

The Rise of Exchange-Traded Funds

In recent months, there has been much excitement on the growing demand for exchange-traded fund (“ETF”). Many product providers are rolling out a slew of ETFs, focusing on different regions or sectors or asset classes. It was reported in The Straits Times (1 June 2006) that the Singapore Exchange would be the first in the world to list an India-focused ETF, called iShares MSCI India. This ETF, which caters to investors wanting to ride on India’s economic growth, has since started trading from 15 June.

So, what exactly is an ETF and how does it work? From the CPF Board website, it states that an ETF is an investment fund that is listed and traded on a stock exchange. It is designed to track an index of markets and sectors or a fixed basket of stocks, and is bought and sold on a stock exchange similar to stocks.

One of the main benefits of investing via an ETF is that investors, especially retail investors, reap the benefit of diversification relatively effortlessly. These investors need only to buy an ETF share to gain exposure to a diversified portfolio of stocks or other instruments without the need to buy them individually. In addition, ETFs tend to have lower management fees compared to unit trusts. Investors can also buy or sell ETFs at prevailing market prices throughout the day rather than buying at the end-of-day Net Asset Value (“NAV”) like unit trusts.

However, just like every coin has two sides, there are disadvantages to investing in an ETF. An ETF can never outperform the index it is tied to, as it is designed to get the market return by buying the index rather than being actively managed. When buying an ETF, there are also commission fees incurred in addition to management fees. There may also be a difference between the ETF’s price and the NAV of its underlying stock portfolio, especially for less frequently traded ETFs. In the event of a deep market correction, it is possible that investors may have to sell their ETFs at prices below the ETF’s NAV.

For PMA, ETFs are just another investment tool we use, and complement our other investments in stocks, bonds unit trusts and cash. We may invest in an ETF to gain broad exposure to a particular market or sector in combination with selective investments in direct stocks. Our investments in iShares MSCI EAFE for Europe and Asia exposure and in streetTRACKS Gold Shares for gold exposure are good examples. We may also use ETFs to access markets where direct stock investing may not be cost efficient, especially for smaller portfolios. However, we are mindful of illiquidity risks, and would therefore invest in ETFs listed on major markets.