Using Exchange Traded Funds (ETFs) to Build Investment Portfolios

GRAYSWAN

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INTRODUCTION

In the ever-evolving landscape of investments, one approach has gained significant traction among savvy investors: the strategic use of Exchange Traded Funds (ETFs) to construct robust and diversified investment portfolios.

The growth of the ETF industry has been nothing short of remarkable, with the global ETF market now exceeding $13 trillion in assets under management. The cost-effectiveness of ETFs has been a significant attraction for investors. With their low expense ratios and minimal trading fees, ETFs have made it possible for investors to build well-diversified portfolios without the burden of high management costs.

Two distinct approaches exist - passively managed and actively managed ETFs. Each has its unique strengths and weaknesses, offering investors a choice between consistency and flexibility.

This article delves into the basics of ETFs and outlines the key characteristics of both types of ETFs, highlighting the advantages and considerations for investors.

WHAT IS AN ETF?

An Exchange Traded Fund (ETF) is a type of investment fund that is traded on stock exchanges, like individual stocks, allowing for intraday trading investment decisions. ETFs allow investors to gain broader exposure to various markets or asset classes with a single investment.

Unit trusts on the other hand, are traded through distribution channels such as investment platforms or Linked Investment Service Providers (LISP's). A LISP is an independent administration company that offers investors access to mutual funds or unit trusts across various management companies.

The intraday trading feature of ETFs distinguishes it from unit trust funds, which are only priced at the end of the trading day. The combination of flexibility, liquidity, and diversification make ETFs a versatile tool for building diversified local and offshore investment portfolios.

ETFS VS. INDEX FUNDS: UNDERSTANDING THE DIFFERENCES

ETFs and index funds share the goal of tracking market movements at low costs. However, their pricing mechanisms differ significantly. Index funds' prices are set at the end of each trading day, similar to unit trusts. In contrast, ETFs are priced and traded continuous and throughout the day on regulated stock exchanges, offering more liquidity and control, particularly in volatile markets where entry and exit points are critical.

EXAMPLE OF ETF'S

The iShares Core MSCI World UCITS ETF tracks the MSCI World index, which represents stocks from 23 developed markets around the world and is traded in USD. This ETF is managed by BlackRock Asset Management, which is the largest asset manager in the world, with over $10 trillion in assets under management.

The MSCI World index has 1,465 constituents and covers approximately 85% of the market capitalization in each of the 23 developed countries. With over $70 billion in assets under management, this ETF is the largest MSCI World tracker and one of the largest ETFs globally. The total investment cost of the iShares Core MSCI World UCITS ETF is 0.20% per annum.

Satrix, the largest provider of ETFs in South Africa, also offers an ETF which tracks the MSCI World ETF in South African Rand by investing in the iShares Core MSCI World UCITS ETF. The TER for this ETF is 0.35% per annum.

KEY ADVANTAGES OF ETFS

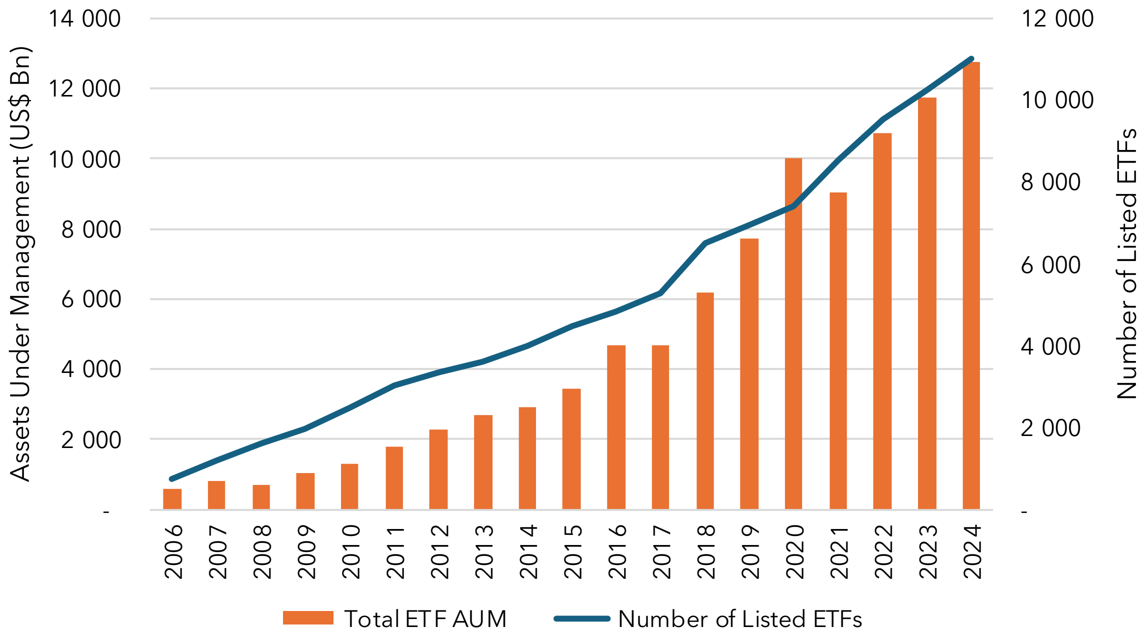
- Intraday Trading: ETFs allow investors to trade throughout the day, unlike unit trust funds, which only price at the end of the trading day. It therefore allows for more timeous entry and exit points.
- Cost Efficiency: ETFs may have lower expense ratios compared to unit trust funds, making them a cost-effective investment option.
- Transparency: Both ETFs and unit trusts are transparent in their holdings and operations. However, ETFs disclose their holdings daily, providing investors with clear information about their investments. This transparency can be particularly important for investors who want to monitor their investments more closely.

KEY CONSIDERATIONS FOR INVESTORS

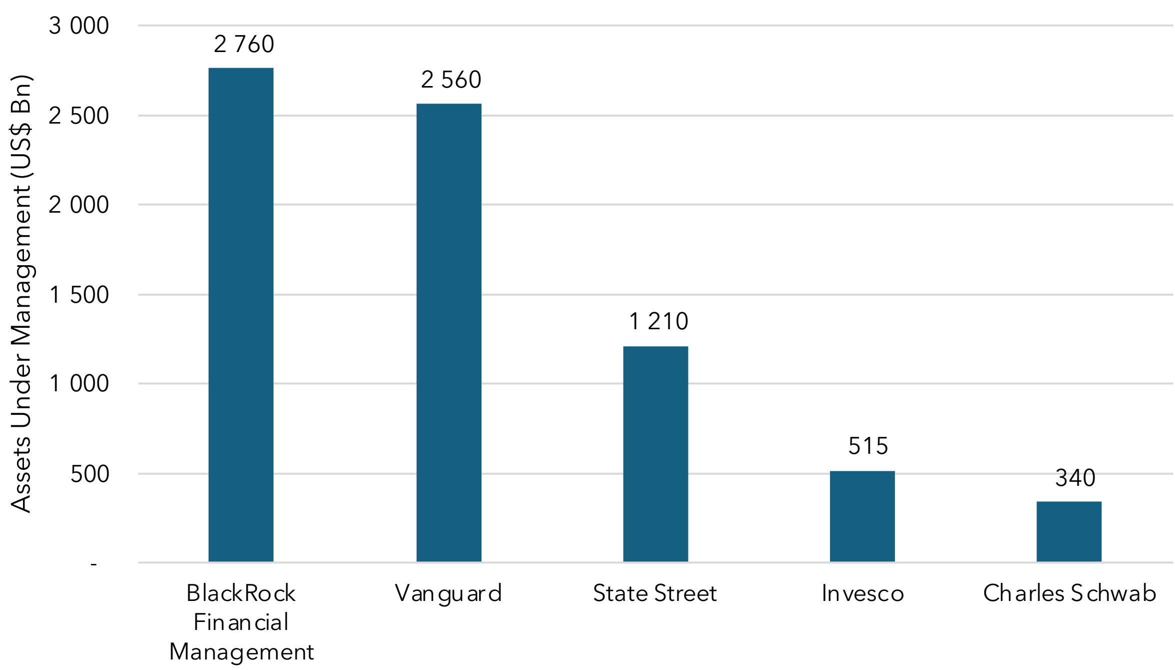
- Expense Ratios: While ETFs are generally cost-effective, it's crucial to compare expense ratios across different ETFs and comparable unit trust funds.
- Trading Costs: Frequent trading of ETFs can incur additional costs. Investors should consider these costs when making trading decisions.
- Accumulating vs. Distributing ETFs: ETFs may be "accumulating" or "distributing." An accumulating ETF reinvests income, while a distributing ETF pays out income to investors.
- Availability: ETFs are typically traded through stockbroker platforms, or can be accessed via Linked Investment Service Provider (LISP) platforms which then finally also trades such via a selected stockbroker.

THE ETF UNIVERSE

Today there are more than 10,000 Exchange Traded Products available for investors to select from. Assets managed via ETFs have grown significantly, peaking at nearly $13 trillion in 2024.



The offshore ETF market is dominated by investment managers such BlackRock, Vanguard and State Street, whose combined assets under management (AUM) account for over 50% of the ETF market.



Satrix introduced the first ETF in South Africa in 2000. The South African ETF industry has experienced consistent growth. As of the end of the first quarter of 2024, the total market capitalization of the entire South African Exchange Traded Product industry, which includes ETF's increased to more than R175 billion.

THEMATIC INVESTING WITH ETFS

There are also now more than 250 global thematic ETFs, which focus on specific themes or trends such as clean energy, artificial intelligence, and cybersecurity and which allows investors to align their portfolios with prevailing and emerging megatrends. These ETFs focus on specific sectors, industries, or trends, such as:

- Green Technologies: Investing in sustainable energy solutions and eco-friendly innovations.
- Blockchain Technology: Capitalising on the transformative potential of blockchain across industries.
- Artificial Intelligence: Gaining exposure to companies leading the AI revolution.
- Healthcare Innovation: Investing in companies at the forefront of medical and healthcare advancements.
- Cybersecurity: Targeting companies providing cybersecurity solutions amid growing digital threats

Another theme experiencing extraordinary growth is cryptocurrency. The first cryptocurrency-based ETF was launched in January 2024, and since then, 21 additional ETFs have been introduced. These ETFs have collectively amassed nearly 5% ($68 billion) of the total Bitcoin currently in circulation. The two largest players in this space are the Grayscale Bitcoin Trust ETF (GBTC) and the iShares Bitcoin Trust ETF (IBIT), each holding approximately 25% of all Bitcoin owned by spot Bitcoin ETFs.

VettaFi

Symbol	ETF Name	Asset Class	Total Assets ($MM)
IBIT	IShares Bitcoin Trust Registered	Currency	$21,156.00
GBTC	Grayscale Bitcoin Trust	Currency	$20,371.00
FBTC	Fidelity Wise Origin Bitcoin Fund	Currency	$12,346.70
ARKB	ARK 21Shares Bitcoin ETF	Currency	$3,575.64
BITB	Bitwise Bitcoin ETF Trust	Currency	$2,708.94
BITO	ProShares Bitcoin Strategy ETF	Currency	$2,119.84

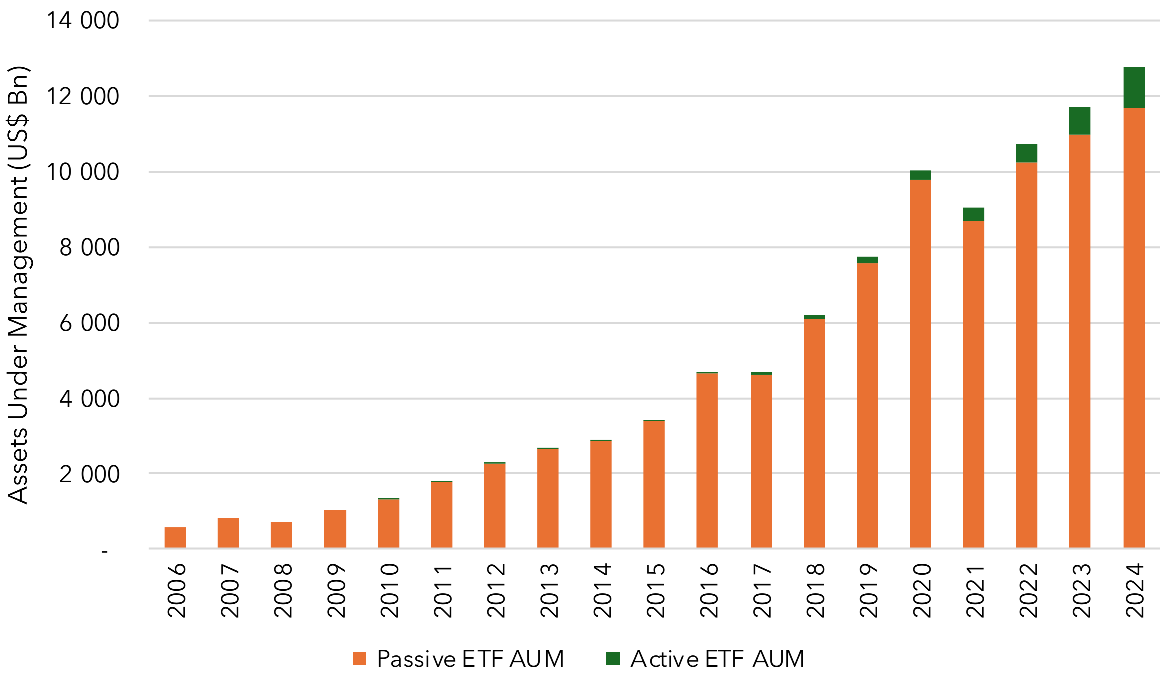
THE RISE OF ACTIVELY MANAGED ETFS

While passive ETFs have traditionally dominated the market due to their low costs and broad exposure, actively managed ETFs are gaining traction.

Unlike passive ETFs, which track a specific index or market, actively managed ETFs are managed by a professional investment team that actively buys and sells assets within the fund to achieve a specific investment objective.

Consider an actively managed ETF focused on technology stocks. The investment manager, a team of experienced investment professionals, actively monitors the technology sector and adjusts the portfolio accordingly. For instance, if they believe a particular technology company is undervalued, they might increase the holdings in that company. Conversely, if they think another company is overvalued, they might reduce the fund's exposure to it.

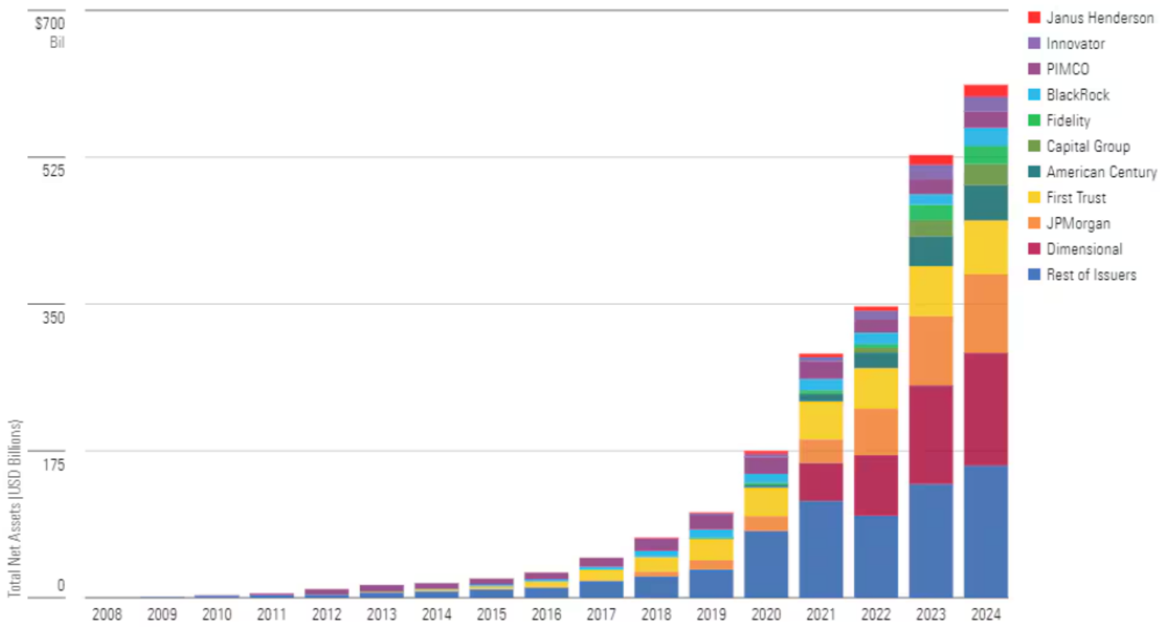
Despite a slow start, actively managed ETFs are now gaining significant traction.



As of 2024, there are now more than 700 actively managed ETFs managing assets worth approximately $250 billion. Actively managed ETFs have experienced a compound annual growth rate (CAGR) of about 30% over the last five years, indicating strong investor interest and market expansion. In 2024, actively managed ETFs saw record inflows of around $90 billion, reflecting increasing investor confidence in these products.

Firms such Dimensional, JP Morgan, First Trust and American Century have experienced strong growth in actively managed ETF AUM over the last five years.

Active ETF Market Composition



Source: Morningstar Direct. Data as of March 31, 2024.

EXAMPLES OF ACTIVELY MANAGED ETFS

- ARK Innovation ETF (ARKK): This actively managed ETF focuses on companies involved in disruptive innovation across various sectors. The ETF is managed by ARK Investments, renowned for their high-conviction investments in technology and biotechnology. ARKK was launched in October 2014 and have approximately $7 billion in assets under management (AUM) as of the latest available data.

- PIMCO Active Bond ETF (BOND): Managed by the Pacific Investment Management Company (PIMCO), this actively managed ETF offers exposure to a diversified portfolio of global bonds, leveraging PIMCO's expertise in fixed income. Launched in March 2012, this ETF had around $4 billion in AUM as of the latest available data.

- JP Morgan Equity Premium Income ETF (JEPI): This actively managed ETF combines dividend-paying stocks with options strategies to optimise income generation. Managed by JP Morgan, utilising their extensive research and market insights, JEPI was launched in May 2020 and had approximately $33 billion in AUM as of the latest available data.

Locally, the JSE announced in 2022 that the Financial Sector Conduct Authority (FSCA) approved amendments to the JSE listings requirements that paved the way for issuers to list and investors to trade actively managed ETFs on the exchange. The amendments were effective from 14 October 2022. The addition of actively managed ETFs enables the JSE to attract more issuers to list new instruments. In addition, actively managed ETFs allows South African investors to diversify their portfolios cost-effectively.

KEY FEATURES OF ACTIVELY MANAGED ETFS

- Professional Management: Actively managed ETFs are overseen by professional investment managers who make active investment decisions based on research, market conditions, and emerging opportunities.

- Transparency: Unlike unit trust funds, actively managed ETFs typically disclose their holdings daily, offering investors a continuous fully transparent view of their investments.

- Liquidity: Actively managed ETFs are traded throughout the day, providing the same liquidity benefits, in line with ETFs that simply track a specific sector or broader market.

- Cost Efficiency: Although management fees are higher for actively managed ETF's than those for ETFs that simply track a specific sector or market, they are often lower than traditional actively managed unit trust funds.

BENEFITS OF ACTIVELY MANAGED ETFS

- Flexibility and Adaptability: Investment managers can adjust their strategies at any point during a trading day in response to market changes, economic developments, or emerging trends, allowing for a dynamic investment approach.

- Potential for Outperformance: By employing the advanced research and sophisticated strategies which investment managers utilise, actively managed ETFs can potentially outperform their benchmarks.

- Diversification and Risk Management: Actively managed ETFs often employ various strategies such as sector rotation and tactical asset allocation to diversify holdings and manage risk.

COMPARING ACTIVE AND PASSIVE ETFS

- Passive ETFs: Aim to replicate the performance of specific indices, such as the S&P 500 or the MSCI World Index. They offer lower costs, greater transparency, predictable performance, and tax efficiency due to fewer trades. However, they are limited in flexibility and their performance is tied to the index.

- Active ETFs: An investment manager or team making active decisions about asset allocation and/or stock selection, aiming to outperform a benchmark or achieve specific investment objectives. They offer potential for outperformance, flexibility in adapting to market conditions, and proactive risk management. However, these ETFs come with higher costs due to more frequent trading and research, and their performance depends heavily on the portfolio manager's skill.

CONCLUSION: EMBRACING CHANGE FOR INVESTMENT SUCCESS

In conclusion, both passive and active ETF strategies have merit, and the optimal investment approach depends on each investor's goals, risk tolerance, and also the prevailing market conditions. Investors should opt for a combination of both strategies to balance the potential for higher returns with the stability and lower costs associated with passive investing.

Both passively managed and actively managed ETFs have their unique characteristics and advantages. While passive ETFs provide cost-effective, diversified market exposure, active ETFs may offer opportunities for outperformance in certain market environments.

At GraySwan, our dedication to identifying and providing access to cutting-edge investment opportunities remains unrelenting. We always strive to optimally position our clients for success in the rapidly transforming global investment landscape.

Contact us if you are interested to learn more about our wealth management approach where we utilise passively managed and actively managed ETF's.

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