Exchange traded funds

Plain Talk® Library

Contents

Introducing exchange traded funds

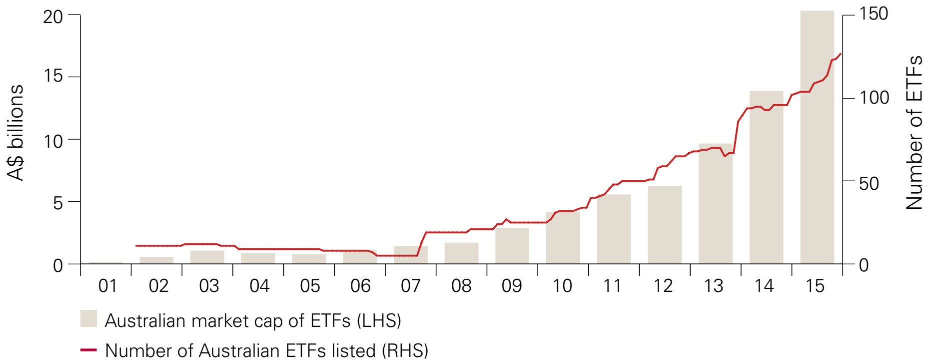
Exchange traded funds, or ETFs, are attracting increasing attention from investors with a growing range of products available on the Australian Securities Exchange (ASX).

In this Plain Talk Guide you will find answers to common questions we get asked about ETFs. You will also learn how ETFs and traditional index managed funds compare and gain a better understanding of how ETFs could benefit your investment portfolio.

ETFs were first introduced in the US in 1993. They have since become one of the fastest growing investment products in the world. At the end of October 2015 the ETF market was worth $20.6 billion in Australia—that's a rise of close to 30 per cent since December 2014.[1] Along with traditional index funds, ETFs are another way investors can access Vanguard's proven index management approach.

Growth in ETF assets in Australia[1]

Data as at October 2015



1 Source: *ASX Monthly ETF Report,* October 2015.

What are ETFs?

An ETF is a fund which is traded on the stock exchange. An ETF is made up of a collection of holdings in different companies that when combined together replicate an index such as the ASX 300, S&P 500 or FTSE 100.

ETFs come in different shapes and sizes. They can be either equities or bonds, with variations such as domestic or international, small cap or large cap, hedged or unhedged. They can also be sector specific products such as property, commodities, gold, oil and banks.

ETFs use an indexing approach that seeks to track a specific market or sector index. Index-based ETFs carry all the benefits of traditional index funds, such as low operating costs, diversification, tax efficiency and simplicity. As ETFs are traded on the exchange they replicate changes in price in the underlying holdings throughout the day.

ETFs — Track an index but trade like a share

ETF

Index fund characteristics

- Diversification
- Low fees
- Low portfolio turnover

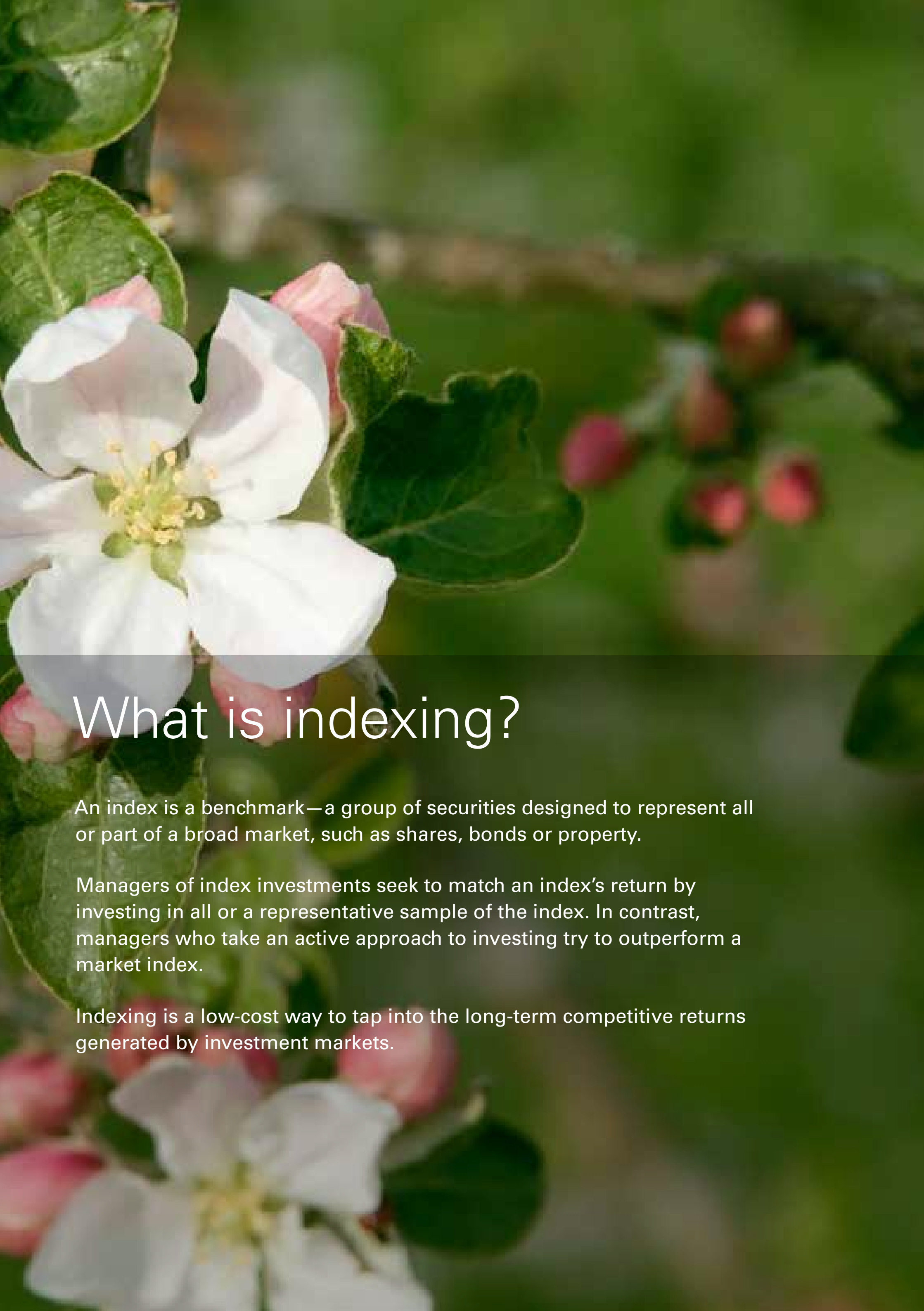
Individual share characteristics

- Continuous pricing
- Trading flexibility
- Low execution costs

How do they work?

Vanguard ETFs are index funds which aim to deliver the index return, before fees, by investing in assets according to the weightings of the benchmark index. This means an ETF's return, before costs, should closely match the index it tracks, just like a traditional managed index fund.

The value of a Vanguard ETF moves in line with the index it tracks. For example, a 2 per cent rise or fall in the index would result in approximately a 2 per cent rise or fall for an ETF which tracked that index (all other things being equal).



What is indexing?

An index is a benchmark—a group of securities designed to represent all or part of a broad market, such as shares, bonds or property.

Managers of index investments seek to match an index's return by investing in all or a representative sample of the index. In contrast, managers who take an active approach to investing try to outperform a market index.

Indexing is a low-cost way to tap into the long-term competitive returns generated by investment markets.

How can you invest in ETFs?

ETFs trade like individual securities, but are open-ended like managed funds. So new shares can be created and existing shares redeemed daily, based on investor demand. Closed-end funds and individual securities generally issue a fixed number of shares.

You can buy and sell ETFs on the ASX through a full-service broker or a non-advisory broker like CommSec or E*Trade that allow you to transact online or over the phone with an account.

The two most common ways to trade ETF securities are market orders and limit orders. It depends on your needs, but to make sure of the price you'll pay we recommend you use limit orders.

1. Market orders

With a market order, the investor instructs the broker to buy or sell ETFs at the best available price.

For example, if you want to buy 100 ETF securities you can put in a market order for 100 securities and hit the execute button. The order will be automatically matched up with the best ask price and executed immediately. The downside of a market order is that you could end up paying a higher price than you intended, particularly during the first 10 minutes of the trading day, when opening prices of the underlying securities in the ETF are still being determined.

Example

Investor A logs into their brokerage account. → Investor A puts in a **market order** to buy 100 ETF securities. → The order will automatically be matched up with the best ASX price and executed. → Trades settles 3 days later and investor now owns 100 ETF securities.

2. Limit orders

With a limit order, the investor instructs a broker to buy a specified quantity of a security at or below a specified (or limit) price, or to sell it at or above a specified price.

For example, if you want to buy 100 ETF securities at $50 per security, then your order will be automatically executed when the ETF price hits $50.

With limit orders there are no surprises about price. On the downside it may take a long time, if ever, for the price of the security to get to the same place as your limit order. So it's a good idea to set a reasonable limit.

Example

Investor B logs into their brokerage account. → Investor B puts in a **limit order** to buy 100 ETF securities with a limit price of $50. → The limit order is automatically executed if the ask price hits $50. → Trades settles 3 days later if the order is executed or if the limit price is not reached the trade expires.

Fees and costs

Index-based ETFs are generally a low-cost investment, and substantially lower in cost than investing in the same exposure of individually purchased shares. Because the funds are managed using an indexing approach, this means the cost to manage the fund is generally less than actively managed funds.

Management fees

The fund issuer charges management fees that are generally included in the unit price. They cover the costs of managing the ETF, including custodian fees, accounting fees, audit fees and index licence fees.

Brokerage fees

The broker charges a fee when you buy or sell an ETF, starting from around $10 per transaction.

Costs involved

- Management cost
- Buy/Sell spread (Managed fund) or Bid/Ask spread (ETF)
- Brokerage fees

ETF Fact—Bid/Ask spread

The amount by which the ask price exceeds the bid price. This is the difference in price between the highest price that a buyer is willing to pay for a security and the lowest price for which a seller is willing to sell it.

Who’s who in the ETF market?

There are three main players in the ETF market—issuers, market makers and authorised participants.

Issuer

Issuers provide investors access to the performance of the ETF’s underlying assets by issuing ETF securities.

Market maker

Market makers provide continuous liquidity to the market by:

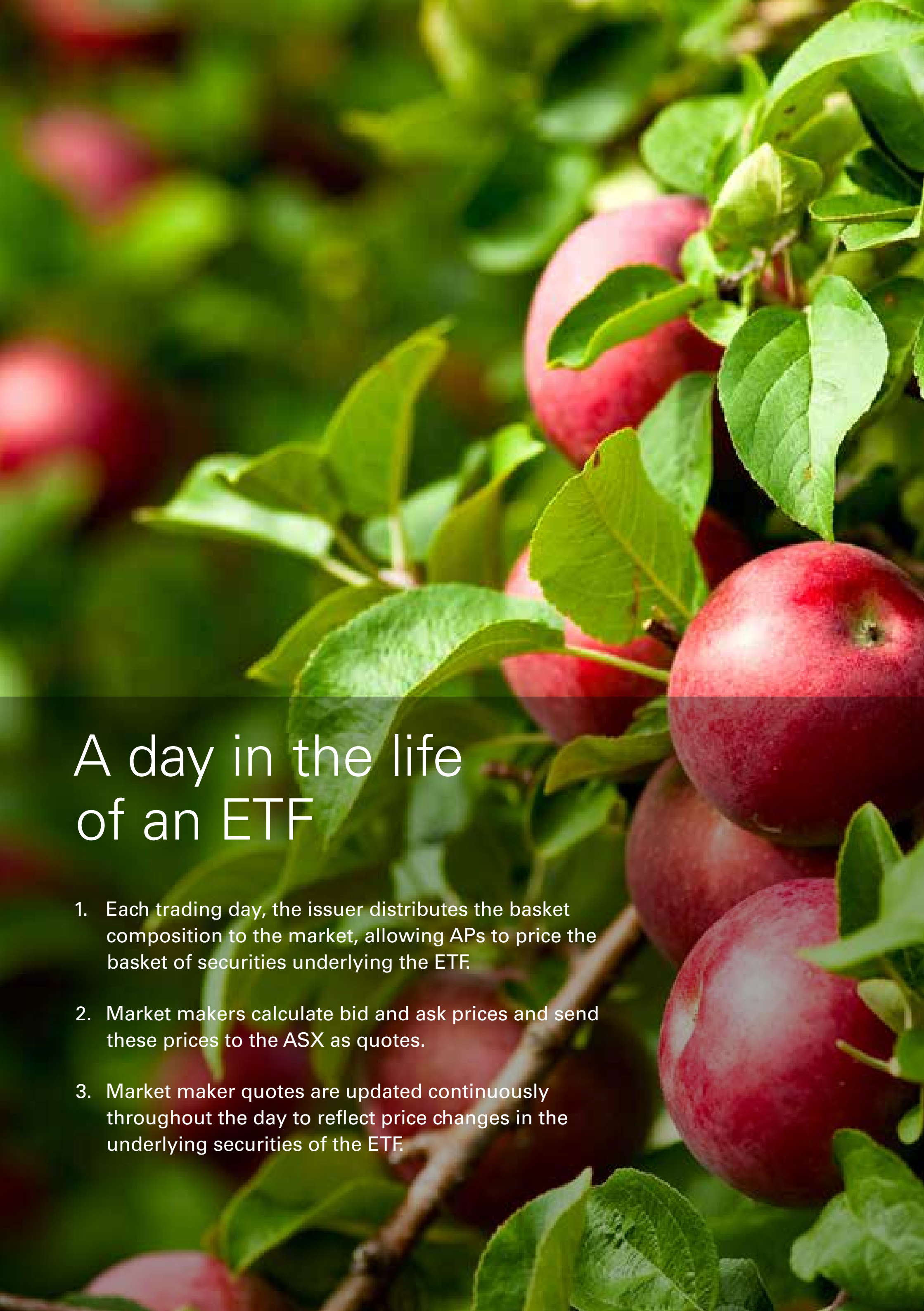
- buying and selling ETF securities throughout the trading day
- creating and redeeming ETF securities off-market to meet supply and demand.

Authorised participant

Authorised participants (APs) also create and redeem ETF securities off-market to meet supply and demand. APs exchange the underlying securities in the basket for large blocks of ETF securities called an ETF creation unit. A firm may act solely as an AP or as both a market maker and an AP.

ETF Fact—Basket of securities

A basket of securities is a list of securities which an ETF issuer prepares daily which replicates or closely tracks the underlying index. The issuer publishes this ‘basket’ to the market makers to allow them to price the ETF and a list of assets which can be exchanged for an ETF security.

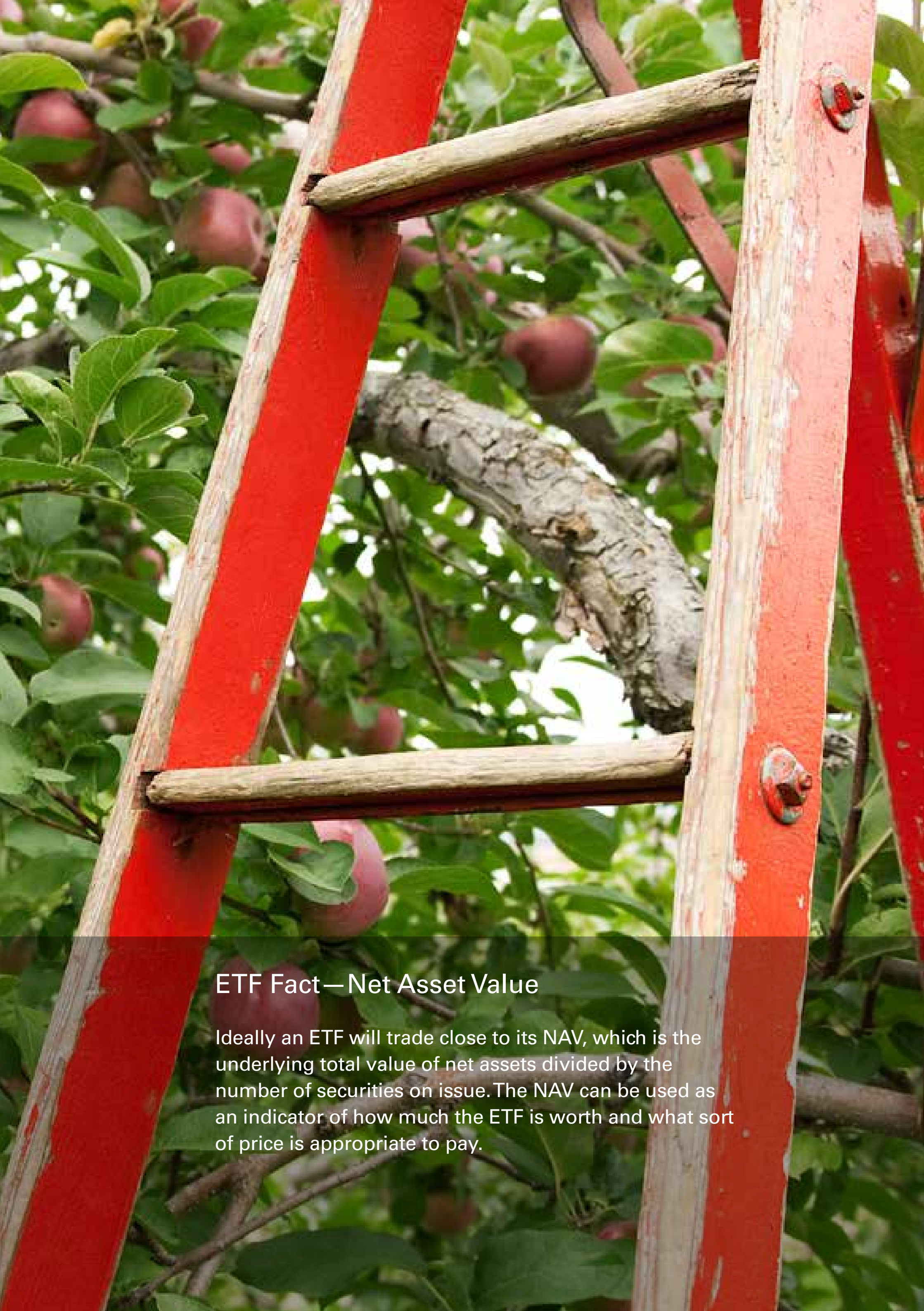


A day in the life of an ETF

1. Each trading day, the issuer distributes the basket composition to the market, allowing APs to price the basket of securities underlying the ETF.

2. Market makers calculate bid and ask prices and send these prices to the ASX as quotes.

3. Market maker quotes are updated continuously throughout the day to reflect price changes in the underlying securities of the ETF.



ETF Fact—Net Asset Value

Ideally an ETF will trade close to its NAV, which is the underlying total value of net assets divided by the number of securities on issue. The NAV can be used as an indicator of how much the ETF is worth and what sort of price is appropriate to pay.

Benefits of ETFs

Low cost

ETFs generally cost less than actively managed funds, and substantially less than buying individual shares.

Diversification

Vanguard ETFs provide investors with broad exposure to entire markets within an index, including shares that investors may not be able to access directly on the ASX, such as international shares.

Tax efficiency

Indexing's low turnover minimises capital gains, improving long-term performance and tax efficiency.

Liquidity

You can buy and sell ETF units easily and quickly on the exchange.

- There's a primary source of liquidity as ETF units are created throughout the trading day.
- There's also a secondary source of liquidity through the volume of trading on the exchange.

Transparency

Every day at Vanguard we provide detailed information to the market including:

- the fund's net asset value (NAV)
- the basket of holdings in each index of every product
- the intraday net asset value (iNAV) to value domestic equity and fixed income ETFs every 15 seconds throughout the trading day.

Risk and return

As with any investment, investing in ETFs is not risk free. Investors in ETFs should bear in mind one of the main principles of investing—the higher the potential reward, the higher the risk of losing money. In general the reverse is also true—the lower the risk, the lower the potential reward.

Risk

Asset classes generally range from low to high risk in the following order—cash, fixed interest, property and shares. See *The risk spectrum* chart on the next page.

ETF prices can fluctuate within a wide range just like the overall sharemarket, so you should consider your tolerance for market ups and downs.

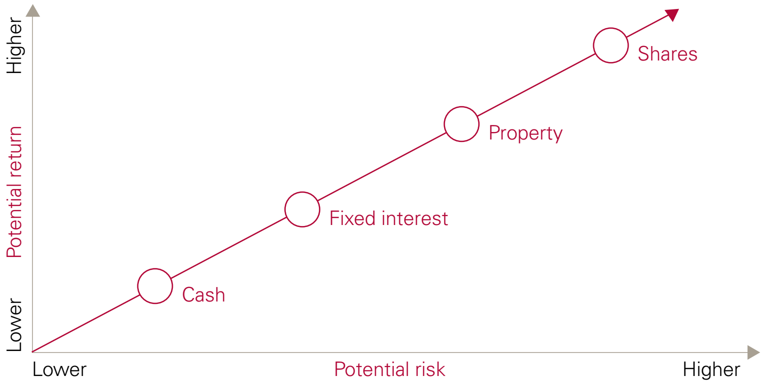
Returns

The expected returns of Vanguard ETFs should align with the index returns (before fees) that they track.

Returns generally come in the form of income and growth.

- Investors can receive income in the form of distributions that are usually paid quarterly or semi-annually based on the amount of ETF securities they hold.
- Growth comes from any increase in the value of the portfolio's assets and will be reflected in the ETF's NAV.

The risk spectrum



Currency risk

International ETFs are subject to fluctuations in the value of the Australian dollar against other currencies. Currency movements can impact on your returns because losses or gains must be converted back into Australian dollars.

For example, if the value of the Australian dollar rises, the value of investments held in non-Australian assets (e.g. US dollars) will fall. Conversely, a weaker Australian dollar increases the value of investments held in non-Australian assets.

International ETF currency exposure can be hedged to reduce the impact of currency fluctuations on performance.

ETFs or managed index funds?

Vanguard ETFs and their equivalent index managed funds own the same underlying assets. So which to choose will come down to which investment best suits your particular circumstances.

ETFs could particularly suit investors who are looking to trade more regularly on an exchange and need more up-to-date pricing.

How can you use ETFs in your investment portfolio?

ETFs are a simple and highly cost-effective way of gaining broad market coverage across a range of asset classes.

We believe in a top-down approach to constructing your portfolio.

1. Work out your risk profile and investment timeframe—from conservative to high-growth.
2. Develop your strategic long-term asset allocation based on your risk profile.
3. Decide how much to allocate to each asset class—cash, fixed interest, property and equities.
4. Select specific ETF investments to provide broad exposure within each asset class.

Diversifying across and within asset classes helps to reduce volatility and smooth out returns over time.

The ease, flexibility, diversification and low cost of ETFs make them an innovative and effective investment solution to:

- Construct an investment portfolio—ETFs covering different asset types and markets can be used to build a robust low-cost portfolio.
- Build the foundations of a portfolio—ETFs can be used to create the diversified core of an investment portfolio, complemented by other investments like direct shares or actively managed funds to seek returns above the benchmark.
- Rebalance a portfolio—Over time portfolios can move away from their initial asset allocations as the value of different assets change. ETFs can be used to correct these imbalances quickly, easily and cost-effectively by buying or selling assets.
- Trade in the market—ETFs offer investors the ability to rapidly deploy cash into the market, and gain exposure to market movements while deciding on a more long-term investment strategy.

The Vanguard difference

When you invest with Vanguard, you have more than 40 years of investing experience behind you. So no matter which investment products suit your needs, you can feel confident that Vanguard investments are built on a rigorous investment philosophy that stands the test of time.

Since launching the first index mutual fund for individual investors in 1976, Vanguard has strived to be the world's highest-value provider of investment products and services. We have an unwavering focus on our clients with a commitment to champion what's best for investors by offering outstanding service, while keeping costs low.

Low-cost investing

We know we can't control the markets, but we can control the costs of investing. To that end, providing low-cost investments isn't a pricing strategy for us. It's how we do business.

We can keep our costs low because of our unique ownership structure in the United States, which allows us to return profits to investors through lower costs so investors can earn more over time.

Our range of managed funds and ETFs

Vanguard offers a complete range of funds across all asset classes.

To see our complete product offerings, visit vanguard.com.au.

For more information

Contact us or speak to your financial adviser.

Personal investors

Web	vanguard.com.au
Phone	1300 655 101 8:00 am to 6:00 pm Monday to Friday (Melbourne time)
Email	clientservices@vanguard.com.au
Mail	Vanguard Investments Australia Ltd GPO Box 3006 Melbourne VIC 3001

Financial advisers

Web	vanguard.com.au/adviser
Phone	1300 655 205 8:00 am to 6:00 pm Monday to Friday (Melbourne time)
Email	adviserservices@vanguard.com.au
Mail	Vanguard Investments Australia Ltd GPO Box 3006 Melbourne VIC 3001

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1300 655 101

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Past performance is not an indication of future performance.

Vanguard ETFs will only be issued to Authorised Participants, that is persons who have entered into an Authorised Participant Agreement with Vanguard. Retail investors can transact in Vanguard ETFs through a stockbroker or financial adviser on the secondary market.

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