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HOW AND WHEN TO USE EXCHANGE TRADED PRODUCTS?

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With 62 Exchange Traded Products now listed on the JSE, the choices for utilising exchange traded passive investment products for portfolio management have multiplied.

The good performance of most of the ETFs/ETNs is now well established (performance data of all index tracking ETPs and Unit Trusts can be followed on the www.etfsa.co.za website – go to "Monthly Performance Surveys"). Far from being penalised for choosing only passive investment products, most investors are being rewarded by total returns from ETPs which beat the average returns of the actively managed products.

The "narrowness" of the South African equity and bond markets, i.e. trading values and volumes are concentrated in the top 5-10 percent of all listed products, means that investors can purchase the average total return of the market performance of the top shares and bonds cheaply and transparently through ETPs. Rather than pay higher fees to active managers who typically struggle to match the market performance, particularly once their fees and asset churning costs are taken into account.

But which ETPs to choose and why?

Overall Market Performance (BETA)

For most investors, seeking to achieve the average return of the market (BETA) is a critical objective, for at least a significant portion of their investment portfolios. In such circumstances, the "core" of the portfolio is invested into BETA return products and a "satellite" strategy which actively seeks ALPHA (above market returns), is typically a smaller portion of investment portfolios. The indices which measure the broad return of the entire market are typically the benchmark for BETA objectives.

The FTSE/JSE Top 40 index covers the major shares on the JSE, measured by market capitalisation. It provides diversity through holding shares in different market sectors and in various geographical locations. Most investors now prefer to use the ETP SWIX index products, which allocate constituents in the index according to the shareholder weightings on the South African share registers only, as the BETA benchmark. Popular choices here are the **Satrix SWIX Top 40,** and the **STANLIB SWIX 40.** Another alternative, recently introduced is the **Investec SWIX Top 40 ETN**, which charges no management fees, making it a very low cost solution.

A further option, which offers broad exposure to the top shares on the JSE, is the **BettaBeta EWT 40**, which equally weights funds to all 40 shares in the Top 40 index. This has been the most consistent and best performing ETP in this class for the past two years.

BETA returns are globally considered as a "commodity", i.e. they can be purchased cheaply and with low risk and performance certainty. ETFs are ideal for this purpose. Of course, diversification amongst other investment classes, sectors and assets is also an important component of investment portfolio construction.

Sector Allocation

The **Satrix INDI 25 ETF** provides exposure only to industrial shares, excluding any mining or financial shares, which reduces volatility. The Satrix INDI ETF has been amongst the top six best performing Collective Investment Schemes over the past 1 to 10 years according to the latest Quarterly Unit Trust Survey.

Property tracker ETPs such as the **Proptrax SAPY ETF** and the **STANLIB Property ETF**, provide passive portfolios on the JSE listed property sector. The FTSE/JSE SA Property Index, which is the index tracked by the two ETFs above, has consistently outperformed the JSE All Share index for each of the periods 1 to 20 years as measured in the Unit Trust Survey.

Offshore Exposure

A number of ETFs and ETNs, listed on the JSE, track global indices, in both developed and emerging markets. They offer direct exposure to international equity portfolios which replicate the main market indices. However, these offshore ETPs trade on the JSE in rands, thereby providing pure "rand hedges". These international ETFs are listed under the "inward listings" rules and requirements, so are regarded as rand investments and do not affect the foreign exchange allowances of individual investors. **DBX MSCI USA ETF, DBX World ETF, DBX Emerging Markets ETN** and **Standard Bank Africa Equity ETN** are amongst the current sought after products.

Bond ETFs

Most investors effectively track the All Bond index in terms of duration and exposure, so it makes sense to use passive tracker funds, which exactly replicate these indices, for a diversified bond portfolio.

The **Investec zGOVI ETF**, which tracks the RSA Government All Bond index and the **RMB Inflation-X ETF**, which tracks a portfolio of RSA Government inflation-linked bonds, are well established ETFs. The RMB Inflation-X ETF was the best performing domestic bond fund over the past three years in the recent Morningstar performance awards.

"Smart ETFs" (ALPHA)

Indices can also be constructed to track ALPHA related objectives and criteria in order to provide potential market beating performances. Some examples are:

- **Dividends** – high dividend paying companies normally outperform the market over time. The **Satrix DIVI Plus ETF** is a portfolio of 30 JSE companies with excellent dividend payment potential.

- **Fundamentals** – the RAFI ETPs (**Satrix RAFI, NewFunds eRAFI** ETFs) select portfolios based on the past five year's fundamental accounting valuations. This is a "value" strategy, which can be expected to deliver relatively consistent ALPHA.

- **Momentum** – the **NewFunds (Absa) Momentum Equity ETF**, uses a series of momentum techniques to structure a portfolio of shares benefitting from the current growth momentum in local equity markets.

With this number of ETPs now available to provide the returns of different sectors of the market and various asset classes, it is possible to construct asset allocation portfolios very transparently and with low costs. Also, live trading on the JSE, with market makers for each ETP provides excellent liquidity, if your asset allocation views change. It is also easy to construct portfolios to meet, with complete transparency, all compliance and exposure limits, such as the Regulation 28 Requirements pertaining to Retirement Funds.

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