use ETFs in your investment portfolio?

ETFs can be a simple and highly cost-effective way of gaining broad market coverage across a range of asset classes.

We believe in a top-down approach to constructing your portfolio. Work out your risk profile and investment timeframe. Then develop your strategic long-term asset allocation based on your risk profile. Then decide how much to allocate to each asset class. Finally, select specific ETF investments to provide broad exposure within each asset class. Diversifying across and within asset classes helps to reduce volatility and smooth out returns over time.

The ease, flexibility, diversification and low cost of ETFs make them an innovative and effective investment solution to:

- **Construct an investment portfolio**—ETFs covering different asset types and markets can be used to build a robust, low-cost portfolio.
- **Build the foundations of a portfolio**—ETFs can be used to create the diversified “core” of an investment portfolio, complemented by other investments like direct shares or more actively managed funds (‘satellites’) to seek returns above the benchmark.
- **Rebalance a portfolio**—Over time portfolios can move away from their initial asset allocations as the value of different assets change. ETFs can be used to correct these imbalances quickly, easily and cost-effectively by buying or selling assets.
- **Trade in the market**—ETFs offer investors the ability to rapidly deploy cash into the market, and gain exposure to market movements while deciding on a more long-term investment strategy.
The Vanguard difference

When you invest with Vanguard, you have more than 40 years of investing experience behind you. So no matter which investment products suit your needs, you can feel confident that Vanguard investments are built on a rigorous investment philosophy that stands the test of time.

Since launching the first index mutual fund for individual investors in 1976, Vanguard has strived to be the world’s highest-value provider of investment products and services. We have an unwavering focus on our clients with a commitment to champion what’s best for investors by offering outstanding service, while keeping costs low.

Low-cost investing

We know we can’t control the markets, but we can control the costs of investing. To that end, providing low-cost investments isn’t a pricing strategy for us. It’s how we do business.

We can keep our costs low because of our unique ownership structure in the United States, which allows us to return profits to investors through lower costs so investors can earn more over time.

Our range of managed funds and ETFs

Vanguard offers a complete range of funds across all asset classes.

To see our complete product offerings, visit vanguard.com.au.
For more information

Contact us or speak to your financial adviser.

**Personal investors**

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<td>vanguard.com.au</td>
</tr>
<tr>
<td>Phone</td>
<td>1300 655 101</td>
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<td></td>
<td>8:00 am to 6:00 pm</td>
</tr>
<tr>
<td></td>
<td>Monday to Friday (Melbourne time)</td>
</tr>
<tr>
<td>Email</td>
<td><a href="mailto:clientservices@vanguard.com.au">clientservices@vanguard.com.au</a></td>
</tr>
<tr>
<td>Mail</td>
<td>Vanguard Investments Australia Ltd</td>
</tr>
<tr>
<td></td>
<td>GPO Box 3006</td>
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<td></td>
<td>Melbourne VIC 3001</td>
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**Financial advisers**

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<tr>
<td>Web</td>
<td>vanguard.com.au/adviser</td>
</tr>
<tr>
<td>Phone</td>
<td>1300 655 205</td>
</tr>
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<td></td>
<td>8:00 am to 6:00 pm</td>
</tr>
<tr>
<td></td>
<td>Monday to Friday (Melbourne time)</td>
</tr>
<tr>
<td>Email</td>
<td><a href="mailto:adviserservices@vanguard.com.au">adviserservices@vanguard.com.au</a></td>
</tr>
<tr>
<td>Mail</td>
<td>Vanguard Investments Australia Ltd</td>
</tr>
<tr>
<td></td>
<td>GPO Box 3006</td>
</tr>
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<td></td>
<td>Melbourne VIC 3001</td>
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Past performance is not an indication of future performance.

Vanguard ETFs will only be issued to Authorised Participants, that is persons who have entered into an Authorised Participant Agreement with Vanguard. Retail investors can transact in Vanguard ETFs through a stockbroker or financial adviser on the secondary market.

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