

What makes ETFs attractive

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EXCHANGE-TRADED funds (ETFs) are hybrid investment products which have a unique set of characteristics. ETFs offer investors the best of features of both unit trust funds and individual stocks. This article will look at the differences and similarities of ETFs compared with other types of investments.

Comparison of ETFs with Other Investments Before we do a comparison, let us first understand what other common investment options are, namely unit trusts and stocks, as it can help to enhance an investor's understanding of how ETFs are structured and how they are similar or different from these other investments. An ETF is a unit trust, listed and traded on a stock exchange. It is an open-ended fund that tracks or follows the performance of a benchmark index. An index is made up of a basket of securities and usually reflects the movement of an entire market. This gives ETF investors the opportunity to invest in a pre-packaged basket of securities of an index rather than just an individual security. ETF can also be used as a tool to build one's investment portfolio. Similar to ETFs, a unit trust fund is a vehicle which enables individuals, corporations and institutions with common investment objectives to pool their money for investment. Professional fund managers then use this pooled money to acquire investments which will help meet those objectives. These sorts of investments can include investments which are not available to investors through direct investment, such as corporate bonds. A more popular investment, stocks or equities are shares of ownership of a company. Stocks entitle the investor to receive profits from the operations of the company, usually by payment of a dividend and to any voting rights attached to the stocks. These three instruments are unique and can be compared in the following aspects: diversification; fees, charges and expenses; and tradeability in terms of liquidity and flexibility.

* **Diversification** ETFs provide investors with a diversified portfolio of securities, all in a single fund. Each ETF unit follows the performance of its benchmark index. It is intended to provide investors with similar diversification benefits to the holdings of the benchmark index's many constituent stocks without having to invest in each of the stocks directly. "ETFs are very efficient and convenient for an investor who would otherwise have to build a similar portfolio by purchasing individual stocks, bonds or commodities," said Datin Maznah Mahbob, chief executive officer, funds management division of AmInvestment Group Bhd.

In comparison, stocks do not provide investors with any diversification as any investment going into a stock means the investor is buying into an individual company. Unit trusts, on the other hand, provide diversification but the diversification is based on the funds' investment strategies. Therefore, unit trust investors might not have the same benefit of an entire market diversification like ETF investors. "As ETFs are very transparent, investors do not have to worry about the ETF's portfolio. Investors can regularly monitor and have up-to-date fund information about the ETF. For example, investors buying the FBM30etf can know what stocks the ETF buys into as the fund's information is easily available from the website," said Maznah.

* **Fees, charges and expenses** ETFs offer low fees, charges and expenses such as low transaction costs and management fees. They do not incur entry fees as compared to unit trusts which charge fees of up to 6 per cent of the net asset value (NAV) of a fund. ETFs incur transaction costs such as brokerage fee of up to 0.70 per cent, a clearing fee of up to 0.04 per cent and stamp duty which are applicable when trading securities on Bursa Malaysia. As a passively managed fund, an ETF incurs lower management fees of up to 0.5 per cent, as compared to a managed fund's management fee of up to 1.5 per cent per annum. Investments in stocks do not incur management fees as they do not involve any professional management. Maznah highlighted that

FBM30etf investors only have to pay an annual management fee of 0.50 per cent and no entry fee but are subject to brokerage fees which are nominal. "A similar index tracking unit trust fund will incur an entry fee of up to 7 per cent of NAV per unit and up to 1.5 per cent of NAV per annum for management fee*," she said. "All these charges and fees make ETFs a cost-efficient investment to gain access to a diversified portfolio through a single transaction," she added. * **Tradeability** ETFs experience price changes throughout the trading hours of the stock exchange as they are bought and sold. They are traded through regular brokerage accounts and settled like ordinary stocks. In addition, ETF investors do not need to worry about liquidity as market liquidity is enhanced with the presence of market makers. Market makers are always ready to buy and sell to investors. "ETFs are very liquid. More so compared to unit trusts and stocks. This is a value-added feature that makes ETFs very appealing," commented Maznah. On the other hand, transactions for unit trusts can only be settled at the end of the day. They cannot be traded throughout the day like stocks as the NAV is only calculated at the end of the day. As such, unit trusts do not offer trading flexibility like stocks and ETFs. Investors will not enjoy the liquidity benefit like the ETFs investors as there are no market players for unit trusts investments. **Conclusion** ETFs are attractive as alternative investment tools because they offer a unique combination of the best features from both worlds of unit trusts and stocks. The unique attributes and benefits of ETFs appeal to both individual and institutional investors. Investors who want to diversify their investment might want to consider ETFs as they gives diversification through a diversified basket of securities, incur lower fees, charges and expenses compared to other investments as well as offer trading flexibility and liquidity.

**Source: Lipper Hindsight as at 30 May 2009 This article was contributed by the Funds Management Division of AmInvestment Group Bhd.*

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