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ETFs: the fear, the fiction and the facts

They are standard equipment in an investor's toolbox yet mistrust and misinformation abound

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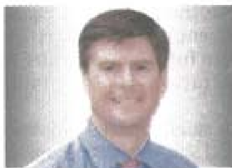

Jerome Kerviel, right, a former trader at Societe Generale, entered into fictitious trades
AFP

AS the local exchange traded fund industry continues to grow rapidly, the product has come under increased scrutiny from both regulators and investors. The extra attention has also led to increased media coverage around the complexity and safety of the product. That in turn has brought some incorrect theories out of the woodwork.

Myth 1: ETFs are opaque, complex products

Put simply, an ETF is a managed fund that is quoted and traded on a stock exchange, and that aims to track the performance of an asset class or index.

I would argue that the vast majority of ETFs are simple and transparent. At any time during the trading day, investors can buy or sell ETFs and view pricing, performance and the underlying assets held. The same cannot be said for many non-ETF funds. A number of concerns raised by the media relate to ETF structures that are not available in Australia. It is a testimony to our regulatory system that the products traded on ASX are subject to stricter compliance guidelines than those traded on overseas exchanges. All ETFs traded on ASX are backed by physical assets (cash, equities or physical commodities).

Myth 2: ETFs are often mispriced

Recently, there has been attention on ETF pricing. An Australian Securities and Investments Commission report noted that in six months, there were 22 counts of pre-emptive action due to an ETF trading significantly away from the price of its underlying value. Let's put that into context: there were about 19,000 ETF trades in June. This average implies about 114,000 trades in the six-month period. Using these figures, 22 counts of mispricing represent about 0.02 per cent of all trades during the period, which is hardly a significant number of mispricing events.

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In addition, ETF investors have access to data they can use to ensure they transact ETF units at close to the true value of the fund. For example, best practice ETF issuers provide investors with indicative intraday net asset values on their websites or through data vendors.

The iNAV, indicative net asset valuation published on issuers' websites, provides an estimate of the value of the ETF throughout the trading day. Investors should examine this iNAV before transacting an ETF and compare it with the bids or offers on the market at the time of buying or selling. This is a simple way to check on fair pricing.

Myth 3: Synthetic ETFs are 100 per cent derivatives based

There is confusion regarding the extent to which derivatives are used in ASX synthetic ETFs. ASX synthetic ETFs are like traditional physical ETFs, investing in shares of the index being tracked. The derivative component represents a small part of the assets and, in fact, no more than exposure to derivatives in many non-synthetic ETFs or managed funds.

There are differing types of synthetic structures internationally and when the Australian landscape matures, this will also be the case.

Take for instance certain commodities ETFs, which are popular with investors in the US and Europe. For these ETFs the use of derivatives is necessary as it is physically impossible to hold barrels of oil or many other commodities in an efficient way. Such ETFs will, however, be backed by physical cash with limited counterparty exposure.

Myth 4: ETFs are new and dangerous instruments and have even caused rogue trading

At various times, commentators have pointed the finger at ETFs as being at the heart of fraudulent episodes, or even the global financial crisis. The recent UBS rogue trading scandal is one such example. Here, it appears the trader booked fictitious trades in ETFs to cover up losses that had been generated via futures. In another famous example, involving Jerome Kerviel at Societe Generale, the trader entered into fictitious trades in instruments other than ETFs. The failure in these examples is not a failure of the instrument being used, but rather the compliance arrangements in existence when the fraud was perpetrated.

Rogue traders have managed to lose money in many types of instrument. ETFs, per se, are not the issue. ETFs have been around for more than 20 years globally, and investors should take comfort knowing that in the history of these products, no ETF has ever defaulted, even throughout the GFC.

In many global markets, ETFs are considered mainstream, a standard tool in the investor toolkit. For example, ETFs account for 30 per cent to 40 per cent of daily turnover on the US stock exchange.

Many of the common misconceptions about ETFs derive from a simple lack of education. Market participants should take responsibility to provide investors with as much information as possible to raise the level of understanding.

ETFs have been and always will be a highly flexible investment tool. They open up investment opportunities previously inaccessible while maintaining the key ingredients that have led to the products' rise on the global investment stage: simple, transparent and low-cost exposure.

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