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More than meets the eye

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The latest fad, ETFs are cheap, easy to manage and a reliable source of liquidity - but they have a downside, writes David Potts.

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For less than \$100 you could buy an entire share portfolio – though the way the market is going, that might be what you finish up with as well. Except that the right shares always rise over time. Eventually. One day.

The most popular exchange-traded fund, or ETF, has 200 different stocks, not that you'd own much of any of them no matter how many units you bought – but then you want to ride the rally when it comes and grab any dividends along the way.

Better than high-risk futures contracts, propping up the lifestyle of a fund manager you've never met, or going out on a limb picking a stock. There are ETFs for almost every occasion, at little cost or effort on your part.

No wonder they're the latest sharemarket fad. Funnily enough, DIY super funds especially love an ETF because, well, then they don't have to do anything themselves.

ETFs are low-fee index funds that trade on the stock exchange, just like the shares they own. Take the top 200 shares. One phone call or mouse click to a broker can get you units in the SPDR 200 Fund run by State Street, which trades under the ASX code STW.

It also pays dividends. As a trust fund, ETFs have to pass all income on to their unit holders. In fact several specialise in fully franked dividends – Aii's FIN, which tracks the banks, SPDR's SYI, Russell's RDV and iShares' IHD.

Anyway, bung an ETF into a share portfolio and it's suddenly diversified. Not only can you tap into 200 stocks but you can add, say, the 100 biggest multinationals with the S&P Global 100 (IOO, though curiously it doesn't seem to have Apple, the world's most valuable stock – surely not an oversight?).

While their prices will bob up and down with whatever they're indexing – this is the sharemarket after all – the crucial thing is they can't go off on their own merry way. They're nailed to the index they're following because if the price goes higher than it should, more shares are issued to bring it back into line. Or if the price drifts too low they cancel some shares and the resulting shortage pushes it back up again.

The ETFs hire special brokers, called market makers, who make money by fixing any discrepancy between the price and value. You want them to be greedy enough to do their jobs and they haven't disappointed so far.

The devil inside

Yet all's not quite as it seems. Most trading in ETFs, apart from STW, is by the market makers. But they can hedge their risks with, dare I say the word, derivatives. And you know how they can implode. There can be a hidden, if small, tax trap, too.

The price paid for market volatility is that you may not see the bill until the annual tax statement from the ETF arrives. The one for STW, for example, has 25 lines in it though, to be fair, most have zeroes. Nor is there any guarantee that an ETF will precisely reflect the index they're copying.

I tracked trading in the property trust SLF for two weeks. It stuck fairly close to the ASX200 A-REIT index but at times was way out. On one day when the index rose 2.2 per cent, SLF slumped 13.3 per cent – bad luck if you were selling then and there. But then it had inexplicably climbed 8.7 per cent the day before when the index was barely up.

One of the biggest selling points of an ETF is its liquidity – you can get in and out easily at the price it's worth. While true as far as it goes, an ETF won't improve liquidity if the stocks it holds don't have much in the first place.

On the contrary, "it is possible that, in some shock event, market makers absent the market and liquidity temporarily dries up", ratings group van Eyk says. That might be rare but liquidity is only important when you need it.

"ETFs are often represented as being simple, transparent, flexible, cost-effective, liquid and low risk. While this can be the case, these characteristics are certainly not a given," van Eyk says.

Its lead analyst, James Armstrong, says the investment cost can be "significantly different from what could be assumed based on only the stated management fee". Of the nine ETFs van Eyk rated, it recommends only State Street's STW and the iShares MSCI Australia 200 fund, or IOZ.

The three specialised high-franked dividend-paying ETFs didn't pass muster, each scoring a "we have little confidence" in its rating. The reason wasn't their returns but "weaker expected tax efficiency with higher risk of capital gains distribution and income dilution" for SYI and IHD – though for a super fund in pension paying phase, and so tax free, this shouldn't matter – and RDV for "weaker than expected" performance.

ETFs, the old-fashioned way

For franked dividends it can be cheaper to buy shares in old-fashioned listed investment companies or LICs. Their fees will be higher because you're paying for professional managers, as distinct from an index copy cat, but many are trading for less than their portfolios are worth.

Take Milton Corporation, often recommended by financial advisers. The stock is trading at an 11 per cent discount to the value of the shares it holds. That's 89 ¢ for a dollar's worth of shares. Even better, Contango Microcap, which is recommended by Chris Morcom, a director at Hewison Private Wealth, is trading at an almost 30 per cent discount.

One LIC, WAM Capital, has made "handsome returns" by investing in other LICs trading at big discounts, its former chief executive Matthew Kidman reveals in his book *Bulls, Bears and a Croupier*.

As illogical as it seems, an LIC can trade at a discount for a long time. That's one reason advisers like to mix ETFs and LICs. "An ETF must distribute all its income but a company can smooth it out over time. So an advantage of an LIC is a fairly stable income flow and it's fully franked. We use both with the LIC as a core part," Morcom says.

But if an LIC is trading at a premium to its underlying value, an ETF would be better, he adds. By the same token, ETFs are easily the best way to invest internationally, though, naturally, you have to bear the exchange-rate risk.

Even then, tread carefully. As a rule, ETFs have the lowest fees but van Eyk says the iShares Global 100 has a slightly higher fee than Vanguard's unlisted international shares index fund. The same goes for iShares' emerging markets (EEM) compared with Vanguard's unlisted Emerging Markets Shares Index Fund.

"We typically use both ETFs and LICs. Diversification is the key," the managing director of strategy at Dixon Advisory, Chris Brown, says. "STW is a good liquid proxy for the sharemarket, while there are some LICs we recommend to get some active management. In these volatile times, some conservative active management is a benefit," he says.

Secrets of the share race

It's the only race where you can back the winner after it's started, place a new bet in the middle of it or quit losers well before the finish. That's why Geoff Wilson, one of Australia's best fund managers, loves the sharemarket, though it's a marvel that so many still lose their shirts.

The portfolio of his listed investment company WAM Capital has returned more than 20 per cent a year since it started 13 years ago. Now we have the inside dope from Matthew Kidman, Wilson's former right-hand man turned financial author. Wilson's racing analogy is in his book *Bulls, Bears and a Croupier* (published by Wiley, \$34.95),

which lets us in on the secrets.

One is that they get it wrong half the time.

Kidman says the trick is to cut your losses quickly — if a stock drops 10 per cent “from the average cost of purchase” it’s sold — though there’s no denying the ones they get right must be something else. The truth is you can be right but wrong at the same time. Or to be more exact, have the right idea but get your timing wrong. “It doesn’t always pay to be right,” he writes. Nor does it pay to stay. “I have come to the conclusion that most companies listed on the sharemarket are rubbish — they just have good periods,” he writes.

Although blue-chip stocks “have some fabulous periods” these are invariably “followed by long and unexplained lean periods”. So Kidman says treat the market like a game of snakes and ladders. “Your job is to jump from ladder to ladder.”

A reader will be struck by how many contacts a professional fund manager has — getting tips from brokers first hand and a foot in the door of chief executive’s offices — yet Kidman says it is ordinary investors who have the advantage. They can be more fleet-footed, can move in and out of cash and can deviate as much as they like from any sharemarket index.

But where to start? “If I was to select a single financial indicator,” Kidman says, it would be “the earnings forecast for the year ahead, simply because the rest of the market is so sensitive to it”.

In fact, he argues “an investor should never buy shares if a company has recently downgraded its earnings forecasts by more than 10 per cent”. The other figure to watch is the price-earnings (P/E) ratio, which you can get off the sharemarket list or a broking website.

This tells you whether a stock is cheap (the lower the better) or not, though it’s not infallible. Usually used to compare stocks, for Kidman P/Es are more useful against themselves. A stock’s historic P/E will tell you whether it’s a bargain or not. A sudden spike suggests it’s on a roll that won’t last.

Perversely, cyclical stocks — those that move most closely with household spending such as retailers — will often have a high P/E in bad times and low P/E in good times. The reason is that when they’re at their peak, the market anticipates a correction coming, so marks them down.

Another insight into market logic is the way that analysts can be unanimously wrong about a stock (think ABC Learning Centres).

“Stockbrokers will place price targets for the stock near the current share-price level and when the P/E ratio goes from, say, 10 to a head spinning 20, the analysts will generally follow with their valuations of the business.” And so everybody gets sucked into the vortex.

But in the end it’s the quality of management that makes the difference and it’s a hard call. Don’t think chief executives with a decent shareholding will have the same interests as you, either. They have their own agenda and, in any case, are also responsible for employees and customers. And don’t be your own worst enemy by being subjective about your stocks. Kidman says: “View your portfolio as if you had inherited it from someone else.”

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