Exchange traded funds and portfolio construction

By Roenica Tyson, Investment Product Manager and Dean de Nysschen, Research & Investment Analyst

Roenica:
Today we're talking about the use of exchange traded funds (ETFs) in a portfolio and with me is Research and Investment Analyst Dean de Nysschen.

Dean, how would you best use an exchange traded fund in a portfolio?

Dean:
Hi Roenica, there are a lot of benefits that one can harness from ETFs and we've briefly covered some of these advantages in our previous podcast, but the big one really is the cost saving that you're getting from these instruments.

In addition to that you can really introduce some good flexibility and some liquidity into the portfolio. That makes the instruments very attractive.

When it comes to actually using them and the approach that you take when building the portfolio with these instruments, a common approach is the core-satellite method and that's been a well-publicised one. Essentially what that means is that you're building the core of your portfolio with a low-cost, passive vehicle – obviously harnessing the benefits of the fact that your performance hurdle is lower. And then around that you would use smaller strategic allocations to selective active asset managers.

Roenica:
In terms of asset allocation – what role can ETFs play in that regard?

Dean:
There are a couple of angles that you can use when looking at asset class construction specifically, and I think a good example to use is regional allocation. If you were to look at your portfolio and identify that you're perhaps a little over-exposed to a specific region – emerging markets for example – then you could use ETFs as a way to load up on developed markets. Perhaps access developed markets through an S&P 500 ETF. That might make a lot of sense

from the point of view that developed markets are often more efficient, and it's arguably more difficult to generate alpha in those regions.

Roenica:
And then lastly Dean, are there any risks that investors should be wary of when considering ETFs?

Dean:
That's a good question. I think it's important to take into consideration when using these instruments, that obviously market beta comes into the equation. So what that means is that you're paying lower costs for the fact that there's no active management involved in the instrument. Therefore when the market experiences a drawdown you'll experience the exact same sensitivity. You're not going to be able to access the protective type of characteristics that you may have access to when you're invested with an active manager.

It's important to take that into consideration when you're blending ETFs with active managers and on the local side it's also important just to keep in mind how our local index is put together and the fact that it can be quite concentrated, especially from the Top 40 point of view. There are fantastic benefits available with these instruments but you want to combine them nicely and ensure that your portfolio is well diversified.

Roenica:
Thank you for the insights Dean.

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