What you should look at before buying an ETF

Description

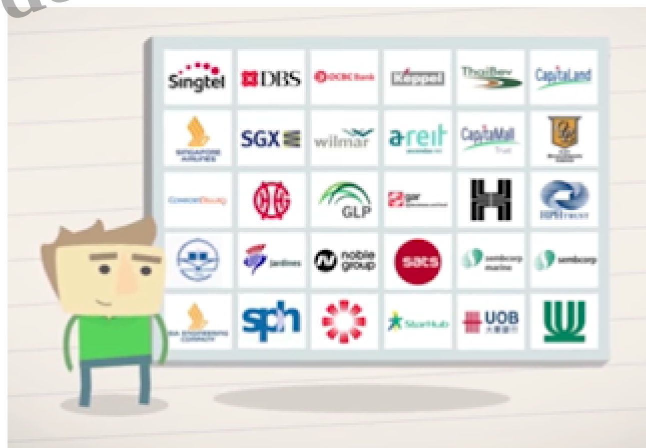
With a wealth of information out there today, it is easy for anyone to get lost in a sea of financial jargons and articles that keep telling you, *XX things you MUST know before investing*!

Recently, I received an email from a reader who asked me what I would look out for before I buy any exchange-traded fund (ETF). She mentioned that she was keen to explore index investing, but got overwhelmed by all the information online.

I've previously talked about how index investing is an easy way out for anyone who wants to avoid losing 1/3 of their wealth to the underlying fees associated with unit trusts or mutual funds here, but realised that I've never really done a proper post about this method of investing before, so today's article will focus on what you should look at before buying into any ETF, as well as some recommendations.

<u>What to look at before buying an ETF</u>

1. Which stocks do the ETF buy into?



Components of the STI ETF (Image from SGX)

The Straits Times Index (STI ETF) comprises of securities from the 30 largest blue-chip companies in Singapore. Every unit of the STI purchased allows you to own (albeit indirectly) shares across all these companies, which concurrently helps you to diversify across different sectors at the same time.

Here's a good introductory video by SGX:

Aside from broad market indices, there are also industry-specific ETFs which enable you to buy into different stocks within a sector. The **Vanguard Energy ETF**, for instance, buys into stocks of Exxon

Mobil, Chevron, Haliburton and other companies involved in the exploration and production of energy products such as oil, natural gas and coal. Want to invest into the growth of social media? The **Global X Social Media ETF** allows you to buy into Facebook, Tencent and Twitter; you would have made a whopping 46% in returns if you had bought into that at the beginning of this year and held it until today!

There are also ETFs for consumer staple products, financials, health care, etc.

2. What is the expense ratio?

The expense ratio basically tells you how much annual fees you'll be charged for every $1,000 you invest. An ETF with a expense ratio of 0.5% means you'll be paying $50 in annual fees if you invest $10,000 into it.

Ideally, you'll want to look for ETFs with low expense ratios – anywhere between 0.1% to 0.3% is my personal benchmark, although I tend to apply a higher expense ratio limit of 0.5% when I look at overseas ETFs as the fees could range up to 0.7% abroad.

Vanguard ETFs are known for their low expense ratios, and you can choose from a variety of indexes. *(Nope, #notsponsored to say this)*

3. Does the ETF have a low tracking error?

Look at how much the ETF deviates from the index which it tracks. Locally, if you wish to buy into the STI ETF, you can choose from **SPDR STI ETF** or the **Nikko AM STI ETF**. The annual tracking error for these ETFs are 0.66% and 1.01% respectively, which makes the SPDR STI ETF potentially a better choice. *(However, the reason for the discrepancy is due to the fact that Nikko AM does not engage in derivatives to replicate the index, so the margin of error could be larger.)*

4. What is the liquidity of the ETF?

Look at the market capitalisation of the ETF to determine if the pool of investors buying into it is small; you'll want to find ETFs with a bigger market cap which makes it easier for you to buy and sell units of it.

5. What about other types of ETFs, such as synthetic, leveraged or inverse ETFs?

Synthetic ETFs, also known as swap-based ETFs, mimic the behaviour of an ETF through the use of derivatives. They do not actually own the shares of the companies being tracked, although proponents of synthetic ETFs claim that they do a more accurate job of tracking indexes than their physical ETF cousins. Instead, synthetic ETFs make agreements with a counterparty (usually an investment bank) who will pay the ETF the return of its index. Such ETFs are quite popular in Europe, but if you buy into a synthetic ETF, you basically expose yourself to counterparty risk as there is no guarantee that the bank will carry through with its obligation to pay the supposed returns.

Inverse and leveraged ETFs, on the other hand, are more common and popular in the US.

Inverse ETFs deliver the opposite of the benchmarks they track. For instance, when crude oil prices tumbled recently, the **ProShares UltraShort DJ-UBS Crude Oil ETF** was very much in demand by investors looking to short the oil index. When the index goes down, the inverse ETFs yield a positive returns, so you generally won't want the market to recover when you invest in such ETFs.

Leveraged ETFs, as their name suggest, attempt to deliver multiple times of the index benchmark returns. The **ProShares Ultra S&P 500 ETF** offers double the return of the S&P 500 for a single day, and this is achieved using stocks and derivatives such as futures contracts.

Tip: If you invest into inverse or leveraged ETFs, remember that they are designed to achieve their objectives on a daily basis, so you may not want to hold onto them for the long term.

Trying to construct a diversified portfolio with global exposure? You could even use a combination of ETFs to that effect! Or save on research time and try the below combination, as recommended by John Prestbo a.k.a. the editor of Dow Jone Indexes:

Name	Symbol	No. of Stocks	Net Assets
iShares MSCI ACWI Index Fund	ACWI	1,201	$2.7 billion
Vanguard Total World Stock ETF	VT	3,750	$1.2 billion
iShares S&P Global 100 Index Fund	IOO	102	$1 billion
SPDR Global Dow ETF	DGT	155	$96.6 million

Source: MarketWatch

Instead of trying to time the market, try applying the dollar-cost averaging (DCA) method instead so that you regularly buy into your ETF of choice. This doesn't require much analysis (or actually, none at all! It is a pretty no-brainer approach). Locally, I like **POSB InvestSaver**, which allows you to start investing with as little as $100 a month, and helps you buy more stocks when they're cheaper (and less stocks when the price increases). Combine it with the POSB Cashback Scheme to maximise your returns from this move; that's what I call real cashback kung fu!

Still not convinced? Hey, even legendary investor Warren Buffett is a huge fan of ETFs. If you wish to start your investing journey but aren't yet too keen on analysing individual stocks (or if you've no confidence to do so), ETFs might very well be your answer.

With love,
Budget Babe
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