The Australian

Active ETFs attract experts

- **by: Andrew Main, Wealth editor**
- From: **The Australian**
- April 24, 2012 12:00AM

Amanda Skelly would like to see an increase in the number and variety of bond ETFs. Picture: James Croucher
Source: News Limited

THE Australian exchange traded fund market is suffering the same distortion as our much criticised equity market: it's still way too dependent on equities.

So says Amanda Skelly, director of ETFs at Russell Investments. But unlike other critics such as Ken Henry and Lindsay Tanner, she has put a time qualifier on the statement by being careful not to call for an immediate reweighting when the bond market is looking particularly toppy worldwide, thanks to the dramatic quantitative easing policies being pursued in the US and Europe.

She's also aware that Australia has come a very long way to redress the imbalance in recent weeks, having gone from having not one fixed-interest ETF at the start of this year to six, with at least two more on the way from Russell and Vanguard.

"Without a doubt there will be more fixed-interest ETFs appearing in Australia," Skelly says.

Until this year the Australian Security Exchange's rules forbade the issue of fixed-interest ETFs because they could not be backed by ASX-listed assets, but since a change in the rules to enable unlisted bonds to be assessed as allowable collateral, the gate has opened.

Skelly spent five years working in Russell's Seattle headquarters, so has seen the much more highly developed US market for ETFs from up close and expects Australia to take close note of US developments before committing to new ETF directions.

That's a sensible way of avoiding problems such as the "flash crash" of May 6, 2010, when the Dow Jones index briefly dropped 1000 points under an avalanche of automated sell orders exacerbated by the ETF industry.

But following the lead of the US may be a problem, she says, given that, for instance, US investors have infinitely less of a currency risk issue to deal with than Australians.

"A lot of Australian investors have put money into global ETFs and have lost badly on the exchange rate," she says, making it clear that an increase in the number of available currency ETFs would be a useful development to reduce risk.

They are a relatively recent innovation in Australia, with BetaShares having introduced three (euro, US dollar and sterling) in 2010 and last year.

One new product to have emerged in the US that has yet to appear here is the active bond ETF, where an element of active selection features in the asset allocation process, with the aim of beating the relevant benchmark.

For instance, there are two PIMCO active fixed-income ETFs. The Bond ETF (Total Return Fund) has attracted $US350 million since its launch early last month. The better established fund, the MINT ETF, with shorter dated maturities, has attracted $US1.5 billion ($1.45bn) since its launch in 1999.

Skelly says although there is a degree of scepticism about active ETFs in some corners (several equity-based ETFs with active strategies in the US have come to grief through lack of liquidity) an actively managed fixed-interest based ETF may produce a better product.

"If Bill Gross (of PIMCO) can make it work, then there's hope," she says, adding that an increase in the number and variety of bond ETFs will also make it possible, in due course, to introduce model portfolios where investors are given a blueprint for constructing exposures through ETFs alone.

Another likely innovation, she believes, is the creation of "ETFs of ETFs" as a diversification exercise. Based on the "fund of funds" approach, it is not as silly as it sounds. The main reason people buy ETFs is to get low-cost access to a much wider range of assets than otherwise might be possible, and this approach would deliver that.

Australia's most popular ETF, the official S&P 200, is widely used by international investors seeking exposure to the Australian equity market and accounts for about $2.1bn of our total $5.3bn ETF market capitalisation.

But overall her biggest concern is that institutional investors have been slow to take up ETFs in Australia.

"We've really struggled with institutional acceptance of ETFs in this market," she says, adding they remain "much more comfortable with derivatives and direct equities in this market".

The only exception, she says, is where local fund managers use ETFs to access overseas markets.

"They've been very active there," she says.

BetaShares' head of investment strategy Drew Corbett says it is much likelier Australia will see an active market in bond-based ETFs rather than equity ETFs, for several reasons. He says it is counter-intuitive for active equity fund managers to sell their knowledge at low prices.

But he does note that "we may see a hybrid type fund with active rules" coming in next year.

He says a small resource-based ETF is already operating that way, working against an index devised by the issuers, Chimaera Capital.

A bigger issue, he says, is the Australian Securities & Investments Commission is likely to rule on the admission of specifically active ETFs in Australia.

Jonathan Morgan, business development manager at ASX, makes it clear that while the overall value of the ETF market in Australia is still modest as a percentage of the total, the rate of creation of new issues in the market is moving along strongly.

"In March 2010 there were 32 ETFs listed in Australia," Morgan says. "That grew to 47 this time last year and there are now 68, a rise of 44 per cent in a year. There are around 10 commodity-based ETFs likely to list here in the June quarter so it's realistic to say there will be around 80 ETFs by the end of June."