

# Exchange Traded Funds

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**Vanguard<sup>®</sup>**



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## Introducing Exchange Traded Funds

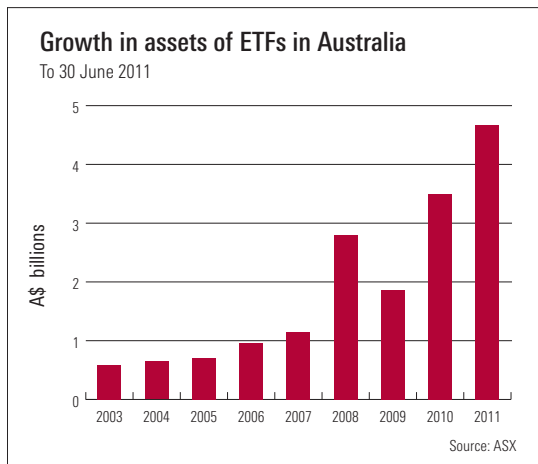
Exchange traded funds, or ETFs, are attracting ever increasing attention from investors with a growing range of products becoming available on the Australian Securities Exchange (ASX).

In this Plain Talk Guide you will find answers to common questions we get asked about ETFs. You will learn how ETFs and traditional managed index funds compare and gain a better understanding of why and how ETFs may benefit your investment portfolio. Since Vanguard first introduced indexing to retail investors in the United States in the 1970s, it has become a popular investment strategy with institutional, individual investors and advisers alike. In Australia index funds under management makes up over 16 per cent of the broad market with \$240 billion in assets as at March 2011\*.

Vanguard pioneered the concept of indexing, introducing the first retail index fund in the US in 1976. Vanguard has since become one of the world’s most experienced and successful indexing specialists. In fact, the Vanguard Group manages almost A\$1.9 trillion worldwide (as at 30 June 2011).

Now there is another way to access Vanguard’s proven index management approach – through exchange traded funds. Exchange traded funds were first introduced in the US in 1993. They have since become one of the fastest growing investment products in the world. At the end of June 2011 the market capitalisation of ETFs was \$4.7 billion in Australia – 34 per cent growth since June 2010.\*\*

\* Rainmaker Roundup March 2011  
\*\* ASX ETF Monthly Report 30 June 2011



## What is indexing?

An index is a group of securities designed to represent a broad market or a portion of the broad market. Today there are indices measuring the investment results of all major markets and asset classes.

An index fund or an index based ETF invests in all or a representative sample of the securities of the index it tracks.

An indexing approach will ensure portfolio performance is broadly in line with the returns of the underlying asset class or market over the long-term.

## ETFs

An ETF is a sharemarket quoted fund which is constructed as a broadly diversified investment portfolio of either shares, bonds or real estate securities.

Most ETFs use an indexing approach that seeks to track specific market or sector indices. Consequently, index based ETFs carry all the benefits of traditional index funds, such as low operating costs, diversification, tax efficiency and simplicity while also offering the liquidity and pricing transparency of securities listed on an exchange.

Australian investors currently have access to both domestic and cross-listed ETFs.

Domestic ETFs are funds that have their primary listing on the local exchange (relative to the investor) such as the Australian Securities Exchange (ASX) for Australian investors. Cross-listed ETFs are ETFs that have a listing on a different exchange than their primary or original listing.



## How do Vanguard ETFs work?

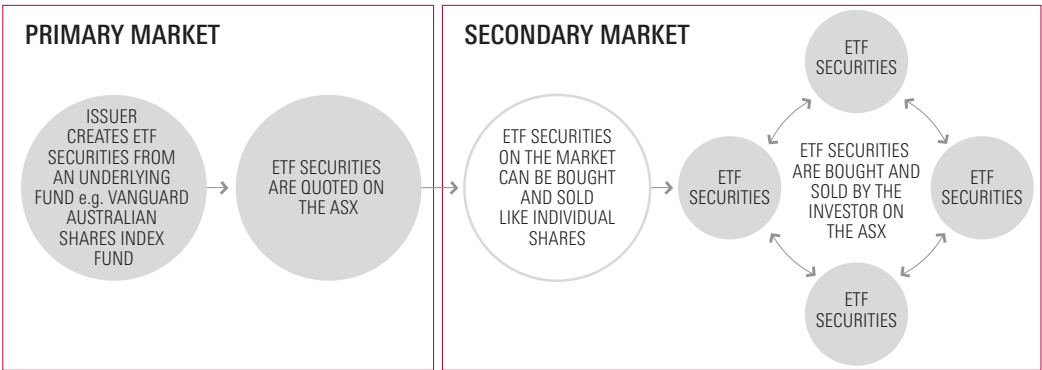
Vanguard ETFs are index funds which aim to deliver the index return, before fees, by building investment portfolios using similar assets and weightings as the benchmark index. This means an ETF’s return, before costs, should closely match the index it tracks, just like a traditional managed index fund.

Through purchasing a Vanguard ETF security, investors gain access to a diversified index fund. You can buy or sell ETFs at any time throughout the ASX trading day.

Vanguard ETFs are constructed using an indexing approach, so their value generally moves in line with the index they track. For example, a 2 per cent rise or fall in the index would result in approximately a 2 per cent rise or fall for an ETF which tracked that index (all other things being equal).

### From Issuer to Investor

The creation of domestic ETF securities



### EXCHANGE TRADED FACT - ASX AQUA Market

The ASX AQUA market is a service for quoting managed funds, ETFs and structured products on the ASX. It is aimed at domestic and international product issuers who provide investment products that have not traditionally been provided with a dedicated operating framework. Investors purchase ETF securities on the AQUA market in exactly the same way they would any other security on the listed market, for example BHP or ANZ.

## ETFs - fees and costs

Index based ETFs are generally a low cost investment, and substantially lower in cost than investing in the same exposure of individually purchased shares. Because the funds are managed using an indexing approach, the cost to manage is generally less than actively managed funds.

### Management fees

A management fee applies to ETFs as with any other managed fund. This is a fee charged by the fund issuer, generally included in the unit price, covering all relevant fees and costs involved in managing the ETF. These fees and costs include things like custodian fees, accounting fees, audit fees and index licence fees.

### Brokerage fees

Brokerage fees are fees charged by the broker each time you buy (or trade) an ETF. These fees vary, starting from around \$10 per transaction.

### COSTS INVOLVED

#### MANAGED INDEX FUND

MANAGEMENT COST

BUY/SELL SPREADS

#### EXCHANGE TRADED FUND

MANAGEMENT COST

BROKERAGE FEES

BID/ASK SPREADS

### EXCHANGE TRADED FACT - Bid/Ask Spread

The amount by which the ask price exceeds the bid price. This is essentially 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.



## How can you invest in ETFs?

ETFs can be bought and sold on the ASX through a broker. The services of brokers range from full service brokers through to non-advisory brokers. Non-advisory brokers enable transactions via the telephone or internet – for example CommSec or E\*Trade. Investors need to open an account in order to purchase ETF securities.

After trade execution the investor will receive confirmation of the trade settlement. On a regular basis the investor will also receive distribution statements, tax statements and other relevant information to their investments.

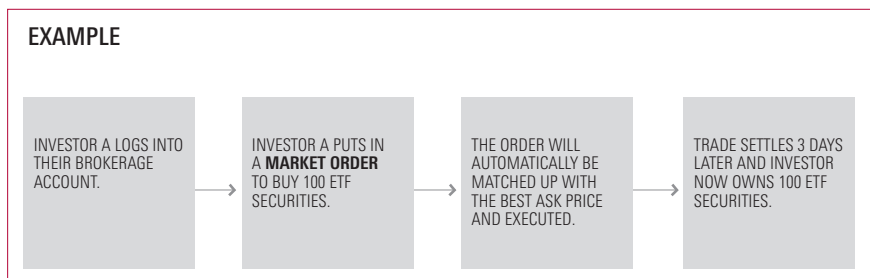
There are different ways to trade ETF securities:

### Market Orders

A market order is a buy or sell order in which the investor instructs the broker to execute their order at the best price currently available.

For example, if an investor wants to buy 100 ETF securities they will put in a market order for 100 securities and hit the execute button. The security order will automatically be matched up with the best ask price and executed.

The downside of a market order is that you could end up paying a higher price for a security than you intended. This can be especially evident during the first ten minutes of the trading day, when opening prices of the underlying securities in the ETF are still being determined.



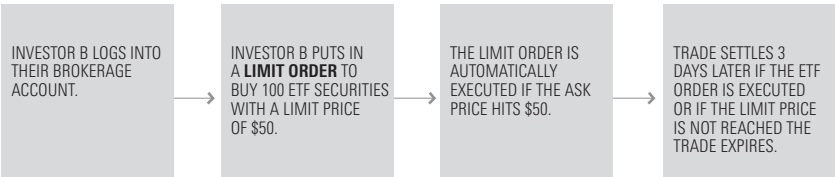
### Limit Orders

A limit order is an order in which an investor instructs a broker to buy a specified quantity of a security at or below a specified price, or to sell it at or above a specified price. The specified price is called the limit price.

If you want to buy 100 ETF securities at \$50 per security, then your order will be automatically executed when the ETF price hits \$50. Limit orders can be used in both the buying and selling of securities. For most investors this method ensures you only pay a price that you wish to buy at or sell at a price you wish to sell at.

With the limit order you are certain of the price at which your securities will be bought or sold so there are no surprises. Another aspect of the limit order is the fact that your orders can be placed and executed while you are busy at work or enjoying a game of golf. On the downside it may take a long time, if ever, for the price of the security to get to the same place as your limit order. In this regard, investors need to ensure their maximum price is set at a reasonable limit.

#### EXAMPLE





## Participants in the ETF market

### Issuer

The issuer of an ETF provides investors access to the performance of the underlying assets which make up the ETF by issuing ETF securities.

### Market maker

The market maker's job is to satisfy supply and demand for ETF securities, seeking to provide continuous liquidity to the market. Market makers have two roles in the ETF process:

- They provide liquidity to the market by acting as the buyer and seller of ETF securities throughout the trading day.
- They create and redeem ETF securities off-market to ensure there are enough ETF securities on issue to meet the supply and demand in the market.

### Authorised participants

Authorised participants (APs) also create and redeem ETF securities off-market to meet supply and demand.

They play a critical role in the creation process of ETF securities. After acquiring the underlying securities (in the basket) the AP will exchange these securities for large blocks of ETF securities called an ETF creation unit.

A firm may act solely as an AP or as both a market maker and an AP.

The process begins with the issuer distributing the basket composition to the market each trading day, allowing APs to price the basket of securities underlying the ETF.

Market makers will calculate bid and ask prices and send these prices to the ASX as quotes. Market maker quotes are updated continuously throughout the day to reflect price changes in the underlying securities of the ETF.

### Share registry

The issuer of an ETF appoints a share registry to manage the administration for ETF investors such as paying distributions and providing tax information.

### EXCHANGE TRADED FUND FACT - Basket of securities

A basket of securities is a list of securities which the issuer of an ETF prepares each day which closely tracks the underlying index. The issuer sends this 'basket' out to the market makers who in turn exchange the basket of securities for ETF securities.

## What are the benefits of Vanguard ETFs?

### Low cost

ETF fees are usually significantly less than actively managed fund fees. ETFs are also more cost efficient than investing in the same exposure of individually purchased shares.

### Diversification

Vanguard ETFs provide investors with a highly diversified investment with broad exposure to entire markets within an index. This also includes shares that investors may not be able to access directly on the ASX such as international shares.

### Tax efficiency

The traditional low turnover of investments provided by an indexing approach minimises the capital gains distribution impact. This improves performance and tax efficiency over the longer term.

### Liquidity

The ability to create and redeem ETF units on a daily basis ensures the primary underlying depth of liquidity. Secondary sources of liquidity exist in the volume of trading of the ETF itself and the investment environment it is trading in.

### Transparency

Vanguard provides regular information to the market including the daily fund Net Asset Value (NAV) making ETFs highly transparent investments.

### EXCHANGE TRADED FUND FACT - Net Asset Value (NAV)

The process for creating or redeeming ETF securities assists an ETF to trade close to its Net Asset Value (NAV). The NAV is the underlying total value of net assets divided by the number of securities on issue.

$$\text{NAV} = \frac{\text{Total Assets of ETF} - \text{Total Liabilities of ETF}}{\text{Number of ETF shares outstanding}}$$

## Risk and return

As with any investment, investing in ETFs is not risk free. Investors in ETFs should bear in mind one of the main principles of investing which is: the higher the potential reward, the higher the risk of losing money.

In general the reverse is also true – the lower the risk the lower the potential reward.

### Returns

The expected returns of Vanguard ETFs should generally be aligned with the index returns (before fees) that they track. Returns generally come in the form of income and growth.

Investors can become entitled to income in the form of distributions, these are generally paid quarterly but can vary between ETFs. The amount received is based on the amount of ETF securities the investor holds.

Growth comes from any increase in the value of the portfolio's assets and will be reflected in the NAV of the ETF. This return is realised on the sale of ETF securities.

### Risk

As a general rule, asset classes range from low to high risk in the following order; cash followed by fixed interest, property and then shares – as depicted in the risk spectrum overleaf.

The price of an ETF can fluctuate within a wide range just like the overall stockmarket, which means investors should consider their own personal tolerance for fluctuating market values.

### *Currency risk*

International ETFs (e.g. cross-listed ETFs) are subject to fluctuations in the value of the Australian dollar against other currencies. Currency movements can impact the returns on your investment because losses or gains must be converted back into Australian dollars.

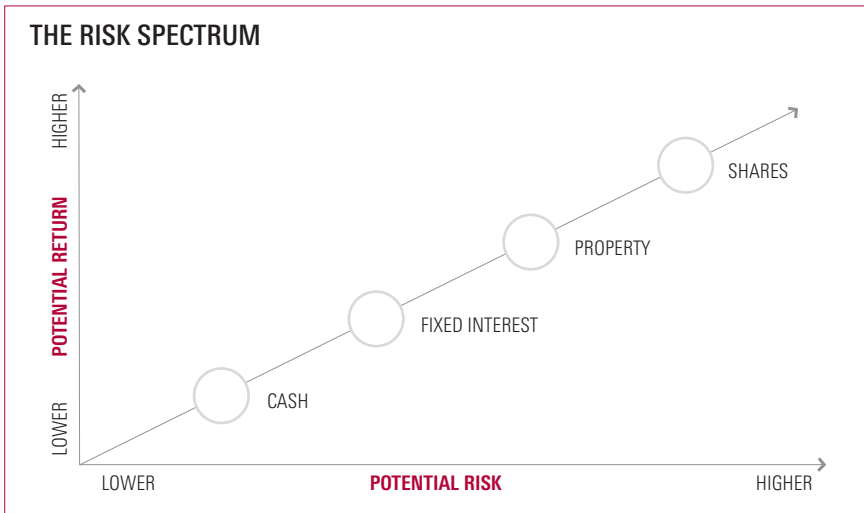
For example, if the value of the Australian dollar rises, the value of investments held in non-Australian assets (e.g.US\$) will fall. Conversely, a weaker Australian dollar increases the value of investments held in non-Australian assets.

ETFs are also subject to market, credit and manager risks associated with any managed fund investment.

### Tax on distributions

Any income in the form of distributions which an ETF investor receives during the year will be counted as part of their assessable income. The tax impact of this depends on the components of the distributions.

If an investor sells their ETF securities they may be liable for tax on any gains they make in this transaction.



## Choosing between ETFs and managed index funds

Vanguard ETFs and their equivalent managed index funds own the same underlying assets. So for investors the decision of which to choose comes down to which investment best suits your particular circumstances.

When deciding between an ETF or a managed index fund, you should consider:

### If you have, or are prepared to open, an account with a broker

You will need a brokerage account to buy and sell ETFs. If you invest using a financial planner, they can access either managed index funds or ETFs via administration platforms such as master trusts and wrap access.

### How often you invest

Brokerage fees (which are often a flat fee for small trades) apply each time an investor buys and sells ETFs on the sharemarket. Contributions to a traditional managed index fund do not attract such fees. So ETFs may not suit investors who make ongoing contributions. Note that both ETFs and managed funds do have some kind of buy/sell spread which is usually a percentage of your invested amount.

### The importance of trading to you

An ETF can be bought or sold during trading hours of the ASX providing investors with the option to buy or sell their investment at any time.

<b>Choosing between an ETF or a managed index fund</b>	
<b>Exchange traded funds are better suited to investors who:</b>	<b>Managed index funds are suited to investors who:</b>
Make large or irregular investments	Make ongoing, small contributions (dollar cost averaging)
Require trading flexibility	Do not require trading flexibility
Require frequent pricing	Do not require frequent pricing
Regularly trade via the ASX	Do not regularly trade via the ASX



## How can you use ETFs in your investment portfolio

ETFs offer many opportunities to meet your investing needs. The ease, flexibility, diversification and low cost of ETFs make them an innovative and effective investment solution to:

### **Construct an investment portfolio**

A combination of ETFs covering different asset types and markets can be used to build a robust investment portfolio that operates at low cost.

### **Build the foundations of a portfolio**

ETFs can be used to create a solid, diversified foundation or 'core' of an investment portfolio, complemented by other investments like direct shares or actively managed funds to potentially 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 quickly, easily and cost effectively correct these imbalances in a portfolio by purchasing or selling the required asset exposure.

### **Trade in the market**

ETFs offer investors the ability to rapidly deploy cash into the market, trade frequently at market prices and use ETF securities as collateral for margin lending (where approved to do so).

## Vanguard's range of Plain Talk Guides

At Vanguard, we believe it is just as important to know about the potential risks of your investments as well as the rewards. That's why we publish our Plain Talk Guides on a range of popular investment topics. After all, better informed investors make better investment decisions.

Our Plain Talk range includes:

- Understanding indexing;
- Realistic sharemarket expectations;
- Building your investment portfolio;
- Investing for income;
- Self Managed Super Funds;
- Superannuation;
- Managed funds; and
- Exchange traded funds.

## The indexing pioneers

Vanguard pioneered the concept of indexing, introducing the first retail index fund in the US in 1976. Since then, The Vanguard Group, Inc. has grown into one of the world's largest and most respected investment management companies. Vanguard now has global presence with offices in the US, Australia, Asia and Europe. In Australia, Vanguard has been helping investors meet their long-term financial goals with low-cost indexing solutions for more than 14 years.

## Vanguard's range of managed funds and ETFs

Vanguard offers a complete range of funds across all asset classes that can be used as a diversified standalone portfolio solution, or in conjunction with active funds as part of a core-satellite approach.

For more information on our product offerings please visit [www.vanguard.com.au](http://www.vanguard.com.au)

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Vanguard is the issuer of the Prospectus on behalf of the US listed exchange traded funds described in the Prospectus.

Vanguard has arranged for interests in the US ETFs to be made available to Australian investors via CHESS Depository Interests that are quoted on the AQUA market of the Australian Securities Exchange ("ASX").

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Investors should consider the Prospectus and PDS in deciding whether to acquire Vanguard ETFs. Retail investors can only use the Prospectus and PDS for informational purposes.

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You should consider your circumstances and the relevant PDS and/or Prospectus before making any investment decision. You can access the relevant PDSs and/or Prospectus at [vanguard.com.au](http://vanguard.com.au) or by calling 1300 655 888.

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