Investment Solutions

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Welcome

In this edition of Investment Solutions magazine we take a look at investing in ETFs.

BT Financial Group Investment Specialist, Riccardo Briganti, provides us with a market update on local and international markets.

Finally, we share insights on managing cash in your SMSF.

Until next time – happy reading.

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Market update

BT Financial Group Investment Specialist *Riccardo Briganti* brings you our latest market update on both local and international markets, from overseas tensions to the RBA cash rate.

Financial markets started the year on what was, in retrospect, an overly optimistic note. The US S&P500 Index increased by 5.6% in January – an impressive achievement coming after the 19.4% rise seen in 2017. European and Asian markets also posted significant increases, but the Australian sharemarket failed to share in the positive sentiment with the S&P/ASX200 Index falling 0.5% in January.

Continued strength in global economic indicators and the successful introduction of the US Tax Cuts and Jobs Act which will see the US corporate tax rate cut to 21% from 35% were the main drivers of January's jump in US share market performance. At the same time, a number of US companies released positive profit announcements early in the year which further encouraged the optimistic mindset with respect to economic growth and company profitability.

This all seemingly came to an end in early February. The S&P500 fell 2.1% on Friday, 2 February and continued its decline after the weekend, falling a further 4.1% on Monday. The proximate cause was the release of US wage data on the Friday showing that unit labour costs increased by an annualised 2% in the December quarter of 2017, significantly above the 0.9% rise expected by market participants. This set off a chain reaction with investors speculating whether inflation would also spike and if this meant the US Federal Reserve would increase interest rates more than previously expected, possibly to the point of putting the brakes on the growth momentum currently being experienced in the US, as well as more broadly in the rest of the world.

A degree of stability returned to equities markets as February progressed in part due to the realisation that economic fundamentals remain largely positive. US GDP grew at an annualised pace of 2.6% in the December quarter below the previous quarter's 3.2% growth rate but consistent with the broad trends seen over the past three years. Consumer confidence increased in January with the Conference Board consumer confidence index increasing to 125.4 in January from 123.1 in December. The index is at high levels compared to historical trends, partly reflecting continued strong employment growth which has seen the US unemployment rate fall to 4.1%. European economic indicators are also largely positive. December quarter GDP showed the European economy grew at 2.7% over the past year and the Markit Eurozone Manufacturing PMI is at 58.8 – off recent highs but still significantly above levels seen in the past five years.

In Australia, recent economic data has not been as positively received which has been reflected in the underperformance of Australian equities compared to their global counterparts. While signals remain mixed, there have been some encouraging signs. The Westpac/Melbourne Institute consumer sentiment index moved above 100 late last year and has been able to maintain this position with February's reading of 102.3. This follows almost an entire year where pessimists outweighed optimists and readings were below 100. The Australian economy is expected to grow at around 2.5% in 2018. This would be in line with growth seen in recent years, but is likely to be insufficient to see the unemployment rate move lower from its current rate of 5.5%. This is also likely to mean the Reserve Bank of Australia will keep official interest rates unchanged at 1.5%.

Investing in ETFs

The exchange-traded fund (ETF) has had amazing success as an investment product. Since the first ETF was created, ETFs worldwide have swelled to a record of around US$6.6 trillion ($5 trillion) in assets at the end of June 2017[1,2].

A background of ETFs

An ETF is an investment fund that holds a basket of securities – such as shares or bonds that tracks a specified index – and is itself a listed share, traded on a stock exchange. ETFs are low-cost, simple vehicles that can offer exposure to a wide range of Australian and global asset classes, indices and sectors, currencies and commodities, as well as a variety of investment strategies. Investors can gain cost-effective, fast exposure to different markets that were once only accessible to institutional investors, including asset classes and strategies through a single investment by buying an ETF. As ETFs are listed, the investment is liquid, and therefore tradable at any time, however like shares, liquidity is dependent on market volumes and during time of significant market stress, liquidity (the ability to buy and sell) could decrease.

The appeal of ETFs

Typically, ETFs tend to be much cheaper in their annual management costs compared to traditional managed funds. They have no entry or exit fees – investors pay normal brokerage when buying or selling in the same way an investors trades shares. As a note, the price to buy an ETF might be different to the price to sell (much like shares and managed funds) and this is based on a range of things, such as demand. The lower cost of investment in ETFs is an important consideration in the context of long-term investment success, because just as investment returns compound, so do investment fees.

The first generation of ETFs gave investors access to the major share market indices and other asset classes, such as fixed-interest. Second-generation ETFs opened up the opportunity to invest in specific share market sectors, and countries. Third-generation ETFs gave exposure to share portfolios and baskets designed to capture fundamental, 'factor-based' or 'style-based' strategies in shares. Most ETFs are physical ETFs, in that they actually hold the assets, but "synthetic" ETFs have been created to offer investment in commodities and currencies – these ETFs track their underlying commodities artificially, through derivatives.

The attraction of ETFs is that they are very flexible investment tools, which allow investors to easily improve their portfolio's diversification; or to easily implement an investment view; or to use investment strategies that were once too complicated or expensive for them to consider. An investor can use ETFs for their entire asset allocation, or they can act as a low-cost complement, or alternative, to existing investments with active fund managers. Some ETFs also appeal to investors through transparency of the underlying investments. This is not true of all ETFs though.

Understanding the risks

Investments carry risk, and ETFs are no exception to this rule. While there is the obvious risk of gain or loss of value depending on market activity, there are other risks to appreciate.

These range from risks specific to the assets the ETF is invested in, to the liquidity of the underlying investments, currency changes should some of the assets be international or even counterparty risk, that is the risk the issuer of the ETF will be unable to fulfil the duties of managing the ETF.

This is not a conclusive list, and investors can find more information about the risks specific to any ETFs they are considering by reading the product disclosure statements offered by the issuers.

Using ETFs in investments

The simplest way in which investors use ETFs is to establish – or diversify – an investment portfolio. For example, an investor who does not own any shares can simply buy an Australian share ETF, giving them a holding in hundreds of Australian shares, in a vehicle that aims to replicate the annual performance of the Australian share market index (give or take some differences in returns due to challenges of copying the index exactly). Adding a global shares ETF to your portfolio can widen this exposure to an international shares allocation; this might add thousands of shares to the portfolio depending on the particular ETF, picking up the world's top companies (and brands), and tapping into the global revenue streams these generate.

This same investor can then very simply extend the diversification of their portfolio into other asset classes. For example, fixed-income is a great asset class to own, as it provides very sound diversification against shares, but historically it has been a difficult asset class for retail investors to enter, as most types of bonds were sold in prohibitive minimum investment sizes. Effectively, this locked retail investors out of the bond market, unless they wanted to use unlisted bond funds. But fixed-income ETFs offering exposure to investment-grade securities in the Australian commonwealth government and state government bonds arena – as well as the global sovereign (government) and corporate (company) bond market – have opened up the fixed-interest and 'credit' asset classes for investments of any amount.

Some advisers use ETFs for their clients in asset allocation, to build portfolios with exposure to specific asset classes like international shares, domestic fixed income, cash and property. The ETFs can also form the "core" holding of a core/satellite portfolio strategy, where the core is held in a low-cost, broadly diversified exposure to an asset class, aiming to earn a return in line with the market's performance – often referred to as the 'beta' return.

Once the core is established, the 'satellites' are set up around that: these are typically more specialised investments which the adviser or investor believes will deliver additional returns (alpha). The satellites could be direct shares, actively managed funds, even other ETFs.

ETFs can also be used to gain exposure to a specific investment 'theme', as part of a tactical asset allocation process. For example, an investor who believes that the resources sector is poised to out-perform the rest of the Australian share market can tilt their portfolio toward over-weighting the resources industry by buying a relevant ETF. This tilt can be short-term or long-term.

Alternatively, this strategy could involve a view on a particular industry.

Newer styles of ETFs

The third generation of ETFs mentioned earlier target particular "factors," which are fundamental underlying drivers of equity return.

For example, "value" stocks – which are seen as 'unloved' companies that have low prices relative to fundamental measurements (such as price/equity ratio, dividend yield or net asset value) – have historically out-performed the broad share market over the long term. Value stocks are those that are out of favour with the market, being priced low, relative to the company's earnings or assets.

Other common factors include size (market capitalisation), company "quality" (as indicated by a range of fundamental criteria indicating financial health), "momentum" (stocks rising in price) and low-volatility (stocks that historically have fluctuated in price less than the overall index). ETFs based on these factors them can give investors a "smart beta" vehicle through which to make more targeted allocations to potential sources of risk and return, to improve returns, reduce risk or enhance diversification, in both Australian and international shares – and at a lower cost than non-ETF methods of trying to do the same.

Source:

1. The first ETF created was the Toronto Index Participation Fund (TIP 35), in April 1990
2. RBA, The Australian Exchange-traded funds Market Q2 2017

Managing cash in your SMSF

The cornerstone to any successfully operating self-managed super fund (SMSF) is its bank or cash account. After all, it's the first thing that will be opened whenever an SMSF is established[1].

Whilst there is the ability to transfer ownership of some assets from outside the super environment to your own SMSF, most transactions will flow through a cash account. If you think about it, so much of your SMSF operates though the cash account. There will be contributions made to your SMSF by members or employers (such as super guarantee or salary sacrificed amounts), there will be returns from investments such as dividends, there will be amounts paid to purchase investments, amounts paid as benefits to members in retirement, and the costs for running the fund, including insurances, administration and taxation.

So what's the best way to manage cash in your SMSF? Part of this comes to a question of how much cash you need for operating purposes (i.e., to meet regular expenses) and how much is for investment purposes.

Remember that cash can be an appropriate investment for your fund, particular where it is known that it will be needed for a particular purpose in the near term, or the members themselves are concerned about market volatility and looking for a capital stable investment. In these instances, you could be considering a range of options, from an ordinary cash account (with the highest possible interest rate you can find), a term deposit (which may offer a higher interest rate than a cash account, but locks your money away for a period of time), or even some other forms of fixed interest investments such as managed funds.

How do you choose the cash account and how to operate it for your fund? There is a range of choices available, with some accounts having been developed specifically for the SMSF environment. There is a number of considerations you could take into account for your SMSF's bank account. These include:

- **What rate of interest is payable on the account?**
  In an environment of low interest rates, many transaction accounts currently pay little in interest (depending on the amount held in the account). This may not be a concern if the balance you are looking to maintain in this account is comparatively low where it is used for transactional purposes.
- **What fees are payable?**
  Like any investment, consider the fees that may be payable and compare that to the level of return you are generating. Is there also a minimum or maximum number of transactions required that impact the level of fees?
- **What features does the account come with?**
  Remembering that as super funds are generally not allowed to borrow, you may need to carefully consider whether to attach any credit card or overdraft facility to the account.

Another thing you could consider is the possibility of having two cash accounts, if that better suits your needs or circumstances. Having two cash accounts can mean that one is used for the everyday transactions of the SMSF, and another that holds the majority of the cash to be kept aside for working needs. This second account could be in a different form, such as online account, which could pay a higher rate of interest. You then have the option of moving money between the two accounts as needed.

One final item to always be conscious of is to ensure that the bank accounts of the SMSF are always maintained separately to your own personal account(s). The Australian Taxation Office (ATO), as the regulator of SMSFs, has a strong focus on the separation of assets of SMSF members and trustees from personal accounts. There are some simple steps you can consider around this, such as whether it is worth setting up your SMSF accounts with a financial institution that is different to where you bank personally. If there is some form of keycard associated with your SMSF accounts, you can consider ways to reduce chances of being accidentally used if you tend to carry it around in your wallet. Or if there is a cheque book for the SMSF, you can consider separating it from your personal cheque book.

The real key to managing cash within your SMSF comes back to taking your time. Be clear on what it is you are trying to achieve. Understand the type of account you need for specific purposes. And do your research. With so many options to choose from, don't be afraid to ask for professional help to ensure your SMSF gets it right and sets you up for safe operating future around your retirement savings.

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Source:

1. First published in Nestegg.com.au on 18 January 2018.

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