



UNDERSTANDING HOW

EXCHANGE TRADED FUNDS

WORK



WealthAdviser

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Before you get started

This digital handbook contains general and factual information only, and is part of the Wealth Adviser library, published by:

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- Sentry Advice (AFSL 227748)
- Synchron Advice (AFSL 243313)
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Before acting on any information contained herein you should consider if it is suitable for you. You should also consider consulting a suitably qualified financial, tax and/or legal adviser.

Information in this handbook is no substitute for professional financial advice.

We encourage you to seek professional financial advice before making any investment or financial decisions. We would obviously love the opportunity to have that conversation with you, and at the rear of this handbook you will find information about our authorised representative and how to go about booking an appointment.

If ultimately you decide not to meet with us we still encourage you to consult with another suitably licensed and qualified financial adviser.

In any circumstance, before investing in any financial product you should obtain and read a Product Disclosure Statement and consider whether it is appropriate for your objectives, situation and needs.

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Letter from the Wealth Adviser Library

Dear Reader

Welcome to the Wealth Adviser Library

This library was built specifically to facilitate the provision of sound financial information to everyday Australians.

Our mission is to build an accessible, comprehensively supported team of members who share our vision and commitment to providing tailored financial advice and a new foundation of financial understanding and security for everyone.

With a national network of likeminded experts, we have the potential to provide the financial building blocks for future generations.

Knowledge gives you a huge advantage

We believe that knowledge gives you a huge advantage in creating and effectively managing wealth; in planning to reach your goals; and in being prepared for whatever unexpected twists and turns life may present.

That's why our team of experts has created this series of digital handbooks and manuals that seek to inform you of not only the benefits but also the potential risks and pitfalls of various strategies and investments.

We trust you enjoy this publication and find it informative and professionally presented. Of course, your feedback is always welcome as we strive to continually offer content in a format that is relevant to you.

Take the next step

Wealth Adviser (a division of WT Financial Group Limited) supports more than 400 privately owned and operated advice practices around the country. We invite you to engage with one of our advisers to discuss what it was you were hoping to achieve when you obtained this handbook, and to establish if they can help you achieve your goals and objectives.

At the rear of this handbook you will find details on how to book an appointment.

Wealth Adviser Library

Introduction

Exchange traded funds (ETFs) are a managed investment vehicle that you can use to access a wide variety of investment markets. Many investors use ETFs as a diversification strategy in their portfolios. ETFs allow you to buy a 'basket' of shares or other assets to spread your investment risk. Spreading your risk is a fundamental investment risk management strategy.

Investing in exchange traded funds

Units in ETFs can be bought and sold just like shares or other securities on the Australian Securities Exchange (ASX) or on any other securities market around the world. Many investors use online share trading platforms to invest in ETFs. You pay brokerage fees on all ETF buying and selling transactions, just like you would with shares.

When you buy or sell units in an ETF, settlement of the trade usually occurs two days later. The price of individual units in an ETF should be fairly close to the fund's net asset value per unit (NAV). Some ETFs pay dividends/distribution income to members, others don't. It depends on the type of ETF and policy of the fund provider.

However, unlike investing in individual shares, when you invest in an ETF you don't own the underlying fund investments. Instead, the ETF fund does (as is the case with any managed fund investment).

ETFs are managed by a fund manager who monitors the value of a market index (e.g. the ASX200 on the Australian Securities Exchange or the S&P500 on the US stock market), or a commodity like gold, iron ore or copper. In the case of an Index ETF, the fund manager tries to buy and sell assets to match the market performance of the fund's monitored index or commodity.

Types of assets you can invest in via an ETF

The type of assets you can invest in via an ETF include:

- Australian and international shares
- fixed income investments (e.g. bonds)
- listed property securities
- precious metals and commodities
- agricultural products
- foreign currencies.

Physically backed vs. synthetic ETFs

Different types of ETFs specialise in investing in different assets or asset classes. However, ETFs can be broadly categorised as being one of two types:

1. physically-backed, or
2. synthetic

A physically-backed ETF invests in its relevant index or commodity securities. These ETFs purchase the underlying assets in the index they are trying to replicate (e.g. ASX200 shares).

A synthetic ETF on the other hand invests in the index or commodity securities as well as 'swaps' or derivatives that mimic movements in the fund's underlying securities. For example, ETFs that invest in precious metals or commodities are often synthetic. These funds may not actually buy the asset class that they are representing (e.g. gold bars or coins). Instead, they may buy a derivative contract with an investment bank that promises an investment return based on the price movements in the fund's underlying asset/s.

Synthetic ETFs have higher risk than physically-backed ETFs because there is always a degree of risk that the synthetic ETF asset contract will not be honoured. It is a legal requirement for a synthetic ETF to have the word 'synthetic' in its product name.

The advantages of investing in ETFs

Investing in an ETF can provide you with the following advantages:

- diversification
- low-cost access to markets you may not otherwise be able to access
- transparency
- liquidity
- capital gains
- dividends/distributions and franking credits

We'll now look at each of these potential advantages in turn.

Diversification

An investment in an ETF tracking the ASX200 would give you the diversification of your investment tracking the performance of Australia's largest 200 listed companies. Similarly, an investment in an ETF tracking the S&P500 would see you investing in the performance of the 500 largest companies on the US stock market.

Investing in the performance of the share market as a whole is less risky than investing in a single company (or only a few companies). It's the investment equivalent of 'not having all your eggs in one basket'. If you do invest in individual shares rather than an ETF and the value of those individual shares goes down, there is no opportunity for your losses to be offset by gains in the value of other shares that you haven't invested in. However, investing in an ETF gives you access to all the shares in the index. Some will go up; some will go down. Your gains may not be as high, but your losses won't be either.

Of course, a market as whole can decline significantly at any time like the Australian share market did during the global financial crisis (GFC) and when the strict COVID-19 restrictions were first applied in Australia. However, if you are investing in ETFs long term, you may be able to ride out any market downturns.

Low-cost access to markets

For example, debt, currency, and commodity markets that you may not otherwise be able to access. Passively managed ETFs also generally have lower fees than actively managed funds.

Transparency

ETFs on the ASX are required to publish their net asset value daily (NAV). ETF unit prices are based on the fund's overall NAV and can move up or down daily, just like individual share prices do.

Liquidity

Most ETF units can be sold daily, so if you need a liquid investment, investing in most ETFs is a suitable option.

Potential capital gains

If your ETF unit price increases over time, you can sell to make a capital gain. Normal capital gains tax (CGT) rules apply. You pay CGT on an ETF capital gain at your marginal rate of tax. However, if you make a capital gain on an ETF unit that you have held for at least 12 months, you're entitled to a 50% CGT discount if owned personally.

Potential dividends/distributions and franking credits

If you buy units in an ETF that invests in ASX index and pays dividends, you'll be entitled to franking credits. Franking credits reflect the company tax already paid by the company issuing the dividend. If you receive a franking credit, you can use it to reduce your individual tax obligation and even to generate a refund if the credit is large enough.



Possible disadvantages of investing in ETFs

Investing in an ETF also has the following potential disadvantages, which are similar to other forms of managed funds:

- investment sector risk
- currency risk for international holdings
- the potential for international tax obligations

We'll now look at each of these potential disadvantages in turn.

Investment sector risk

This is a risk if you invest all your funds in a single index or commodity, and the market value of that index or commodity falls. In addition, if you invest in a commodity ETF, you may be investing in the future price of a commodity rather than the current price. There is greater risk associated with future prices.

Currency risk

There is a risk if you invest in ETFs with underlying international assets that the currency you invest in will devalue.

For example, imagine that you invest in units in an ETF that monitors the US S&P500 index and that the \$US dollar subsequently weakens against the \$A by 5%. In that scenario, your investment return will also fall by 5% if you sell your units and convert your return into \$A.

A devaluation adversely affects your ETF investment returns unless the fund hedges against international currency risk.

The potential for international tax obligations

If you buy units in an ETF that is listed on an international market (e.g. an ETF listed on the New York Stock Exchange), you may need to pay foreign taxes. It's important to understand the tax implications of any international ETF you invest in as this may affect your investment return.

Products disclosure statements (PDS)

ETFs on the ASX are legally required to provide you with a PDS before you invest in them. The PDS must outline important investment information such as:

- what market index or commodity the ETF investment performance is aiming to match
- any ETF fees and costs
- any ETF investment risk.

ETFs on the ASX

There are a huge range of ETFs on the ASX (more than 200 and the number is growing). They have become increasingly popular with investors over the past decade. According to the latest figures, over A\$65 billion is currently invested in ASX-listed ETFs. Each ETF on the ASX lists as a single entity with a unique ASX code.

It's important to understand that an equity (share)-based ETF doesn't buy an equal number of the shares listed in its index. Instead, it will buy a volume of each company's shares to reflect the importance of each company's performance to the overall index. For example, an ETF investing in the ASX200 index will buy more shares in the largest companies in the index in terms of market capitalisation than it will buy in smaller companies. This strategy will help it to match the overall performance of the index.

These are three ETFs that track the ASX200 index:

1. BetaShares FTSE RAFI Australia 200 (QOZ)
2. iShares Core S&P/ASX 200 (IOZ)
3. SPDR S&P/ASX 200 (STW).

The largest companies in the ASX200 include:

- CSL
- Commonwealth Bank
- BHP

- Westpac
- National Australia Bank
- Fortescue Metals
- Wesfarmers
- ANZ
- Woolworths
- Macquarie

Despite the general uncertainty surrounding investment markets since the economic impact of COVID-19, ETFs on the ASX are still recording a steady stream of inflows.

How to choose an ETF

Important considerations in choosing an ETF include:

- your investment timeframe
- your investment strategy
- the fund's track record of returns
- the fund's fees

Your investment timeframe

Some ETFs have the potential for quicker returns due to the nature of their underlying investments, while others will be more suited to a longer-term investment. As with any investment, taking a longer-term view will help you to ride out any market fluctuations. However, you also need to consider your short-term liquidity needs.

Your investment strategy

It's important to understand your risk profile and investment strategy before you make any investment. For example, are you comfortable

with a riskier, more volatile ETF investment sector with the potential for higher returns or would you prefer a more stable sector with lower returns but less risk?

The fund's track record of returns

While past investment performance is no guarantee of future performance (especially in the post COVID-19 investment environment), it's important to analyse an ETF's comparative investment returns over

the past five years.

The fund's fees

You should also do a comparative fee analysis of ETFs that invest in the markets or sectors that you're most interested in. Although ETFs in general are a low-cost investment, some funds will charge more fees than others. Fee charges can vary by fund and on the type of asset class a fund invests in.

Where to find out more about ETFs

If you'd like to find out more about investing in ETFs, the ASX provides a range of free online courses and information. Before you make any investment decision, it's also wise to get professional advice. Make sure you understand how ETFs work and any associated investment risk. If you don't, ask questions.

Take the next step

We trust you enjoyed this publication and found it informative and professionally presented. Of course, your feedback is always welcome as we strive to continually offer content in a format that is relevant to you.

We now invite you to take the next step and meet with an adviser to discuss what it was you were hoping to achieve when you downloaded this handbook and to establish if we can help you achieve your goals and objectives.

Next you will find details on how to book an appointment with an adviser.

We look forward to meeting you soon.



Appointment booking request form

About the Adviser

Please complete the Appointment Booking Request below and scan and email to:

Appointments are available Monday-to-Friday.

Please nominate your preferred day, date and time to meet with us. One of our client services representatives will call you to confirm your appointment.

Our services

Preferred appointment day and time

Day

Date

Time am/pm

Contact details

If you would like us to contact you via email to confirm your appointment or to answer any questions you have, please provide a valid email address for our records.

Email

Your Details

Title

First name

Last name

Mobile



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