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An all-ETFs pie to fill your portfolio

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PORTFOLIO POINT: There's 81 ways to invest in exchange-traded funds, and counting. And all the ingredients are readily available at the Australian stockmarket.

Following the recent launch of exchange-traded bond funds, it has now become possible to build a properly diversified multi-sector portfolio entirely from exchange traded funds (ETFs).

Given their inbuilt diversification and low cost, this is not an unreasonable way to build a portfolio – although there are some limitations.

Here I will be building a simple and complex portfolio from a palette of currently 81 funds offered by eight suppliers, all available to you on the Australian stockmarket.

In case you aren't familiar with ETFs, they are simple multi-investor unit-trust "funds" which track an index or the value of a commodity (the latter which some call an ETC).

"Exchange traded" means you can only buy and sell these on the stockmarket. Their low cost derives from their unmanaged style and, for retail investors, efficiencies from being bought on-market rather than directly from the fund manager. ETFs were launched in 1989 in Canada and the US.

There is now more than $1 trillion invested globally in ETFs, representing about 10% of investment company funds. While most of these are backed solely by physical assets a few are based on derivative-based promises, which worry some about their security during times of financial system stress.

After a long incubation their use is growing rapidly in Australia, with estimates of about $6 billion now invested – capturing about 10% of the local indexed-equity market. While they are similar to listed investment companies (LICs), like from Australian Foundation Investment Company, their holdings aren't actively selected or traded and their unit price is managed to closely reflect the value of the underlying assets.

Your ETFs palette

In Australia you can use ETFs to invest in local and International shares, sectors within it, various commodities and precious metals, currencies and now bonds. The table below lays out the current universe of Australian ETFs – a chart I expect will become out of date within a month given the rapid introduction of funds.

Asset class	Manager>	iShares	SSgA SPDR	Vanguard	BetaShares	ETF Securities	Russell	AII	Chimaera
Australian equity	Large only	ILC	SFY	VLC					
	Index	IOZ	STW	VAS	*BEAR*				
	Small	ISO	SSO	VSO					
	Value						RVL		
	High dividend	IHD	SYI	VHY			RDV		
	Industry sector		OZF, OZR		QFN,QRE			FIN, FIX, RSR, IDO, ENY, MAM	DGA
International equity	Large global	IOO							
	US large	IVV		VTS					
	US smaller	IRU,IJH, IJR							
	ex-US	IVE		VEU					
	Europe	IEU							
	Asia	IAA							
	Emerging Markets	IEM, IBK							
	Country	IZZ,IKO, ITW,IHK, IJP,ISG							
	Industry sector	IXI,IXJ,IXP							
Property	Australian listed property		SLF	VAP					
Commodity	Multi-commodity basket				QCB	ETPCMD			
	Gold				QAU	GOLD			
	Other metals					ETPMAG, ETPMPT, ETPMPD, ETPMPM, ETPIND, ETPCOP			
	Oil and energy				OOO	ETPNRG, ETPOIL, ETPGAS			
	Agricultural				QAG	ETPAGR, ETPGRN, ETPCRN, ETPWHT			
Australian Bond	Index	IAF	BOND						
	Government nominal	IGB	GOVT	VGB			RGB, RSM		
	Government inflation linked	ILB							
	Corporate						RCB		
Cash	Australian				AAA				
	British Pound				POU				
	Euro				EEU				
	US Dollar				USD				
Total number of ETFs offered	81	26	9	8	11	15	5	6	1

as at 30 September 2012 © Professional Wealth [1]

In Australia, the eight suppliers include the big three global providers BlackRock iShares [2] (locally offering 26 funds), State Street Global Advisors [3] (9) and Vanguard [4] (8), as well as Betashares [5] (11), ETF Securities [6] (15), Russell Investments [7] (5), Australian Index Investments [8] (Aiil) (6) and Chimaera [9] (1). ETFs from iShares (I), Vanguard (V), Russell (R), State Street (S), and ETF Securities (ETP) mostly begin with the same letters, while others have tried their hand at making clever acronyms for you to remember (GOLD, BOND, GOVT, EURO, POUnd, USD) – including me when I suggested earlier to readers the design of inflation [10] and defensive [11] ETFs. A ninth supplier could be the Perth Mint's PMGOLD [12], however since this is only an option to buy gold it is unclear to me whether this technically is an ETF.

While suppliers offer ETFs in similar categories (i.e. share the same row in the table above), not all funds are the same. Many use different index rules about what they include and don't and how much. For instance, each of the four high dividend Australian share funds (IHD, SYI, VHY and RDV) are based on different indices from the S&P/ASX, MSCI, FTSE and Russell and, as such, have different holdings.

You'll need to do your own research or seek advice to select the one best for you. Look also at the bid/ask spread and assets in each ETF – about one-third of ETFs have less than $5 million invested in them today, and if they don't grow they won't survive.

Simple ETFs portfolio

A very simple multi-manager, multi-sector portfolio could be built for example using as little as four ETFs, incorporating:

1. Australian shares – for instance State Street/SPDR STW, iShares IOZ or Vanguard's VAS, which provide the investment return from owning an index weight of Australia's largest 200 or 300 companies.
2. US shares – Vanguard VTS, which delivers the returns from owning the largest 3,300 US companies.
3. International ex-US shares – Vanguard VEU. which delivers returns from about 2,300 companies outside the US.
4. Australian bonds – iShares IAF or State Street's BOND, which provides the return from the UBS Composite bond index made up of over 110 representative Australian federal, state and semi-government and corporate bonds (the latter a modest less than 10%).

The above fund costs range from 0.06% to 0.29% of assets, or about 0.2% depending on your mix of growth and defensive bond investments. Aside from a $150, or 0.1%, once-off discount brokerage cost, your annual costs to invest in over 5,000 share and bond securities would be about $200 for every $100,000 invested. This low cost

and diversification demonstrates the appeal of ETFs.

Interestingly, the cost of this mix is between one-half and one-third the cost of Vanguard's unlisted multi-sector index fund range (the amount of saving depending on amount invested). However, in fairness, those portfolios include additional assets and are rebalanced for you. The reason there is no ex-Australia share fund (a combined US and non-US fund to make this a three, not four ETF portfolio) is because the Vanguard Australian international share ETFs are investing into large US listed, US centric ETFs.

iShares provides the broadest selection of international share ETFs, but they too don't offer an ex-Australian international share fund.

Your proportion of these ETFs depends first on your overall growth – defensive bond mix. If you apply a life stage investment approach to your retirement savings, then the amount of assets to hold in defensive bonds could be your "age in bonds" or "your age in bonds less 15%" as I suggested in an earlier [13] article.

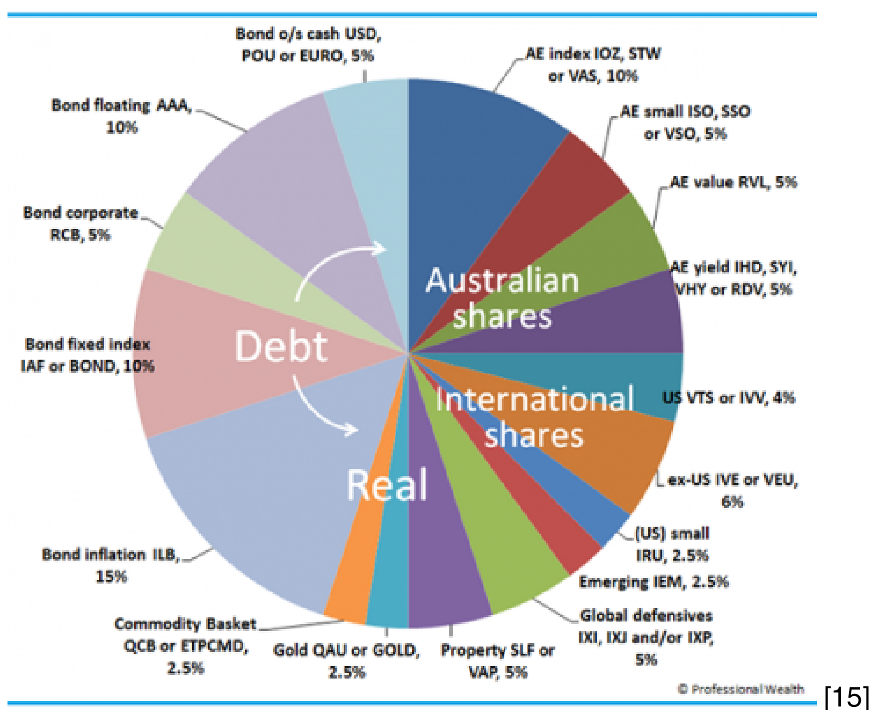
Next you need to take a view on your domestic versus international equity bias. If you think the Australian dollar is only temporarily strong (which I have called a "Bradbury currency [14]") and/or the prospect for growth of banks' and miners' profits and price earnings is weak, then you might have an equal mix of Australian and non-Australian shares.

However note that your portfolio income will be lower, the more non-franked, lower yielding international shares you incorporate. Companies listed on the US market, which include many globally operating multi-nationals, represent about 40% of the world stockmarket. Accordingly, you would mix the US and non-US holdings in a 40:60 proportion, before applying any other "tilt".

Complex ETFs portfolio

While the above portfolio is a neat illustration, I wouldn't invest in it.

It is far too simplistic and it is actually not diversified enough in terms of asset types: both shares and cash and bonds. A more complex portfolio can be illustrated to educate about additional "tilts" to consider improving diversification and potential returns, including:



[15]

- Small companies, both local (for instance iShares ISO, State Street's SSO or Vanguard's VSO, which track the "Small Ordinaries" (SO) index) and international (iShares Russell 2000 IRU, which provide returns from 2000 smaller US-companies only). While these companies may be held in the index, because holdings are market capitalisation-weighted they aren't in substantial proportions to provide a

necessary effect.

- Value companies (Russell RVL), which long-term studies suggest could also deliver outperformance. This is only possible for the Australian share allocation.
- High-yielding Australian companies (where local investors can choose from iShares IHD, which incidentally caps concentration in high-yielding bank stocks more so than Vanguard's VHY, State Street's SYI and Russell's RDV variants).
- Emerging markets (for instance iShares IEM), which increases the small allocation already in ex-Australia, ex-US VEU.
- Defensive sectors (like Global Healthcare iShares IXJ, Consumer Staples IXI and Telecommunication IXP) to try to correct for our local market bias to non-defensive resources and banks.
- Listed property (State Street SLF or Vanguard VAP Australian only real estate trusts) to enhance yield and add inflation protection. Like with small companies and emerging markets, there is about a 10% holding already in the broader share index funds but more may be better.
- Inflation linked bonds (iShares ILB only example) and floating-rate bonds/cash (Australia only Betashares AAA) so as to adopt my preferred three-component defensive bond allocation [16]. You could replace the latter with higher-yielding term deposits but there's not (yet) an ETF for that.
- To further protect your spending power from a falling Australian dollar, the floating-rate cash-like component could be enhanced with cash invested in US$, euros and pounds (Betashares USD, EURO, POU), although at a yield penalty.
- To potentially enhance the return (and risk) investing in Australian fixed interest nominal bonds (using iShares IAF or State Street's BOND), the weighting to corporate bonds from the index could be increased (Russell RCB) – noting this mainly increases your exposure to Australian bank bonds and may not be desirably diversified.
- To increase inflation protection, an allocation to gold (priced in US$ Betashares QAU or in Australian dollars ETF Securities GOLD), other precious metals (ETF Securities ETPIND, ETPCOP, ETPMAG, ETPMPT, ETPMPD, ETPMPM), Chimaera DIGGA, and other "hard" and "soft" commodities (Betashares QAG, QCB, OOO) could be considered.

This portfolio is shown in "balanced-style" proportions, comparable or "benchmarkable" to Vanguard's "balanced" multi-sector index portfolio [17], which has an equal mix of company shares and bonds. I wouldn't compare these with typical Australian employer default super funds, which have less than 25% in defensive bonds – too little for the average age 50-plus investor in my opinion.

The average annual fund fee for this complex ETF portfolio is only a slightly higher 0.27% than the "simple portfolio", given the addition of more costly specialist assets. Establishment and periodic rebalancing brokerage will make this uneconomical for a small portfolio – say under $250,000.

Admittedly the number of ETFs here is excessive, and small allocations can have a negligible impact (e.g. 2.5% in gold is too little for some and 2.5% is too much for others).

While this portfolio is more diversified, in my opinion it is still incomplete owing to some missing features and some better non-ETF asset choices.

New directions

Despite there being 81 *shades of grey* ETFs, there are still some missing colours in your portfolio palette. In addition to my earlier proposed ETFs, my hypothetical family of ETFs would also include:

- A simple single ex-Australia international equity fund, avoiding the need for two
- The same and other international funds available in a currency hedged version which would provide additional portfolio income as discussed in another earlier [18] article, and to help protect if (and when) the Australian dollar rises.
- An ex-top 20 Australian company share fund to diversify the usual DIY investor's top 20 ASX listed company shareholdings (this the opposite intention of the various large only company funds which duplicate easily accessible holdings).
- High-yield/high-dividend international equity funds that are hedged for maximum income.
- Global infrastructure, the merits of which I discussed a while ago [19].
- International currency-hedged bond fund – though I would hold off introducing a non-investment grade

(junk bond) ETF like the US market-listed JNK and its cousins.
- International or a global (Australia and international) real estate investment trust.
- While there is now a BEAR market ETF (which goes up when the ASX200 goes down) I would like to see a simple ETF, based on out-of-the-money "puts", which declines in value in a flat or rising market but pays out when the market crashes. This is a simpler and more accessible form of portfolio insurance than complicated and expensive structured products.
- Ethical and opposing "SIN" stocks ETFs – the latter likely to outperform.
- A residential investment property fund given the importance and costs of this asset.
- A few multi-sector ETFs – which could be used by some as the core in a core-satellite construction [20]. Note you can make up just about any fine-tuned equity-bond allocation if you blend a conservative and aggressive, or growth version. That, incidentally, is my solution to MySuper, which is dangerously simplified.

At the risk of mixing metaphors, with the launch of bond ETFs you now have all the food groups from which you can make your own investment pie – with more ingredients on the way. Bon Appetit!

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