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Morningstar retirement bootcamp

Webinar 1 - Everything you wanted to know about ETFs and were scared to ask

Webinar 2 - Traditional passive ETFs

Webinar 3 - Thematic and factor ETFs

Webinar 4 - Using ETFs to generate income

Learning objectives

1. Understand the technical aspects of how ETFs work and answer questions around the safety of your money, how prices work and when to buy and sell ETFs

How your money is safeguarded

Many investors are understandably nervous about misappropriation of their funds by the fund manager that runs an ETF. All regulated investments funds including managed funds and ETFs separate the safekeeping of assets from the investment activities.

Fund manager: Responsible for directing investment activities. No access to cash or underlying assets.

If a fund manager goes out of business the client funds will not be impacted. Either another fund manager will take over the ETF or the assets will be liquidated and returned to the investors in the ETFs.

Custodial bank: The actual assets – cash and securities – are held by a custodial bank. The bank is responsible for the safekeeping of the assets.

If a custodian were to go bankrupt the creditors of the custodian would not have access to the ETF assets and they would be liquidated and returned to the investors in the ETF.

Example of fund managers: Vanguard, Betashares, Blackrock (iShares), Van Eck

Examples of custodial banks: JP Morgan, Citi, Northern Trust, State Street

How an ETF works

Before ETFs However, were two structures for collective investment vehicles:

1. **Closed-end funds or LICs which trade on an exchange.** The advantage of this structure is that it is easy for investors to trade since they are on an exchange. However, prices are driven by supply and demand like a share and their may be a sizable difference between the net asset value of the basket of holdings and the price of the closed-end fund / LIC unit price.
2. **Open-end funds or managed funds which don't trade on an exchange:** The advantage of this structure is that the price of the net asset value of the basket of holdings and the price of the open-end / managed fund will always be the same. The disadvantage is that you can only transact at the end of the day directly through the managed fund company.

The goal was to create a product that trades on an exchange which allows investors to transact at the net asset value

How an ETF works: A hypothetical ETF with two shares

Hypothetical ETF: NAV of $196.73
1 share CBA $157.13
1 share BHP $39.60

More buyers of the ETF drive up the price to $200 per unit

The ETF is now worth more than the shares that are held in it. The authorised participant / market maker buys 1 share of CBA and 1 share of BHP for $196.73 creates an ETF unit and sells it for $200.

This same process will happen again and again until enough of the ETF is sold to drive the price down to the NAV where it is no longer profitable for the authorised participant / market maker

More sellers of the ETF drive down the price to $192 per unit

The ETF is now worth less than the shares that are held in it. The authorised participant / market maker buys 1 unit of the ETF for $192, redeems it and sells both shares for $196.73

This same process will happen again and again until enough of the ETF is purchased to drive the price up to the NAV where it is no longer profitable for the authorised participant / market maker

How an ETF works: Premium / discount

The price of the ETF will never exactly match the NAV however the mechanism of creation units and redemption units will keep it close. There is a cost for the authorised participant / market maker for the creation and redemption process. The less liquid and more volatile the holdings in the ETF the bigger the cost will be and the bigger the premium and discount will be.

How an ETF works: Misnomers about ETFs

All ETFs are passive, and all managed funds are active: ETFs and managed funds both come in active and passive varieties.

ETFs pay dividends: ETFS pay distributions which include both income and capital gains from changes made to the portfolio. There can be a meaningful difference between income earned by an ETF and distributions for actively managed, thematic and factor ETFs.

Passive ETFs will match the return of an index: The return of a passive ETF will not perfectly match the underlying index with the difference known as tracking difference when looked at over a specific holdings period. During specific market conditions the differences can vary and is known as tracking error. More liquid indexes will experience less tracking error.

All ETFs are tax efficient: Investors tend to conflate the benefits of passive investing with ETFs. Broad index tracking ETFs are generally tax efficient however many factor and thematic ETFs have high turnover which limits tax efficiencies.

Investing in a bond ETF is the same as investing in a bond: Bond ETFs that hold a portfolio of bonds and constantly refresh that portfolio are not the same as investing in a bond. There is no maturity for the ETF and interest income will vary based on the changing nature of a portfolio.

How an ETF works: Misnomers about ETFs (continued)

ETFs are 'better' than other investments: There are two misnomers here – the first is that an ETF is an investment and the second is that ETFs is the best choice for all investors. An ETF is an investment vehicle and what you are investing in is the underlying holdings in the ETF. All investment vehicles (ETFs, LICs, managed funds) have certain positives and negatives that suit different types of investors. There are studies that suggest investors in passive ETFs and ETFs in general earn lower returns than investors without them because of behavioural risk.