QUANTUM
Investment Solutions

Exchanged Traded Funds (ETF Explained)

Quantum Portfolio of Warrants

What is an ETF?

Exchange traded funds (or ETFs) are pooled investment products designed to track an index through a carefully selected portfolio of securities. As their name suggests, ETFs can be traded on a stock exchange like shares. A typical ETF is a passive investment; however, some providers offer active ETFs that are actively managed by a professional fund manager.

Active Vs. Passive Investing – What's the Difference?

While there are many different types of investors out there with varying strategies and goals, some can be separated into two distinct groups, active and passive. Here's a breakdown of how active and passive investors typically differ in their tactics, tools and attitude towards investing.

What is Active Investing?

A key difference between the two portfolio managing strategies is that generally an active investor tries to beat the market, whereas a passive investor tracks a market index. With this in mind, active investors tend to keenly watch the market and make trades appropriately. And some active investors choose to engage with a professional fund manager to actively manage their investments on their behalf.

Potential Pros:

There are definitely advantages to taking the active approach to investing. Firstly, as active investors tend to try to beat the market, when they succeed it may translate to higher than average returns. Although, taking this approach to investing usually requires a high level of confidence when making investment decisions, and would typically involve higher risk, which should be taken into account.

Therefore, for some, engaging with an active fund manager to oversee their investments might be a good option. Additionally, having an active fund manager on board may give investors access to products that the average person cannot obtain.

Cons:

By using a professional fund manager you are placing your trust in them and have to accept there is a possibility they could misjudge the market and choose under-performing stocks. It's important to do your due diligence before choosing a fund manager. Additionally, having a middle man, i.e. a fund manager, oversee your investments comes at a cost. Often fees for a managed fund will include a management fee and an administration fee. However, just as performance can differ greatly between managed funds, so too can the fees charged. Active investing is a highly involved strategy. So, if you decide to take the path of actively managing your own portfolio, be aware of the time you will need for stock analysis and keeping up with market movements.

What is Passive Investing?

Often seen as a low cost and low maintenance way to invest, passive investing tends to suit those who would rather take more of a 'set and forget' approach and have a lower risk tolerance when compared with active investors. For this reason, passive investors are often investing over long periods of time, adopting the buy and hold tactic. They tend to keep their eye on the prize and ignore short term setbacks and even sharp downturns in the market. This is the opposite of active investing which tends to suit those who are chasing shorter term gains.

Potential Pros:

The relaxed nature of passive investing is a positive in itself. However, this investment strategy has a couple of other attractive qualities up its sleeve that may suit some investors. Taking the passive investing approach can be a more affordable way to access the market, as it can exclude the sometimes-hefty fees that come with an active fund manager. Also, passive investors generally have complete transparency over their investments. They often know exactly where their money is and can remove and reinvest it as they please. They also don't have to worry about whether they've chosen the right professional fund manager.

Cons:

On the other side of the coin, the passive investment strategy can be limiting in a number of ways. Firstly, there are fewer products available that suit the passive investing approach. Investors are basically limited to index funds, such as an index ETF and an index managed fund. Also, unlike active investors, passive investors will never beat the market, as they track the market (although, neither will they under-perform the market!).

ETF vs Managed Funds

COMPARISON OF EXCHANGE TRADE FUNDS TO MANAGED FUNDS

	ETPS	MANAGED FUNDS
RISK DIVERSIFICATION	High - -exposure to entire index	Varies depending on the fund
EXPENSES AND FEES	Brokerage costs; low management fees; bid/offers spreads	Buy/sell spreads, higher management fees, performance fees possible
PRICING	Real time, intra-day	Varies from end of day to weekly or even monthly
LIQUIDITY	High	Varies significantly from high to limited liquidity in closed end structures
MARKET PRICE V. NAV	Generally no significant and sustainable divergence	NAV subject to entry, exit and management charges
ACCESSIBILITY	Purchased like a share	Entry via manager or intermediary (platform or advisor) - generally high administration burden
TRANSPARENCY OF UNDERLING PORTFOLIO	Portfolio constituents available at all time	On request, rarely daily, can be opaque

Risk Diversification:

Depending on the underlying exposure, ETFs can provide all the diversification benefits of traditional managed funds, in that they can provide an investor exposure to an entire index. For example, most large ETF's gives an investor exposure to the performance of the largest Australian companies via a single trade. This diversification means that the risk position for an investor in an ETF is significantly lower than investing in a single stock. In the case of managed funds, it is up to the discretion of the individual fund manager to invest in particular stocks – while typically they would also invest in a portfolio of stocks, there are several funds which have significantly concentrated exposure, increasing the risk position from an investor's perspective.

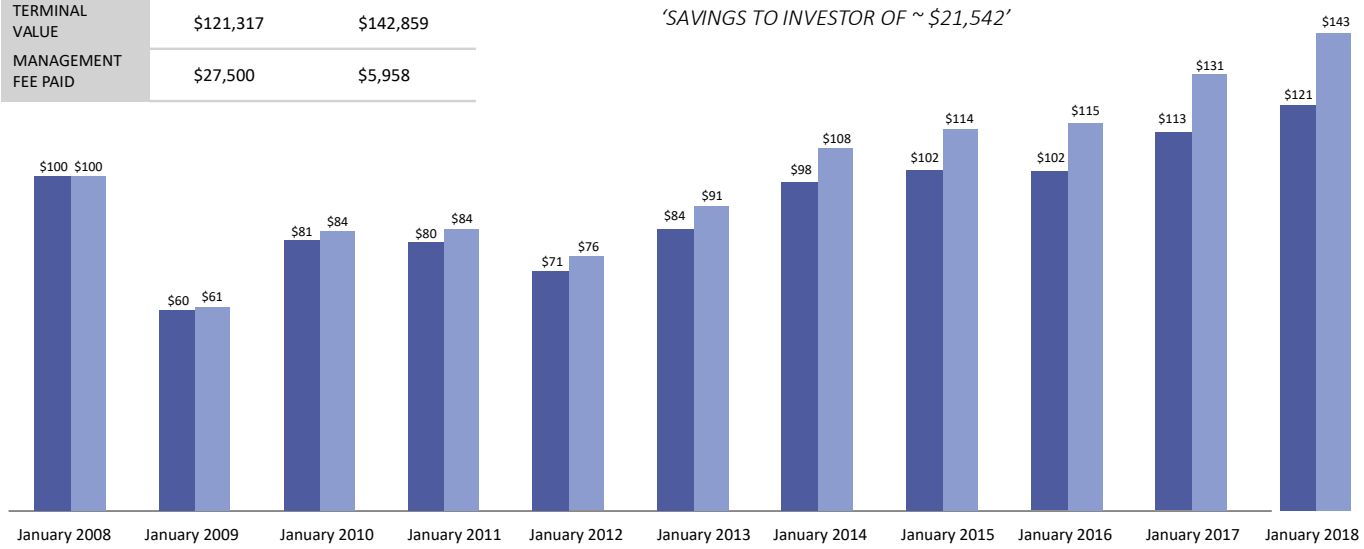
Expenses and Fees:

It is arguable that the cost differences as between managed funds and ETFs are one of the primary reasons for ETFs global success. Managed funds typically charge significantly higher management fees than similar ETFs. In addition, several managed funds also charge investors "performance fees" when their performance exceeds a nominated benchmark. By comparison, ETFs charge a simple management fee and typically no performance fees. The primary reason for this dramatic cost differential is that ETFs are not actively managed, and thus experience lower levels of turnover, shielding investors from the costs of buying and selling shares.

The impact of fees on investor returns can be significant. As an example, the below exhibit indicates the differences in an investor's returns assuming the performance of the S&P/ASX 200 Index, and assuming a fee of 0.40% vs. a fee of 2.00% per year. As you can see from the below, over 10 years, assuming an investment size of $100,000, the savings to an investor are over $20,000! VALUE OF $100,000 INVESTED IN S&P/ASX 200 ACCUMULATION INDEX UNDER VARYING FEE ASSUMPTIONS

VALUE OF $100,000 INVESTED IN S&P/ASX 200 ACCUMULATION INDEX UNDER VARYING FEE ASSUMPTIONS

	2% MANAGEMENT FEE	0.40% MANAGEMENT FEE
TERMINAL VALUE	$121,317	$142,859
MANAGEMENT FEE PAID	$27,500	$5,958



Source: Bloomberg. Illustrative only. Past Peformance is not an indication of future performance of the index or ETF. You cannot invest directly in an index.

Performance

Investors are increasingly scrutinising the performance of actively managed funds vs passive options. This is particularly so due to the fees charged by active fund managers, relative to lower cost alternatives, such as ETFs.

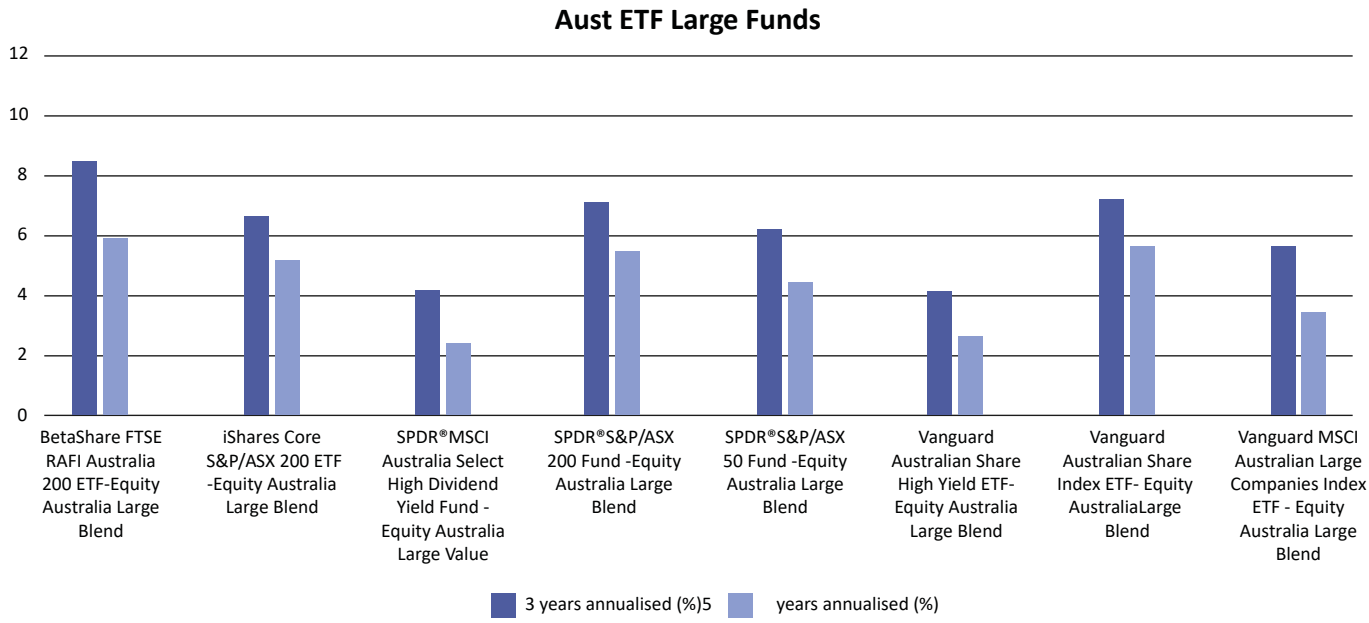
The track record of active fund managers in outperforming their benchmark indices has been statistically poor. As the below table indicates, only 41% of Australian equity fund managers who benchmark to the S&P/ASX 200 Accumulation index actually beat this index in the year to December 29, 2017. By comparison, ETFs provide simply the index return, at low cost.

PERCENTAGE OF ACTIVE FUNDS OUTPERFORMING THE INDEX - AS AT DECEMBER 29, 2017

Fund Category	Comparison Index	One year (%)	Three year (%)	Five year (%)
Australian Equity General	High - -exposure to entire index	41%	33.2%	37%
Australian Equity Mid - and Small - Cap	Brokerage costs; low management fees; bid/offers spreads	25.9%	25%	44.3%
International Equity General	Real time, intra-day	47.5%	19.1%	9.1%
Australian Bonds	S&P/ASX Australian Fixed Interest 0 + index	31.4%	22.64%	14.6%

Exchange Traded Funds are increasingly being added to investment portfolios, either as a supplement to, or indeed, a substitute for managed funds. Furthermore, as more and more products are launched onto the Australian marketplace, investors will be able to access new investment strategies, asset classes and performances – all as simply as buying a share.

Australian Large ETF



World Based ETF

Expanded Opportunity Set

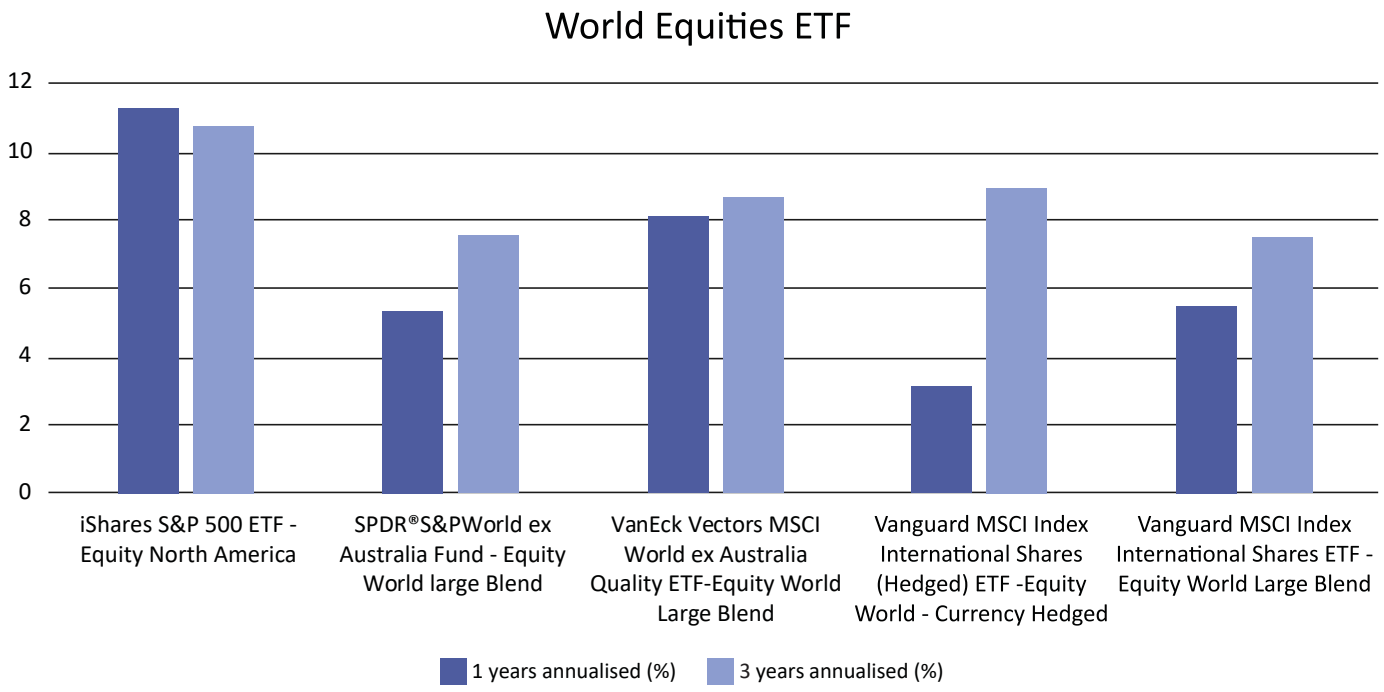
Australian equities represent less than 2.4% of the global stock market capitalisation. By investing in global equities, investors can gain exposure to a much more diverse range of companies that are truly representative of today's dynamic global economy.

Increased Diversification

Investors can build diversified portfolios of Australian stocks, but at the end of the day they are still Australian stocks. Additionally, the local market is heavily tilted towards stocks in two sectors, resources and financials, which together account for over half of the market cap of the S&P/ASX 2003. With international stocks, investors can gain greater exposure to sectors, such as Utilities, Consumer Staples and Health Care, as well as high-growth sectors such as Technology that are relatively under-represented in the broader Australian market.

Reduced Concentration Risk

Through an investment in international equities, investors can spread their risk across many different companies, sectors and countries. So rather than relying on a single economy, which in the case of Australia is relatively small in global terms, investors gain exposure to markets all around the world.



ETFs on a roll and tipped to hit $50bn

Investments managed by Australia's exchange-traded funds are likely to grow by between $9 billion and $14 bn this year after the industry posted a $5bn lift for2018, despite falls in the broader stock market. Australia's exchange-traded fund industry had $4bn in funds under management at the end of December according to fund management company BetaShares which has tipped the industry's total assets under management to be within the range of $50bn and $55bn by the end of 2019.

BetaShares research found that EFT trading activity in Australia reached a record high, with trading value increasing 14 percent compared to the prior year, with over $36bnin value traded. Globally, the exchange-traded fund industry clocked its second highest year ever in terms of net inflows last year, at $US516bn.[1]

"With secular growth from new EFT launches and still broadening investor interest likely, as well as some general upside for domestic and offshore markets, which we are projecting, flows and EFT assets under management should tend to remain robust overall, even if there are up and downs month to month"

– Mr Tony Brennan 12.01.19 [1]

[1] Information from : *"ETFs on a roll and tipped to hit $50bn"* ***The Australian Newspaper***, p. A1. 12.1.2019

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