USING EXCHANGE TRADED FUNDS TO GENERATE INVESTMENT “ALPHA”

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ETFS FOR ALPHA – EDITORIAL

This is the third in our series of “LPAC Essentials” booklets, following our pathbreaking publications on ETFs and direct equity investing. As a service to Australia’s leading financial advisers and wealth managers, these previous editions have covered the use of ETFs to generate low cost “beta,” and the use of concentrated, low turnover direct share portfolios to generate efficient “alpha.” Although these style of investments are now rapidly coming to the fore, as a valuable part of the adviser service and value proposition, until recently they have been the preserve of a small minority of financial planners. So, why all of a sudden are ETFs (and direct equities) becoming so important for so many advisers?

The answer lies in the content which is the special focus of this LPAC Essentials booklet: “Using ETFs to generate investment “alpha.”” Given the usual focus of ETFs as a way to generate “beta” you may be excused for wondering how they can be used to generate “alpha”...or even if you asked the related question, “why would I bother?”

Most advisers and clients seem to be living in hope that our investment markets will someday (soon?) return to “normal”... and wonder what is the fuss about the alternative idea of the “new normal.” After all, we have all lived through big (and small) economic downturns, and have heard from promoters of products that are supposed to benefit in adverse market conditions, who often spruik their wares using the mantra that “the world has permanently changed for the worse.” Often though, the problem is that the world returns to its previous patterns, and these supposedly “bear market proof” investments haven’t performed. Having heard these claims previously, many advisers and clients could be excused for ignoring them, and deciding to wait for the good times to return.

Personally, I am inclined to the view that the global markets are recovering, and that we will ultimately rise above the carnage produced by the GFC. But where I do agree with the “new normal” proponents is that it’s very likely that the recovery will be slower and patchier than many are hoping for. This will continue to produce volatile investment returns for some time, underscoring the need to be more efficient and cost-focused in constructing investment portfolios than ever before.

The emergence of a new wave of ETFs, targeting specific sectors, styles and even “alternative” assets like gold or currencies, heralds the opportunity to use these ETFs to add investment “alpha” to the overall portfolio, with lower costs and better efficiency than the traditional, actively managed alternative. But to really benefit from these new style ETFs, advisers need to understand:

- How to evaluate the new style ETFs, including those which embed a derivative component within the overall investment;
- How to use sector and alternative asset ETFs in a broadly diversified portfolio;
- How to implement “sector rotation” strategies using these new style ETFs;
- How to develop a framework that can assist in the decision as to when to change or re-focus the overall sectoral or alternative asset composition of the overall portfolio;
- How to frame and deliver a service and value proposition for clients which embeds the use of ETFs as a key component of the advice process.

In this LPAC Essentials we re-examine the “case for equities” – ie why Australian investors should continue to hold exposure to growth assets, like Australian and international shares. We expand this to include an appraisal of the benefits (and risks) of including commodities like gold, and currencies in the portfolio. Whether the new style ETFs which can help to implement exposure to these assets are used as a “core” or “satellite” part of the portfolio, they are definitely able to deliver a precise, low cost and easy to implement investment outcome – helping to deliver the “alpha” that is able to be provided by the specific sector or commodity.

Consider for example an ETF that provides exposure to (say) the resources sector within the S&P/ASX 200 broad market index. It’s impossible to ignore the excellent prognosis for resources in the next part of the cycle. The RBA keeps banging on about how resource prices will continue to rise for at least the next few years — and how the massive increase to our national terms of trade which this will deliver, must inevitably lead to rising interest rates to quench inflation. Efficient ETF exposure to the companies within the resources sector can be used both as an investment “sword” as well as a “shield” – targeted exposure to the growing fortunes of the sector will help to improve overall investment returns, as well as providing a hedge to investors suffering as a result of rising interest rates (eg – typical homeowners!)

Depending on the view of the adviser and the end investor, a resource sector ETF could be used as a part of the “core” of the portfolio, or as a “satellite.” As we have shown in the previous LPAC Essentials booklet, although the “core” of the portfolio should mainly focus on the efficient generation of “beta,” it is also the place where the long term components of the portfolio can be housed. Thought of in this way, if it’s likely that resources are going to be “stronger for longer,” then a resource ETF can be seen as having a permanent (or at least semi-permanent) role within the core of the portfolio. The percentage of the core which is allocated to a resource ETF may be adjusted up or down, but if some exposure to that ETF is envisaged to be maintained for the long term, then it’s ideal to use the ETF in the “core” of the portfolio.

Alternatively the resource ETF may be used as a shorter term way of tilting the overall portfolio towards a specific sector or asset which is expected to be held within the “satellite” part of the portfolio. Satellites are used in this way to generate “alpha” from sectors or assets that are possibly in vogue for the shorter term. As sectors decline in importance — either because the income they produce stops growing at its previously fast rate, or because the price of the shares or asset becomes overstretched — an ETF offers the opportunity to quickly and efficiently reduce exposure to the deteriorating sector or asset, and to replace it with investments with better prospects.

Using new style ETFs to generate “alpha,” whether as a longer term part of the core portfolio, or as a shorter term approach to sector rotation, can deliver a lower cost and more efficient approach to portfolio construction. And since ETFs are far more likely to deliver performance in line with their specifications than the vagaries of the actively managed fund, they also help advisers deliver the control and certainty which more investors are now seeking. We trust that you will enjoy and benefit from the analysis of new style ETFs which is set out in the following pages of this LPAC Essentials booklet.

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USING EXCHANGE TRADED FUNDS TO GENERATE INVESTMENT “ALPHA”

Exchange traded funds have traditionally been used in Australia to provide a low cost and efficient way to generate the returns of the overall market (known as market “beta”). The first generation of “passive” ETFs which replicate the overall market returns — by holding and tracking the specific shares in the general market indices — provide a low cost and transparent way to obtain market beta. In most major international markets, “next generation” ETFs have also been used for some time, to generate returns over and above those available from the general market. These next generation ETFs provide exposure to specific sectors of the market, or to alternative assets like commodities or currencies. Sector, currency or commodity ETFs can be used to tilt the overall portfolio to provide exposure which is expected to be superior to that of the general market, ie investment “alpha.” Since these ETFs enjoy the same overall benefits of traditional ETFs — such as low cost, transparency, and certainty/control, they can be used as an efficient way to assist portfolio construction, to improve the performance of the portfolio. Financial advisers can implement ETFs in this way, to improve their value and service proposition as well as to demonstrate differentiation compared to their peers.

I. What do investors want (and how can ETFs help deliver it)?

The floodgates of investor dissatisfaction have well and truly been opened in the last decade. With the havoc wreaked by 3 market crashes in 10 years (September 11, 2001; the “tech wreck,” and the GFC) and the inability of traditional investment management techniques to avoid the significant loss of value caused by these crashes, Australian investors have been flocking to a “do it yourself” approach. SMSF is now the largest and fastest growing component of the Australian superannuation landscape, and a majority of SMSF investors take a lead role in the selection and management of their portfolios. Where does the financial adviser fit into this new paradigm?

For many advisers the answer is to show their clients that they understand the needs and aspirations of the new wave of DIY investor — and to show that they can help the investor achieve those goals better than by the investor seeking no external counsel. To do so, the progressive adviser must take account of the true needs of the discerning client — and then shape a service proposition that is suitable for that purpose.

Surveys of SMSF and HNW investors disclose that “investment control” is the main reason why many establish the SMSF in the first place. The more typically thought of reasons for using an SMSF (eg retirement planning, estate planning, changing jobs, etc) all feature as reasons for setting up an SMSF — but none of these are as frequently cited as the pursuit of “investment control.”

When asked to identify the matters that are most relevant when “investment control” is sought after, the majority of SMSF investors cite the following three factors as most important to them:

- Capital growth
- Franked dividend income
- Income with capital protection

Also of significance is the data that shows that more than 50% of SMSF investors don’t own any traditional managed funds, at all. Clearly, SMSF investors don’t see traditional funds as delivering the things that they crave the most: investment control, and the “top 3” ingredients of investment performance listed above.

Although most investors can’t articulate what specifically concerns them about traditional, actively managed funds — eg why don’t these managed funds deliver the performance attributes they seek — the relatively poor performance, high fees and tax ineffectiveness of managed funds are all cited as common reasons for disappointment with them. Perhaps the simplest explanation is that the typical managed fund just doesn’t meet the real outcome that most investors seek. What that outcome is, and how best to achieve it, is explored in detail in this paper.

Enter the ETF. Traditional commentary on ETFs highlights that they can be seen as improving certainty and “control” compared to the vagaries of actively managed funds — since the traditional ETF provides the exact returns of the index to which it relates. This perspective can be seen in statements like the following which appears in a research report on ETFs published by the US ETF research provider, Alta Vista:

“The central drawback of actively managed funds is that investors don’t really know what they own. This needlessly complicates portfolio building. ETFs overcome this thanks to their transparency, allowing investors to know exactly what they own at any point in time. And with so many variations available—from the broadest to most narrow indices — ETFs fit the bill in a way that opaque mutual funds cannot...”

In fact, ETFs do far more than just help with “control.” The traditional view of ETFs, as set out in the Alta Vista statement quoted above, is actually a narrow perspective, missing some of the powerful attributes which ETFs can deliver.

To properly appreciate the benefits and uses of ETFs, we need to dig deeper into the needs and aspirations of the investor. Research shows that over 2/3 of Australian investors are benchmark unaware, focusing instead on the absolute return of their portfolio. In fact, the traditional focus by fund managers and consultants on “risk” and “return” is a gross oversimplification.

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Australian-owned and managed, BetaShares is affiliated with BetaPro Management, one of the largest ETF issuers in North America.

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INTRODUCTION TO BETASHARES
www.betashares.com.au

BetaShares is an Australian-based specialist provider of Exchange Traded Funds (ETFs) with a mission to expand the universe of investment possibilities available to Australian investors. Australian-owned and managed, BetaShares is affiliated with BetaPro Management, one of the largest ETF issuers in North America.

ETFs are one of the fastest growing investment vehicles today. Globally, ETF assets are now valued in excess of US$1.5 trillion. The reason for this is clear – ETFs are simple, liquid, transparent, flexible and low-cost investment products.

Unlike their global counterparts, Australian investors have traditionally had very limited choice when it comes to investing in ETFs. We think Australian investors deserve better.

BetaShares management team combines global experience with a keen understanding of the Australian market and is specifically focused on delivering ETFs tailored for Australian investors. We believe increased product choice, particularly where such products are designed specifically for investors in this country, will drive further growth in the ETF industry.

BetaShares products are Australian-domiciled ETFs which trade on the Australian Securities Exchange, and are bought and sold by investors just like shares. They allow investors to track the performance of a range of market indices and asset classes including traditional equity indices and alternative asset classes such as currencies and commodities.

BetaShares ETFs appeal to a wide range of investors ranging from individuals, including those maintaining self managed superannuation funds, to financial planners and institutional investors.

What makes us different?

More Experience

BetaShares management team and directors bring many more years of experience in the ETF market than any other team in Australia. The team has been involved in the global evolution of ETFs since their inception and have helped drive their transition from being an innovation to a mainstream part of the investment management product landscape. This experience equips BetaShares to deliver a wide range of ETFs to the Australian market.

Australian owned and run

The majority of current ETF providers in Australia are subsidiaries of foreign companies. In many ways Australia is a secondary market for these providers, which reduces product innovation and limits suitable product options for local investors.

BetaShares is a specialist Australian ETF issuer run by Australians but with the backing of one of the biggest ETF Issuers in North America. Due to our local focus, our intention is to introduce innovative products that don't just replicate existing products but actually expand options for investors.

Strong backing

BetaShares benefits from the experience and track record of Horizons ETFs. Horizons is a strategic shareholder in BetaShares and is a member of the Mirae Asset Global Investment Group, one of the largest asset managers in Asia, currently managing over $50B of assets.

A smart distribution strategy

We understand the importance of support from the broader financial services community. BetaShares has strategic partnerships and longer term relationships with well known global financial institutions. BetaShares' trading partners include some of the largest participants in the ETF market globally. Our ETFs benefit from tight trading spreads and substantial liquidity provided by multiple market makers and participating brokers.

- Current BetaShares dedicated Market Makers: IMC Pacific, Optiver, Susquehanna
- Current BetaShares Participating Brokers are: ABN Amro, Bank of America Merrill Lynch, Citibank, Credit Suisse, Goldman Sachs & Partners, Morgan Stanley

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II. Using ETFs to improve portfolio construction and performance.

Improved “control” is the tip of a far bigger iceberg of benefits that ETFs can help deliver. ETFs have the potential to assist investors improve the “Six Dimensions” that they seek from their investment portfolio. This is easily implemented using ETFs in a “core and satellite” approach:

“One of the most promising investment models is “core and tactical satellite.” This model allocates a significant portion of the equity investment to a passive tax-managed core (possibly with style or class tilt). The balance of the allocation is made to satellite (investments). These satellite(s) may be given broad mandates and the strategy may incorporate tactical changes in satellite(s). The total portfolio is managed to be dynamically efficient... This may become the basic wealth manager investment model for the future.”

But to fully appreciate why ETFs are able to improve portfolio efficiency in line with the “Six Dimensional” approach, we need to understand the basis for the under-performance of the traditional, actively managed fund. Unless we can understand the source of this under-performance, using a different approach to investment and portfolio construction may end up proving to be nothing more than a passing fad. So why have traditional managed funds under-performed their benchmarks for extended periods, especially in the last decade?

In that period, close analysis of the performance of traditional managed funds shows that the traditional fund manager consistently underperforms compared to their index benchmarks. That data has been reinforced by the landmark APRA paper released in June 2009 – which makes some very harsh statements regarding typical managed fund underperformance.

Until the June 2009 APRA paper, the most accurate performance appraisal of traditional Australian actively managed equity funds has been produced using data provided by Mercer.1 This research shows that the median Australian active equity fund has underperformed its benchmark in 10 of the 15 years surveyed.

Asset consultants like Intech have been making similar statements for the last decade. The newly launched S&P “SPIVA” Index shows the same persistent underperformance by the majority of traditional managed funds.

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2 It is acknowledged that the APRA paper analyses the performance of balanced funds, not the norm for use by financial advisers that recommend funds for specific asset classes or sectors. However, the APRA findings are consistent with the earlier work of 56% et al.
Trading at ‘fair value’ with BetaShares ETFs

Apart from offering low-cost index and asset class exposures, ETFs also generally provide investors with greater transparency pertaining to fees, holdings, and valuations.

Intraday Net Asset Value and trading at fair value
One of the least understood aspects concerns the ETF’s intraday net asset value and how investors can use this value to ensure they are trading at ‘fair value’. Within the industry this valuation measure is known as the “iNAV”. The iNAV refers to the value of the ETF’s assets on a real time basis or “fair value”. It is important to note that this is not the price at which you can purchase the instrument – it is only used as a reference for the investment’s underlying value.

For most investors this is highly beneficial information. In particular:
(1) many investors do not always have access to information services that display performance information of indices or assets that the ETF’s track; and/or
(2) the unit prices of many ETF’s have arbitrary initial prices and therefore a real-time value cannot be easily inferred.

BetaShares display live iNAV levels by way of its website (www.betashares.com.au) and via other information sources such iress. Prior to purchasing an ETF, BetaShares advises all investors to use iNAV information as a guide when buying and selling ETF units in order to achieve a price as close as possible to the current valuation of the ETF’s underlying holdings.

Ensuring the ability to trade close to iNAV
ETF providers usually employ parties known as Market Makers that offer to buy and sell ETF units on the exchange. This is a very important component of the ETF market as these Market Makers provide liquidity in the ETF units even if there are no other buyers or sellers. Market Makers price their bid and offer prices as close as possible to the iNAV and this process results in investors being able to trade at levels close to iNAV or “fair value” during the course of any trading day. BetaShares use multiple and highly experienced Market Makers and considers the provision of this liquidity at highly competitive bid and ask levels to iNAV as one of its core strengths.

When we dig deeper in search of the reason for this underperformance, we see that it is not the lack of transparency of traditional funds that is the main problem: it is the style they adopt and also the high portfolio turnover that they employ.

Certainly, this high portfolio turnover creates a lack of transparency and unease regarding the lack of investment control that accompanies it. High levels of portfolio turnover amongst traditional managed funds (which can often turnover their portfolios up to 80% pa) is a by-product of their “benchmark aware” mandate. This mandate requires the fund manager to try to beat, but not to do worse than, the performance of the general market index. To do so, in falling markets the manager will sell shares (to try to outperform compared to the falling index), and will be forced to buy back into those shares when the market rises. This high turnover crystallizes losses to the portfolio in falling markets and has a nasty by product, high tax liabilities created from this turnover.

In Figure 3, the benchmark is the ASX 200 index plus 2% (which is the median cost of investing in the surveyed funds, via retail or wholesale via wrap or master trust).

... advisers are looking for a better way to manage their client investments – and increasingly, ETFs are being used as part of this solution.
Mainstream financial planners and dealer groups, for whom the managed fund/model portfolio/wrap platform model is the basis of their business, typically counter this critique by asserting that their manager selection processes are superior and that they avoid the median performing manager/s.

Many clients baulk at this when it is noted that manager performance persistence is weak – the Mercer research also shows that managers which perform above the median don’t consistently do so – nearly 2/3 of the outperformers are back below the median within 3 years.

APRA has weighed into the debate with its recent paper “Investment performance ranking of superannuation firms.” The methodology used by APRA is set out in that paper, which leads its authors to make statements like the following, which coincides in many respects with the earlier findings of Mercer, InTech, et al:

“...the average (investment management) firm underperformed their net benchmark by 0.9% per year... this raises a question about the value of the active approach to risk management of investment portfolios and may support our doubt about the appropriateness of the Sharpe ratio in measuring performance...

The net under-performance of the average firm appears more pronounced in down markets. This suggests either inactive risk management where investment managers appear to forego value adding opportunities in down markets or unsuccessful risk management in down markets perhaps due to costs...

The empirical data suggests that superannuation firms may be less efficient at using the tax credits from capital gains and losses than we have assumed...For example, excessive share trading could forfeit capital gains tax concessions which are available after a 12 month holding period.”

And so, supported by hard evidence and client demand, progressive advisers are looking for a better way to manage their client investments— and increasingly, ETFs are being used as part of this solution.

III. Using ETFs to add “alpha” through asset or sector rotation

The previous sections of this paper show that traditional, passive index replicating ETFs are a low cost and efficient way to generate “beta” and that used in conjunction with other investments targeting “alpha,” the overall cost and efficiency of the portfolio can be improved. Since one of the classic methods of generating “alpha” is to tilt the portfolio towards sectors that are contributing more than their proportion of total economic growth to an economy, it makes sense to use a sector ETF to implement that tilt, instead of the traditional alternative (which leaves the “tilt” implementation to the traditional active fund manager).

This approach confronts the orthodoxy preached by large fund managers: the mantra that “investing is too complex for the financial adviser,” and that it should be “left to the “experts” (eg the traditional fund manager). In its full expression this “leave it to the experts” mantra suggests that “if the adviser promotes themselves as an investment expert,” a period of negative or poor returns will destroy the adviser’s business franchise.

These are fundamental questions for any adviser considering a progressive service proposition. This has been noticed in the US, where ETFs are a more common part of the advisory landscape:

“This also has important implications for the business of investment advice. Advisors who entrust client assets to mutual fund managers are essentially outsourcing asset allocation and portfolio management to some degree. But adopting ETFs for widespread use in clients’ portfolios reverses this, putting the advisor in full control. For those who manage portfolios of individual stocks, ETFs are the ideal bridge to transition clients from a transaction-based account to a fee-based account while still providing full-service, individualized financial planning and oversight. However, this increased role requires a heightened level of commitment from advisors as well.”

So, how can a progressive adviser— with a service proposition that is alive to the needs of clients (ie to deliver an improved portfolio outcome based on the “Six Dimensions”, including through a focus on investing) - do so without threatening the client/adviser relationship in periods of poor market performance?

Instead of promising to deliver a specific level of investment return (which is implicit in the mantra of “danger” for the advisor that takes on a more central role in portfolio construction and investment selection), the progressive adviser should simply emphasise that they are seeking to add value to the investor with an improvement in the “Six Dimensions” of portfolio construction. In line with this approach, the advisor will be simply helping the investor improve the outcome of those things that can be controlled – leaving the vagaries of the market to their own devices.

For example, consider the use of a resource sector ETF as a means of tilting the overall portfolio towards the high growth which is now being exhibited in the resources sector. Using a sector specific ETF in this way is an example of “highly tailored investment oversight” of the sort that typifies the use of ETFs to generate investment “alpha.” But on what basis would the adviser choose to tilt towards this sector?

A number of credible analyses suggest that the Australian resources sector will continue to grow at higher than trend levels, potentially for an extended period of time. Jeremy Grantham, of GMO, led his April 2011 “Quarterly Letter” with the headline: “Time to wake up – days of abundant resources and falling prices are over forever.” His theme is that resources are being consumed at an ever increasing rate, as major population bases like those in China and India are modernizing and industrializing. In doing so, they consume natural resources – and since these are finite in supply, this inevitably leads to rising commodity prices. He states, powerfully:

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3. Ibid, p. 18, emphasis added.
Australia’s Resources sector is one of the most important sectors of the Australian economy. For example, for the year 2009, the resources sector earned 69% of Australia’s merchandise export income.\(^1\) The Resources sector is also widely regarded as the growth engine of the Australian economy.

The Resources sector has grown strongly over time, and appears to have the fundamental underpinnings required to continue this growth, including:

- Continued strong resources demand by our largest trading partner, China which continues to grow at phenomenal rates — China is currently building a city the size of Brisbane every month\(^2\)
- A highly sophisticated and entrepreneurial resources sector
- Continued capital investment and exploration activity by Australian resource companies
- Significant corporate activity across the resources sector

BetaShares Resources Sector ETF (QRE) gives investors the opportunity to get their piece of Australian resources as easily and simply as buying any share.

### BHP or RIO? The Difficulty of Stock Picking

Until recently, Australian investors with an interest in the Resources sector faced the dilemma of having to pick individual resource stocks in order to obtain exposure to the sector. Picking the future winners is a daunting task, and one that 70.6% of Australian equity active managers have not achieved last year\(^3\). As a result of the difficulties of picking the future best performers, many investors have simply chosen to buy one of the big stocks in the sector, such as BHP Billiton or Rio Tinto. While these companies are significant components of the sector, investors who choose to invest in this way risk losing out on the smaller outperformers that exist in the Resources Sector.

The BetaShares Resources Sector ETF (QRE) aims to track the performance of the S&P/ASX 200 Resources Index, so now you can buy the whole resources sector, gaining exposure to over 60 of the largest Australian resources stocks, without having to worry about picking a winner.

### The Benefits and Applications of BetaShares Resources Sector ETF

The BetaShares Resources Sector ETF (QRE) enjoys several benefits and applications that make it a compelling choice for investors looking to obtain exposure to the Australian resources sector.

#### Benefits

- Simple to trade – traded like any share through your online broker or adviser
- Liquid – trade on ASX throughout the day with robust bid-offer spreads
- Transparent – index composition available daily
- Flexible – can be used to implement a range of investment strategies
- Portfolio management not required – the ETF tracks the index without the need for any investor intervention
- Can be included in SMSFs (self managed super funds)
- Australian domiciled

#### Applications

- Building blocks for portfolio construction – long term asset allocation to the sector
- Tactical allocation to sectors
- Separation of alpha and beta
- Cash equitisation (invest cash in ETF pending individual stock selection; avoid “cash drag”)
- Pairs trading (buy ETF, short sell individual security)

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\(^1\) Year ‘08-’09 Austrade Report

\(^2\) Dr. John Lee, 27th August 2010...

\(^3\) According to Standard and Poors December 2010 SPIVA Report, 70.6% of Australian Equity Managers underperformed the S&P/ASX 200 Index.
ETFs are also a very cost effective way to get diversified exposure – our products track the performance of an index and therefore there are no active management fees.

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If you like the resources sector but can’t decide which stock to buy, you can now buy the whole sector. 

BHP or RIO?

BETASHARES SECTOR ETFs – RESOURCES

BHP OR RIO?

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While it may be relatively easy to follow trends which have become clear, it is obviously harder to predict when those trends are changing. Using ETFs as a means of implementing asset or sectoral tilts implies rotating out of those assets or sectors when their performance begins to decline (or prior to the rest of the market seeing that trend changing, if possible). Thankfully, the tools to assist with this decision are readily available, and are used by asset consultants and research providers to assist with overall portfolio construction. These tools reflect the fundamental analysis approach to securities valuation made famous by Graham and Dodd in the 1930s:

- What are expectations for sales and EPS growth in the sector or asset?
- What rates of profitability (margins, return on equity, etc.) have the firms in the sector achieved historically and how does that compare to current forecasts?
- How are estimates changing along with economic conditions?
- What’s happening on the balance sheet or companies in the sector?
- How is the sector being valued by the market, both in absolute terms and relative to other investments?²⁰

When seen in this light, we need to sound a word of caution regarding the (lack of) utility of the traditional approach to managed fund ratings, when it is applied to ETFs. Traditional managed fund research allocates around 80% of its scorecard to “people, systems and processes” — since these are seen as highly correlated to the production of returns by traditional active fund managers. In contrast, since ETFs track a defined index, it’s the relevance and relative value of that index that is the primary determining factor in the utility of a specific ETF.

Looked at in this way, we can see that the decision to invest in, or sell out of a sector or asset specific ETF, can usefully be informed by consideration of valuation metrics that have been developed through the fundamental approach to securities valuation.

IV. Putting it all together

We have described why using ETFs to generate “alpha” and as part of the “core and satellite” approach is so conducive to long term wealth creation. The core of the portfolio should access the general market return or “beta” for the lowest available cost. Broad market ETFs with low fees are an efficient way to generate market “beta”. Tilting the portfolio towards assets or sectors that are contributing above average to GDP growth, or reflect broad economic conditions (like commodities and currencies), are an efficient way to add “alpha” — and ETFs are a great way to implement this approach.

By using ETFs to assist with implementing the “Six Dimensions” of portfolio construction, progressive advisers not only improve “control” and “certainty”, they also help to reduce costs, improve tax efficiency, as well as generating overall outperformance and risk management at the same time.

Tony Rumble PhD
Founder, LPAC Online Pty Ltd and Alpha Structured Investments Pty Ltd, AFSL 290054

SOLID GOLD – BETASHARES “QAU” ETF

Gold is a unique commodity. It is a physical asset that is accumulated rather than consumed, and as a result, virtually all the gold that has ever been mined still exists today. Gold is virtually indestructible and is viewed by many around the world as a store of value.

Until the introduction of the BetaShares Gold Bullion ETF it has been difficult for investors to easily access pure, currency hedged exposure to gold bullion.

The events of recent times have shown that during periods of uncertainty and crisis, gold has been demanded by investors as a “safe haven” asset.

In addition, many investors are concerned that large and growing budget deficits around the world may result in a resurgence in inflation. Gold has traditionally been used by investors to protect against the risk of inflation, and many investors are accordingly adding additional gold exposure as part of their investment strategies.

Finally, gold has shown little or no correlation with other asset classes and so an allocation to gold can be a very good diversifier as part of a broader investment portfolio.

The objective of the BetaShares Gold Bullion ETF is to track the performance of the price of gold bullion (before fees and expenses). The BetaShares Gold Bullion ETF offers a secure and convenient way for investors to gain exposure to the price of gold, without the inconvenience associated with directly purchasing, storing and insuring physical gold bullion. In addition, as the BetaShares Gold Bullion ETF is A$ hedged, investors are able to gain “pure” exposure to the performance of gold, without exposure to movements in the AUD/USD exchange rate.

Historical Gold Performance

The price of gold is influenced by a wide variety of factors, some of the most important being fluctuations in the value of the US dollar, political and economic uncertainty, and the buying and selling of gold by central banks around the world. The chart below depicts the long term performance of gold bullion vs. a broad Australian equities index:

²⁰ Ibid, page 12
Key Benefits of QAU

- the performance of gold has varied dramatically depending on the value of the currency that gold is purchased in. As BetaShares Gold Bullion ETF is currency hedged, investors are now able to substantially remove the impact of movements in the AUD/USD exchange rate from the gold price.

- gold prices tend to perform strongly during times of uncertainty, which can make gold an attractive addition to a diversified portfolio. However, experience has also shown that gold can outperform even in a more bullish market environment

- historically, gold has shown little to no correlation with other asset classes and so allocating to gold may provide useful diversification benefits as part of a broader investment portfolio.

Ways to Access Gold

Traditionally, the only way to gain direct exposure to the gold price was through direct gold ownership or the use of gold futures.

Direct gold ownership involves a number of complications and costs, including high minimum investment levels and the costs of buying, physically storing and insuring the gold. In addition, liquidity levels (i.e., the ability to realise cash for the investment) may be low relative to exchange-traded alternatives.

Gold futures can be complicated to purchase, requiring an understanding of derivatives, tolerance for margin calls, experience in futures trading as well as potentially high minimum investments.

Gold exposure can also be obtained by buying shares in gold mining companies. This involves company-specific risk, as well as broader sharemarket risk, and it is therefore a more indirect way to access the performance of gold.

By comparison, the BetaShares Gold Bullion ETF offers investors a simple, low-cost, liquid and efficient way to access the performance of gold – as simply as buying any share.

The Structure of BetaShares Gold Bullion ETF

An ETF is an “exchange traded fund” – a managed fund that is traded on the ASX.

ETFs are built like managed funds, but trade like shares, meaning that pricing is transparent and the products can be bought and sold throughout any trading day just like shares. ETFs aim to track the performance of a specific index or asset. They are transparent, liquid, cost-efficient and flexible investment tools – and are used by both individuals and institutional investors.

The BetaShares Gold Bullion ETF invests its assets into the purchase of physical gold bullion (i.e., bars of gold) from the National Bank of Canada (“NBC”), one of Canada’s oldest and largest prudentially regulated banks. All of the physical gold bullion purchased from NBCs is held in an allocated and segregated account maintained by NBC with JPMorgan Chase Bank N.A., in JPMorgan’s London vault premises (or, on a temporary basis, by an authorised sub-custodian).

The gold will be subject to a registered charge in favour of the ETF.

In addition, to ensure maximum transparency for investors, the BetaShares website includes a gold holdings list that itemises the actual allocated gold bullion bars held in the vault. This list, provided daily by the vault custodian, JPMorgan Chase Bank, includes specific details of each gold bar including serial number, refinery, purity, weight and year of casting.

An independent bullion audit will also be conducted at least annually to confirm the number, purity and weight of the gold bars held in the vault.

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