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THE REAL TRUTH ABOUT THE DIFFERENCES BETWEEN UNIT TRUSTS AND ETFs

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An article has been published on a number of websites, authored by Nick Brummer, Director of Investonline.co.za, entitled "The Truth About the Difference Between Unit Trusts and ETFs". However, Mr Brummer's article contains many inaccuracies and erroneous conclusions that conceal rather that illuminate the true merits and features of both ETFs and Unit Trusts.

ETFs
Exchange Traded Funds (ETFs) are Collective Investment Schemes that typically track an index of shares, bonds or other assets. ETFs are listed on stock exchanges to enable trading in ETFs to take place continuously on such stockmarkets. Managers of ETFs, who by the way are not computers, as believed by Mr Brummer, but professional asset managers with an index tracking mandate, hold these assets in exactly the numbers and weightings stipulated by the compilers of the index, mainly the stock market itself. In this way an ETF exactly reflects the constituents of an index and delivers the performance of that index.

Accordingly, ETFs are "passive" tracker funds that seek to deliver the average return of the market, which is what the index measures. In other words, ETFs deliver BETA, which is the average or benchmark return of the market.

In all corners of the investment profession and in all markets of the world, BETA is understood as a low risk strategy as market prices, at any time, reflect the aggregate of all known information about an asset and the index collates all this information into a basket of shares and prices this basket accordingly. In other words, ETFs are all about risk reduction and aversion, confining investment risk largely to the volatility of the overall market itself.

Unit Trusts
Are also Collective Investment Schemes, but mostly with the mandate to outperform the indices (benchmark) and they aim to achieve ALPHA, i.e. market outperformance. In looking to beat the average return of the market, which is after all the collective wisdom of all the information available at the time, rapidly translated into the price of assets through liquid and transparent markets, the asset manager who is seeking ALPHA has to assume some risk. Most modern investment theory contends that ALPHA is all about risk – the more risk you are prepared to take on, the higher the potential ALPHA, if you are right, or negative ALPHA, if you get things wrong.

Unit Trusts allow managers far more flexibility to mix the assets in the portfolio, to hold cash and to actively manage or churn the portfolio in the search, often elusively, for ALPHA. In order to deliver ALPHA, Unit Trusts have to typically be "actively" managed which inherently adds to the risk.

The assertion made by Mr Brummer, repeatedly in his article, that ETFs, which are BETA products are "far riskier than Unit Trusts" (ALPHA products) is to completely misunderstand the concepts of risk measurement and risk management. ETFs are transparent (all components of the index are known and can be valued at all times); prices are made openly on liquid and widely traded stockmarkets; and risk is confined to the macro risk of the market movements as a whole. They target BETA, which is a low risk strategy.

Unit Trusts are non-transparent; the current components of the portfolio are kept unknown for competitive purposes; prices are made by the manager of the unit trust themselves and there is no trading on open markets. The risk of such products includes, not only the movements of the market, but also the risk the active manager assumes in trying to outperform the market. ALPHA hunting also costs money, which is why ALPHA seeking Unit Trusts are more expensive that ETFs and typically require professional financial advisers to interpret the risk adjusted performance delivered by the Unit Trusts.

Performance Issues

ETFs provide the return of the index and therefore the market, but do not seek to beat the overall performance of the index. Unit Trusts are typically mandated to beat the index and, by the law of averages, a certain number of active managers will outperform a benchmark index over time.

Research conducted worldwide indicates that, on average, 70% of active managers (before costs) fail to beat the benchmark index. As Mr Bummer points out, research undertaken by etfSA.co.za, based on the South African Collective Investment Scheme industry performance figures, published by ASISA, indicate that over the past 1 year and 5 years, 84,5% and 89,2% respectively of all actively managed equity mandated Unit Trusts failed to beat a benchmark index tracking ETF (Satrix 40). Accordingly, the South African performances appear to be worse than the global average, but confirm the general conclusion that active management does not consistently on aggregate deliver better performance than passive management.

Of course, different time periods can be used to make a favourable case for either Unit Trusts or ETFs. Mr Brummer uses a somewhat arbitrary 9,5 years time line to indicate that Satrix 40 underperformed the return of general equity Unit Trusts over that period. This requires some deeper analysis.

First, the performance data for Satrix 40 does not appear to allow for the reinvestment of dividends at the end of each quarter and the capitalisation of such dividends over the remaining period. Using the correct methodology, a benchmark ETF, such as Satrix 40 would have produced an annual return of 16,2% over the past 10 years, much in line with the average performance of general equity Unit Trusts.

Secondly, the 9,5 year data fails to allow for the "survivorship bias". Over half of the equity Unit Trusts available in 2000 failed to survive to 2010, as they were closed by their management companies, presumably because of poor performance. If you add these non-performing closed funds to the performance data, it would significantly lower the average return of general equity Unit Trusts. Generally speaking, the longer the time period used to measure performance ,the greater the impact of the survivorship bias and the greater the case for an ETF, which merely tracks the average index performance.

Thirdly, a general standard for measuring fund management costs, the Total Expense Ratio (TER), was only introduced in 2005/2006. Performance comparisons going back to before this date suffer from inconsistent allocation of costs and most investment professionals take any local performance data that extends further back than 5 years with a strong dose of salts.

Nonetheless, as pointed out in Mr Brummer's article, certain Unit Trusts will outperform an index, some of them consistently over time. The identification of such Unit Trusts (even if they are only 10% or less of the total number of Unit Trusts) is a service which can add considerably to the information available to the investor. This service, Mr Brummer does by identifying the top 5 unit trust performers over the past 10 years or so.

However, for the investors who placed their money in the other 900 other Unit Trusts available over this period and have seen their performance and wealth growth significantly underperform the benchmark, a simple, easy to understand, transparent exchange listed security such as an ETF provides the answer. It will, with certainty, deliver the average performance of the market. ETFs therefore do not require professional skills and analysis to investigate or to access, as they can be bought through any stockbroker, or an online platform, such as etfSA.co.za.

Unit Trusts, by contrast, require professional skills and advice to identify products which offer value and to investigate the risks associated with actively managed products