ETF INVESTING

JOHANNESBURG: I received many emails after my last article requesting more information about ETF's. Most of the people were asking for recommendations about which ETF's to use and how to invest in these products.

THE QUESTIONS

These are two of the questions that were sent to me asking for information and product recommendations about ETF's.

"Hi Warren,
I've just read your article on Moneyweb this morning about saving titled "make your first million".
I have 40k that I would like to put away, and don't need to touch for a long time. I am still young and have a long horizon. What is the best way to get into ETF's without having to pay annual management fees through a broker? and also which etf would you recommend, a SATRIX and if so which one?
Thank you
Giorgio"

"Good day Warren
I have read your article of making a million and enjoyed it. Please explain what is an ETF investment, please give an example e.g. a name of a company.
Regards
Denis"

DISCLAIMER

It is important to note that I am an avid fan of ETF's and have structured solutions in our financial planning business to take advantage of their benefits. This is relevant because you need to know where my preference lies before you read the rest of this article. Having said that, I have no commercial interest in any of the products I am going to recommend in this article. I usually avoid promoting a specific fund or product. However so many people have been asking for recommendations that I feel it is necessary in this instance. If you invest in any of the ETF's that I recommend, you will know that I will not derive any financial benefit.

WHAT IS AN ETF

An Exchange Traded Fund (ETF) is an investment that allows you to buy a number of different shares or other investments on the stock exchange. ETF's are attractive investments because you get access to a number of different investments (securities) for the cost of a single investment. ETFs usually track a specific stock market index like the Top 40. Well constructed ETF's can be very low cost investments that can be bought via a stock broker or directly like a unit trust. The legal structure of ETF's in South Africa is a unit trust, so you get all the regulatory protection offered by unit trusts at the lowest possible cost. The other benefit of ETF's is that they are largely passive investments; that means they don't change at the discretion of a fund manager. The index based ETF's only change when the actual index changes which limits the transaction costs of the investment. In order to understand why ETF's are so good, you need to know why I prefer investing in an index rather than an actively managed fund.

WHY AN INDEX

According to research by Daniel R Wessels from www.indexinvestor.co.za, more than 60% of all unit trusts that invest in shares (equity funds) have not beaten the stock market (All Share Index) over any reasonable period to March 2010. As you can see from the table below, over five years only 17% of all equity funds managed to beat the stock market. If history were to repeat itself over the next five years, you have an 83% chance of underperforming the stock market if you invest in an actively managed fund.

Table A: Equity unit trusts vs. the All Share Index to March 2010

Equity Funds	**1-year**	**5-year**	**10-year**
Best performing fund	59.7%	23.4%	27.0%
Worst performing fund	24.2%	11.4%	9.9%
Average	42.3%	17.2%	17.1%
Benchmark: ALSI	44.1%	19.9%	17.5%
% Funds beating ALSI	38%	17%	38%

Source Daniel R Wessels, www.indexinvestor.co.za

If you are able to select the best performing actively managed equity unit trust (one that tries to beat the market) you can benefit from fantastic returns. Over 10 years, the top performing unit trust beat the market by 10% per year which is astounding performance. That shows there are fund managers who can beat the market over long periods of time. Unfortunately, the odds of selecting the right fund are heavily stacked against you. History tells us that you have more than a 60% chance of being wrong if you try to choose an active manager over a ten year period. That is why index investing is so popular around the world, you can eliminate the risks of poor decisions by fund managers and keep your investment costs down. Investment costs are one of the main reasons why active funds cannot beat the market - high costs destroy returns.

WHICH ETF'S

If you are starting an investment portfolio, it makes sense to select a broad based ETF that invests in a wide range of shares. That means you should look at something like a Top 40 or Swix 40 ETF for your core holding. In my view, the two best Top 40 ETF's are offered by Satrix and BIPS. My reasoning is simple, they offer the lowest cost products which is the most important consideration when choosing between ETF providers.

Your core ETF should constitute at least 50% of your overall portfolio. Once you have built up some assets in your core ETF and would like to diversify, you should look at the Divi 30 or Rafi 40 ETF's. At present there is only one Divi fund and it is offered by Satrix. There are two Rafi providers however I prefer the Satrix option as I think the other Rafi providers are simply too expensive.

For most investors, a combination of a Top 40 plus a Rafi or Divi should be sufficient to create a great investment portfolio. However, there are some investors who want to take specific bets on individual sectors e.g. financial, mining or industrial. There are a number of sector specific ETF's in the market but I would not consider these unless you are prepared to do more of your own homework. The specialist ETF's require more regular monitoring and may need to be traded more frequently. You can get all the information you need on ETF's from www.etfsa.co.za where they supply detailed information on all the ETF's in the market. This is a great starting point for any ETF investor because you can also start your investment with them.