ETFs vs managed funds

Key differences explained

BetaShares

This paper examines the key differences between traditional, actively managed funds (managed funds) and exchange-traded funds (ETFs), and highlights how these differences can affect investors. These differences are summarised in Table 1.

Table 1. Comparison of ETFs with managed funds

	ETFs	Managed funds
Risk diversification	Generally high — exposure to entire index	Varies depending on the fund
Expenses and fees	Brokerage costs; lower management fees; bid/offer spreads	Buy/sell spreads, higher management fees, performance fees possible
Pricing	Real time, intraday	Varies from end of day to weekly or even monthly
Liquidity	High, intraday	Varies significantly from high (daily) to limited liquidity in closed-end structures
Accessibility	Purchased like a share, can be used on or off platform	Entry via manager or intermediary (platform or adviser) — generally, a high administration burden
Transparency of underlying portfolio	Portfolio constituents visible daily	Rarely daily; can be opaque

Risk diversification

A key benefit of ETFs is the diversification they provide. ETFs typically aim to track an index that serves as a benchmark for an entire sharemarket, or a market sector. For instance, BetaShares Australia 200 ETF (ASX Code: A200) gives an investor exposure to the top 200 companies on the Australian sharemarket by market capitalisation, in a single trade. This diversification means that the risk for an investor in an ETF is significantly lower than investing in a single stock.

In the case of actively managed funds, the fund manager selects which stocks to invest in. While the manager typically will invest in a portfolio of stocks, in some cases a fund may have a significantly concentrated exposure, increasing the risk position from an investor's perspective.

Expenses and fees

The cost differential between managed funds and ETFs is arguably one of the primary reasons for the growing popularity of ETFs.

Managed funds typically charge significantly higher fees than ETFs offering similar exposure. In addition, some managed funds charge investors 'performance fees' when their performance exceeds a nominated benchmark. By comparison, most ETFs charge a simple management fee and no performance fees.

The management fees for BetaShares' broad market Australian shares ETF (A200), for instance, are only 0.07% p.a. — whereas managed funds providing exposure to Australian shares typically charge fees of around 1.55% p.a. The primary reason for this dra-

matic cost differential is that most ETFs are passive funds, aiming to track the performance of an index, and so do not incur the costs of active management.

The impact of fees on investor returns can be significant.

As an illustration, Figure 1 compares the returns from a low-fee passive ETF investment with those from a typical actively managed fund, assuming:

- pre-fee returns of 5% p.a.
- a starting balance of $10,000
- A200's fee of 0.07% p.a.
- a typical active management fee of 1.55% p.a. (Morningstar).

Over a 40-year period, the low fee-investment would have grown to be worth $68,547 compared to the high-fee investment's closing value of $38,835. The low-fee option would have been worth around $30,000, or 77%, more than the high fee option at the end of this period.

Seemingly small differences in management fees may not at face value appear to matter all that much, but thanks to the power of compounding, they can have a significant effect on after-fee returns over time.

Pricing

Another benefit of ETFs is their pricing transparency.

Because ETFs are traded on the ASX, an investor and their adviser can see the price of their investment at any time during the trading day. By comparison, pricing for managed funds is typically provided far less regularly, on a daily, weekly or even a monthly basis. Due to the intraday pricing of ETFs, an investor should always be able to determine their investment position. Further, because they are traded like shares, there is no minimum investment size for ETFs (aside from any low minimum the investor's broker may require), unlike many managed funds which set minimum investment sizes.

Liquidity

As ETFs are traded on a stock exchange, an investor can normally buy or sell at any time during the trading day at then-current market prices. In addition, ETFs are required to have at least one dedicated market maker, seeking to ensure there will be sufficient liquidity to permit investors to buy and sell their units, and that the difference between the bid and offer is kept low. Managed funds do not provide intraday liquidity, and investors may only be able to dispose of their investment as at the end of the day or less frequently.

Accessibility

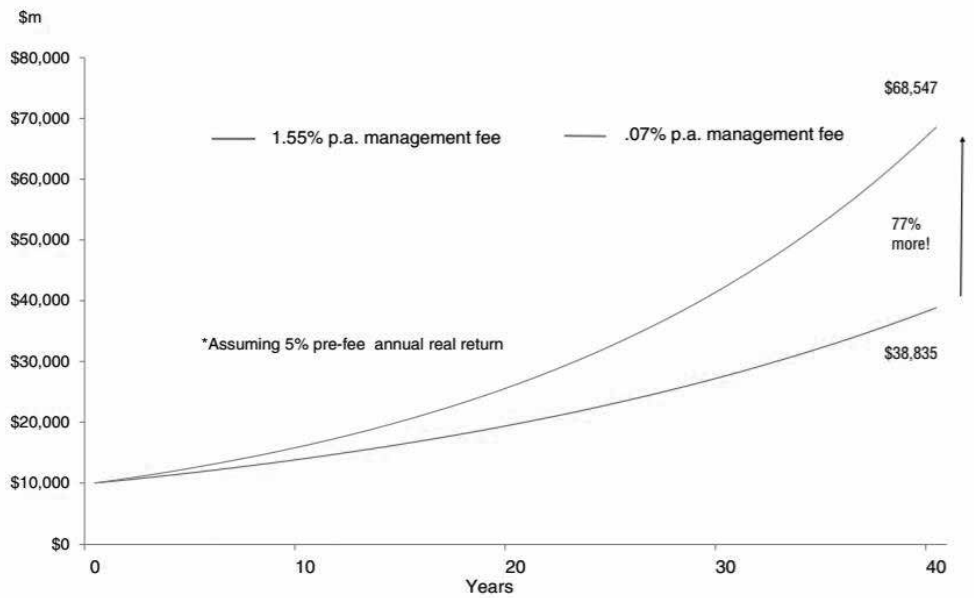
As mentioned, ETFs are traded like shares, so investors can buy units through their broker or financial adviser.

Once an investor has a brokerage account, no additional paperwork is required. In comparison, managed funds are typically purchased off-market. Application forms are usually required, which can be time consuming and complicated to fill out. For the advisers themselves, ETFs can be bought and sold on all major investment platforms, but, should the adviser so desire, can also be bought 'off platform' directly via the ASX.

The quote

One of the most often-cited benefits of ETFs is their transparency.

Figure 1. Investment portfolio value over time



Illustrative only. Assumed performance is not indicative of actual performance. Actual performance of A200 and the Australian sharemarket may differ.

Source: BetaShares

Transparency

One of the most often-cited benefits of ETFs is their transparency. For instance, the BetaShares website provides information on the portfolios held by BetaShares ETFs, updated on a daily basis, so an investor can check what the fund holds at any time. By comparison, many managed funds provide relatively little information about the holdings of the fund. Often an investor is given information only about the largest holdings, and even then on a relatively infrequent basis, making it harder for them to understand exactly what is being held by the manager.

Performance

Investors are increasingly scrutinising the performance of actively managed funds versus passive options, and are becoming more aware of the impact on performance of fees charged by active fund managers, relative to lower-cost alternatives such as ETFs.

The track record of active fund managers against their benchmark indices has generally been poor. As Table 2 shows, after fees were taken into account, fewer than one in five Australian equity fund managers who benchmark to the S&P/ASX 200 Accumulation index actually beat this index over the three and five years to 30 June 2019, while fewer than one in 10 beat the benchmark in 2018/19. By comparison, ETFs aim to provide simply the index return, at low cost.

A200, for instance, aims to track the performance of the largest 200 companies on the ASX by market capitalisation, at a management fee of 0.07% p.a.

ETFs are increasingly used in place of, or as a complement to, managed funds. Further, as more and more products are launched on the Australian market, investors are able to diversify further into new investment strategies, new asset classes and new geographic regions — all as simply as buying a share. **FS**

Table 2. Percentage of active funds underperforming the index: as at 30 June 2019

Fund category	Comparison index	One year (%)	Three year (%)	Five year (%)
Australian Equity General	S&P/ASX 200	93.2%	83.3%	80.6%
Australian Equity Mid- and Small- Cap	S&P/ASX Mid-Small	60.5%	79.8%	75.2%
International Equity General	S&P Developed Ex-Australia LargeMidCap	72.9%	74.0%	82.8%
Australian Bonds	S&P/ASX Australian Fixed Interest 0+ Index	84.6%	77.6%	90.6%

Source: Standard and Poor's. Past performance is not an indication of future performance.