EXCHANGE-TRADED FUNDS

ETFs and core satellite investing

Investors can use exchange-traded funds as a core investment in a portfolio, but as the exposures offered by ETFs increases, they are also increasingly being used as the satellite says Nick Shellard, head of UK sales at iShares

Exchange-traded funds (ETFs) are an increasingly ubiquitous investment tool for investors. By giving exposure to a diverse range of markets and asset classes in a flexible, fast and transparent format, professional investors now realise that ETFs are a very useful tool to help manage investment portfolios.

ETFs combine the advantages of both index funds and stocks. They are liquid, easy to use and can be traded in any quantity just like stocks. At the same time an ETF provides the diversification, market coverage and low expenses of an index fund. These characteristics combine to create an investment tool that provides investors with the broad exposure they require, at the level they want; at the moment they need it. As such, they are fast gaining a reputation as an innovative investment solution – a claim greatly supported by the accelerated growth in ETFs.

In recent years, we have seen a dramatic expansion in the number of indices, styles and asset classes covered by ETFs with a particular emphasis on country related products, single-country exposure, regional indices and sectors.

ASSET ALLOCATION

ETFs can be used for both strategic and tactical asset allocation. Initially, ETFs were primarily used by investors for cash equitisation, asset allocation and exposure to interim beta (or market return) while deciding on stock selection. But investment managers including

wealth managers are now coming up with more innovative approaches to using ETFs in their investment strategies.

Firstly, regulations are allowing the use of more sophisticated delta 1 instruments - making ETFs an effective and simple instrument alongside futures and swaps, and secondly, as active managers are always looking to distil alpha from their portfolios, ETFs are playing an effective role in neutralizing unintended beta bets.

One common use of ETFs is in core-satellite type investing, a strategy used by wealth managers and increasingly within actively managed funds. With this approach, a portfolio is split into a core element, typically passively managed at a low cost and focussed on beta, while the satellite elements are actively managed with the goal of achieving excess returns through the manager's focus and expertise.

While this type of structure is not particularly new in investing, investors are beginning to use ETFs in this manner in two key ways.

EDHEC RESEARCH

Firstly, investors use the core satellite approach to invest the core in ETFs giving broad market exposure at low cost. The satellites would then consist of active strategies, where the manager's investment expertise is concentrated.

An alternative that is being increasingly adopted, as the exposures available through ETFs increases, is for a fund manager to build an investment core using their preferred investment philosophy and the satellite investments to be made using ETFs in specialist areas, such as water, infrastructure or other areas where the growth opportunities have been identified.

In a recent ETF survey carried out by EDHEC, the Risk and Asset Management Research Centre in partnership with iShares, it found ETFs are now widely used in satellite portfolios. 54% of the survey's respondents said they made use of ETFs in their satellite portfolios.

This finding is particularly interesting, as one of the initial precepts of the core-satellite approach was to use very active instruments in the satellite. However, the out performance of the satellite may of course be generated by exposure to different forms of beta (small-cap stocks, value stocks, credit risk, and so on) rather than to manager alpha.

ETFs can also be used to enhance the risk-adjusted returns from a core-satellite portfolio. Suppose an active fund, selected by a mix of top-down, bottom-up stock selection, was used for the original core portfolio, with a global index benchmark and tracking error target.

Replacing the core with regional ETFs that make up the global index can reduce the volatility of the core. To boost overall returns, satellite funds seeking higher returns in specific sectors, such as oil and gas, emerging markets and mid-cap funds, can be established using ETFs.

For active managers, ETFs represent an extremely efficient way of gaining sector exposure, in order to reduce risk in a portfolio. This is particularly the case where the active top-down or bottom-up processes concentrate on favoured sectors, leaving less time to pick stocks in less favoured sectors. However, these sectors can be a source of risk and their exclusion could greatly bias a portfolio.

The efficiency of using ETFs for sector coverage can be shown when compared to a common alternative for active managers, where two or three of the largest stocks in a sector are held to gain exposure to that sector. The latter approach is easy to implement by active managers but the securities held might not represent all the attributes of the sector.

Unicredit HVB Bank recently conducted research in the European banking, oil and gas, telecoms and food & beverage sectors, and compared holding a three stock portfolio of the largest stock in these sectors, versus the equivalent broad European ETFs.

The results showed that the broad benchmarks gave similar or higher risk adjusted returns, and illustrated that using a few stocks as a proxy for a sector introduced additional risks which may not pay off and which may not have been intended.

"ETFs ARE NOT JUST A 'FILLER' IN A PORTFOLIO, BUT ARE POWERFUL TOOLS THAT CAN BE USED BOTH STRATEGICALLY AND TACTICALLY"

Using an ETF gives exposure to a whole sector with a single trade, enabling investors to move in or out of a sector based on the latest information to reduce risk or add returns. For active managers, this also allows them to take a position while conducting more detailed research to pick appropriate securities.

We have identified just some of the key ways ETFs can be used and established that ETFs are not just a 'filler' in a portfolio, but are powerful tools that can be used both strategically and tactically, and which enable more robust portfolio construction.

Core Benefits

Transparency – investors know exactly which securities are held by the fund at any given time.

Flexibility – ETFs are listed on stock exchanges and can be traded at any time the market is open, meaning investors access continuous, real-time prices throughout the day.

Diversification – ETFs provide immediate exposure to a diversified portfolio of securities, while also providing access to a wide range of markets and asset classes that can help to diversify an existing portfolio.

Easy to use – ETFs are potent tools which are traded over the stock exchange, meaning that investors can buy and sell ETFs exactly as they would trade local shares – no additional operational setup is required, as is often the case with derivatives, and no new accounts need to be opened

Liquidity – The unique primary and secondary market mechanism ensures that ETFs are highly liquid, and that liquidity will always be available for investors looking to buy or sell ETFs

Cost effective – ETFs offer a cost effective route to diversified market exposure. The average total expense ratio (TER) for equity ETFs in Europe is 49 bps, while the average TER for the average equity mutual fund in Europe is 120 bps (Fitzrovia 2006)

For further details, please contact iShares on 0845 357 7000 or visit our website at www.ishares.eu