ETFs...

has the jury reached a verdict?

ETFs are an invaluable tool that provide easy, diverse and low-cost access to a variety of markets and asset classes to both large and small investors.

However, there are some risks that investors need to be aware of which might limit their use. This then begs the question… are ETFs for everyone?

EARLY CHALLENGES

One of the advantages of ETFs is that they trade like stocks, thus investors can buy and sell them during trading hours (unit trusts trade at net asset value [NAV] at market close). This introduces the risk that ETFs do not trade at their fair NAV value but can trade at a discount or premium depending on trading flow.

Additionally, since ETFs are traded on the market, they are subject to liquidity constraints. This can incur risks to investors when they want to exit their position but there is no counterparty in the market.

Similarly, price spikes can occur when there is low volume in the market. In these cases, investors incur the risk of trading at extended prices.

A good indication of illiquidity is when there is a large spread between the bid and the asking price.

Investors can counter this risk by focusing on ETFs where the issuer is actively making prices in the market and by trading ETFs that are liquid. This is particularly acute when an investor holds a large position relative to the average trading volume.

TRADING FEES

Since ETFs are traded on the market, they incur trading fees such as brokerage fees. This is not the case for unit trusts that trade on NAV. Investors must bear these costs in mind and limit their trading appropriately.

MANDATE AND HOLDINGS

Like any investment, it is important to understand the investment mandate of ETFs and thus their underlying holdings.

Some ETFs invest in specific strategies, such as investing in dividend or momentum companies. These ETFs can have very different risk/return exposures and outcomes to other ETFs.

Other ETFs can be sector focused, investing in palladium, resource only stocks, financial only stocks, US companies, global developed markets or emerging markets. Even traditionally market weighted ETFs, such as the ETFs that track the Top 40 index, can provide concentrated risks for investors.

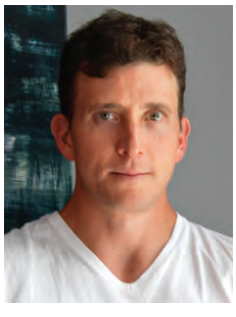
Naspers comprises about 21% of the Top 40 index which is a very concentrated exposure. Naspers fell about 40% between December 2017 and November 2018 due to US/China trade conflict and China's crackdown on gaming.

Investors need to understand the strategy and thus the underlying holdings of ETFs that they invest in, how this affects their overall portfolio and thus other investment strategies they can employ around their ETF positions to mitigate and limit their risk exposure appropriately.

BETTER INVESTMENT DECISIONS

Knowing the risk and limitations of ETFs allows investors to make better investment decisions. ETF's growing popularity is well deserved, but like all things they have their drawbacks.

Knowing all the facts will help investors make sound investment decisions while avoiding some of the pitfalls, thus increasing the likelihood of maximising profits.



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