

DIVERSIFYING YOUR PORTFOLIO USING ETFs

By Wilfred Ling



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Unit trusts, stocks and structured notes are probably the most common instruments used by many. However in recent times the use of Exchange Traded Funds or ETFs has become more common. As at the end of June 2007, Barclay Global Investor is ranked as the world's largest manager and sponsor of ETFs with 291 ETFs and assets of US\$357.4 billion trading in over 10 markets around the world, giving them a global market share of 53.4%.

What Is The Difference Between An ETF And Zero-Strike Call Warrants?

ETFs are index funds that are listed on the stock exchange. Although traded like stocks, in reality an ETF tracks a basket of securities. Unlike a single stock, ETF is "safer" because of its diversification benefit. The risk of the ETF is directly related to the performance of the underlying basket. Another variant of ETF is the Exchange Trade Note or ETN. While ETN tracks an underlying basket of securities, ETN has one additional layer of risk which is the credit risk of the ETN issuer. Some product manufacturers have also come up with zero-strike call warrants with the aim of tracking specified indices. Zero-strike call warrants are poor cousins of ETFs. Many zero-strike call warrants I have seen track the price index of the basket of securities. However, dividends generated by the underlying basket are taken by the issuer. This makes these warrants an extremely expensive way of gaining exposure to an index. For example, if the underlying

basket is generating a dividend yield of 3% per annum, the annual expense of the zero-strike warrant is 3%! On the other hand, an ETF pays out any dividends of the underlying asset after netting off fees.

Important Traits Of An ETF

There are two important characteristics of a good ETF – **tax efficiency** and **high liquidity**. It is generally better to purchase an ETF from the London Stock Exchange (LSE) than from a stock exchange in the United States because the former does not impose withholding tax on dividends while the latter does. Take for example, iShares MSCI Emerging Market ETF (IEEM), listed on both LSE and NYSE Acra. While both have similar expense ratio and stock holdings, it is more tax efficient to purchase from the LSE than the NYSE. Do note that readers should always consult their tax advisers before making any decision because not everyone has the same tax position. As for liquidity, this is where most ETFs listed on the SGX fails. The lack of liquidity means that it is possible to "move the market" if one desires by selling or buying in large

quantities. On some days, there is zero volume on certain ETFs at SGX. While there are market makers for most ETFs, why trust your money in the hands of a single entity? In fact, why bother and be subject to more worry when there are so many choices of ETFs listed abroad with huge liquidity?

Implementing Core And Supplementary Portfolios Using ETFs

The traditional investment portfolio consists of two portions – the **core portfolio** and the **supplementary portfolio**. The core portfolio is meant for the long term and usually diversified in nature. The smaller portion, called the supplementary portfolio, is meant for short-term tactical play. ETFs can be used to construct both core and supplementary portfolios.

One use of ETFs is to gain exposure to a large number of securities that is needed for the core portfolio. The iShares MSCI World ETF (IWRD) that trades on the LSE holds more than 1,000 large cap stocks. For those who are uncomfortable with MSCI World's large weightage to the US market, they can consider the Vanguard FTSE All-World ex-US ETF (VEU) listed on AMEX as it invests globally except for the United States. Currently, the VEU holds a whopping 2217 stocks!

For small cap exposure, the SPDR S&P International Small Cap ETF (GWX) that trades on the AMEX provides exposure to global small cap companies (it excludes the United States though). It holds more than 500 stocks.

As for the supplementary portfolio, there are many ways to construct this portion. We can construct based on countries, themes or market direction. If one is bullish on countries like Brazil, Russia, India and China, the iShares BRIC ETF (BKF) listed on the NYSE Arca provides for this exposure. There are also many choices for thematic approaches as well. The Powershares Water Resources ETF (PHO, AMEX), PowerShares Aerospace & Defense (PPA, AMEX) and PowerShares Global Clean Energy (PBD, AMEX) are some of the many thematic ETFs listed globally.

In recent times, commodity prices have been surging. The increase in worldwide demand for commodities and reducing supply are causing commodity prices to increase. The long-term declining value of the dollar is also helping to support commodity prices because many investors who are concerned with the eroding purchasing power of the dollar are fleeing to assets that are perceived to maintain its value. Thus, those who are bullish on commodities can do so without opening a futures account. A way to gain broad exposure to commodities will be the ELEMENTS linked to Rogers International Commodity Total Return ETN (RJI, AMEX). The ETN has exposure to energy (44%), agriculture (34.9%) and metals (21.10%). However those who want a more concentrated exposure to Agriculture can choose the ELEMENTS linked to Rogers Agriculture Total Return ETN (RJA, AMEX). If this is not concentrated enough, the ETFS Leveraged Agriculture

DJ-AIGCI (LAGR, LSE) is able to provide a return double that of the daily return of the agriculture sector.

As mentioned above, the third way of constructing a supplementary portfolio is market direction. To illustrate this, let's say an investor is bearish on the China market after its Olympics; he can express this view through the use of UltraShort FTSE/Xinhua China 25 ETF (FXP, AMEX). This ETF seeks daily investment results, before fees and expenses, that correspond to twice (200%) the inverse (opposite) of the daily performance of the FTSE/Xinhua China 25 Index. Another interesting market is Japan which many investors have become disappointed with because of its long-term underperformance. No worries, the UltraShort MSCI Japan ETF (EWV, AMEX) works similarly by shorting the market with twice the leverage. So who says one cannot profit from the falling market? But before anyone starts shorting the market with all their money, I would like to caution that shorting should only be done using the supplementary portfolio due to two reasons. Firstly, on a long-term basis, markets tend to move up more than down. Shorting should never be done for the long term. Secondly, inverse ETFs such as those already mentioned use swaps as its underlying instruments. Swap – a form of derivative – carries counterparty risk. If the counterparty defaults, the inverse ETF collapses.

Final Words Of Caution

Before anyone starts liquidating all their investments to purchase ETFs, I would like to give three points of caution. First point to note: all investments must suit the investor in terms of risk appetite and appropriateness in life stage. It does not make sense to invest in ETFs when a person is highly conservative in his investment outlook. It also does not make sense to put all money into ETFs for a person who has a time horizon of merely a few years. Always consult a financial adviser to have a risk profiling done before embarking on any major investment plan.

Secondly, investing in offshore funds must always come hand in hand with some level of estate planning. Estate duties imposed by foreign jurisdictions and issues with probate hindering repatriation back of money upon the decease of the investor are issues that must be addressed. Always ask what tools are used by the financial adviser to help solve the estate duties and probate problems.

Thirdly, it is most important to invest through a portfolio approach rather than adhoc standalone product purchase. A portfolio can utilise the strengths of individual asset classes while reducing the risks of each through diversification.

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