The Australian Finance Podcast Episode Transcript

Episode: ETF investing 2.0: How do ETFs actually work?
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Speakers: Kate Campbell, Owen Rask & Evan Metcalf
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Episode transcript:

Owen:
Hey, welcome to this episode of the Australian Finance podcast.

Kate:
It is good to be back, Owen, on this lovely summer day.

Owen:
It is indeed. Yes. It is March 8th that we're recording. And we're talking ETFs. We're talking what actually goes on inside an ETF. And this is an episode that I think a lot of our listeners are going to get confidence from actually understanding what goes on behind the scenes.

Kate:
Absolutely. We've talked about a lot of the basics of ETFs and how they work on the show, even in our starter pack in January. So a lot of the new investors would've heard about ETFs exchange trade of funds in that episode, but I went on this journey of looking into how does ETFs actually worked underneath the surface a few years ago? And so this is a lot of interesting stuff.

Kate:

And I think if you are interested in investing, in long-term investing, it does give you a bit more confidence when you understand the products a little bit more. So I think if you're a brand new investor, you should head back to our starter pack episode in January, just to get a bit of a rundown of ETFs because we're going to use some terms today that might have a little bit of assumed knowledge.

Kate:
But our guest today, which Owen's going to introduce in a second is going to really unpack everything under the surface. So you can really understand how the product works.

Owen:
Yeah. Evan Macoff is joining us from the ETF securities in Sydney. And Kate, I know that you said that you were doing some random Googling and you came across an ETF securities document, which basically explained all of the things that happened behind the scenes. So Evan, welcome to the show today. We really appreciate your time.

Evan:
Thanks Owen. Thanks Kate. Thanks for having me on.

Owen:
No, it's our pleasure. So we're happy to get an expert on for this episode in particular, because it's going to be a little bit technical, but hopefully, you can break it down for us and explain those terms as we go. So Kate, I know you've got the first question for Evan here.

Kate:
Yeah. To start the conversation, I'd really like to have a look at some of those key people and ideas involved underneath ETFs, because we often look at it from a surface level, and that's how we often talk about it because it can get a little bit [crosstalk 00:02:12] confusing. Yeah.

Kate:
But underneath the neat, attractive packaging of an ETF where it's all packaged up nicely for the consumer, I want to talk a bit more about how they actually work. And one of the first starting points I thought we could talk about, Evan, was the open-ended structure of ETFs, because that's quite a new concept for some people.

Evan:
Sure. Yeah, no problem. So I think when most people think about ETFs, the first thing that they think about is that their funds, I think most people understand that they're kind of similar to a managed fund. But the main difference is that they trade on exchange. And not only do they trade on exchange, they trade on exchange at a price that somewhat reflects the value of the underlying portfolio.

Evan:

So that's a little bit different from a managed investment, like a traditional unlisted type fund. It's also a bit different from a listed investment company or a listed investment trust. So licks and licks. Sorry, licks and lits. So for most people, they understand that's what an ETF is, that's how an ETF works and they're able to successfully trade ETFs based on that, but they don't necessarily always have the opportunity to look underneath and see what actually happens.

Evan:
So to explain that, we need to introduce the concept of the primary and the secondary markets. So there's two separate markets for an ETF that interact with each other. So in the primary market, investors are able to come directly to the fund manager. They place orders with the fund manager themselves for either the creation of new ETF units or the redemption of existing ETF units.

Evan:
So this is exactly what happens, exactly the same as what happens in the unlisted fund world. So what happens there is that someone will come to the fund manager, place an order, and they're given a price at the end of the day. So at the end of the day, they're creating new ETF units. The only difference with an ETF in this respect is that the primary market is only open to investment professionals known as authorised participants or APs.

Evan:
So they're one of the key parties involved in ETF market that we need to understand. So an AP is usually a major investment bank, a securities house or a trading professional. So they're the companies that can create and redeem units directly with the ETF issuer. The other market is the secondary market. This is what most people are more familiar with. So this is where you trade ETF units on the stock exchange.

Evan:
So buying and selling in the same way that you would buy and sell a share, and in the same way that you would buy and sell a lick or a lit. So the secondary market here is supported by not just end users of ETFs, but also by parties known as market makers. So these are effectively liquidity providers to the ETFs. So they're often, but not always, contracted to the ETF issuer and their job is to provide buy and sell prices. So bid and offer prices on an ETF continuously throughout the day.

Evan:
And this is what effectively allows people to trade on the secondary market. So you have these two markets, the primary market and the secondary market, and they're linked. And the reason that they're linked is because there are participants who can trade in both of those markets.

Evan:
So if you have the situation where those two markets are pricing an ETF at different levels, then you effectively have an arbitrage or an opportunity for someone to make risk-free profits by

buying the ETF units in the cheaper of the two markets and selling them in the more expensive of the two markets.

Evan:
So it's really this interaction between these two markets that is the key feature of ETFs and the kind of special source that makes ETFs what they are and keeps the price of an ETF at, or very close to the value of its underlying portfolio.

Kate:
So Evan, if I'm a consumer using my pillar or my sake account, I would be purchasing ETF's via the secondary market. Is that correct?

Evan:
Yeah. That's right. Exactly. So secondary market is what most people trade in and out of. That's what happens on exchange. That's what people see in their brokerage accounts. Primary market is for specialised investment firms only.

Owen:
And so those specialised firms, those authorised participants, do they effectively collect all of the, say if there's like an Australian shares ETF, they collect all of the shares and then hand them to you, the ETF issuer in effect?

Evan:
Yeah. So there's two different ways that the primary market can operate. So there's in-cash and in-kind creations and redemptions. So an in-kind creation or redemption is as you described, where an authorised participant would buy up the securities that form the underlying portfolio for the ETF and deliver those to the ETF issuer in exchange for newly created units in an ETF.

Evan:
The other alternative is cash creations and redemptions, where they provide the ETF issuer with the value in cash of the underlying securities and the ETF issuer, then goes and invests that in the fund. So there's two different models, but they effectively provide the same outcome.

Kate:
And I find the idea of market makers really interesting because unlike shares in a company where you would be buying and selling to some other individual or bank or something like that, with a market maker, they can keep creating more units of the ETF. And you're not always buying directly from another participant from your mate who also has that ETF they want to sell. You could also be buying newly created units in this ETF that the market maker are creating.

Evan:
Yeah, that's exactly right. So a market maker will usually maintain a certain amount of inventory on an ETF. So it'll be like a, think about it like a supermarket where they have stock on the shelf, and they're able to offer that to end investors via the secondary market, but they're also

simultaneously offering to buy units off investors who are wishing to sell. So they're there in the market all the time.

Evan:
When you trade, chances are you probably trade with the market maker, but not necessarily because there's other buyers and seller in there at the same time. So it can be retail investors versus retail investors, or other types of investors interacting with each other, but market makers will be there providing liquidity on both sides. The more market makers you have, the more competition there is, which usually results in tighter bit off of spreads and then better outcomes for end investors as a result of that as well.

Kate:
You touched on liquidity there, are you able to explain a bit more about what that means in the context of ETFs? [inaudible 00:08:43] What an investor should really know about or have a look at it, if they're trying to understand how easy it will be to buy and sell units in ETF?

Evan:
Yeah. Sure, sure. So market makers will provide the underlying liquidity. And they generally are contracted or otherwise incentivized in some cases. Not necessarily, but some of the incentive can just be their own trading objectives. But they'll provide certain amount of liquidity on screen at any time. But that's not necessarily reflective of the underlying liquidity of an ETF.

Evan:
So you can look at either how much liquidity is on screen. So how much in, say, dollars you can buy and sell of an ETF. You can also look at how much a particular ETF trades, historically. Both of these aren't necessarily very good indicators of how much actual liquidity there is in an ETF.

Evan:
So if you look at historic trading volume, that's probably a bit more of a signal of how popular an ETF is and how many investors are trading, but doesn't really tell you about how much you could trade if you wanted to really trade a large amount of a particular ETF. So to understand a bit more about that, you have to look at the actual portfolio of the ETF and see what it's made up of, what the securities are in there and what the underlying liquidity of those securities is.

Evan:
So in theory, an ETF is really just a rapper and just effectively a look through to the underlying portfolio. So if the underlying portfolio is highly liquid, say ASX 200 stocks, then trading liquidity of the ETF or theoretical, at least liquidity of the ETF, is more or less unlimited from the perspective of most investors. I think the only other thing to consider aside from the liquidity of the underlying investments is which market makers are involved in ETF.

Evan:
So certain market makers when they hold inventory, when they create and redeem, there's a funding cost to those market makers. So certain market makers might have access to more

capital and be able to trade in larger parcels. But yes, for most investor trading ETFs on a daily basis, that's not really a concern, but it's worth understanding just in terms of how it works at the sort of institutional scale as well.

Kate:
Yeah. That's really interesting because I've seen a few questions pop up in our Facebook community before, when someone's been looking at a particular ETF, it might be a little bit more niche. And there's only been one trade in the last day and they were going, "Oh, is that a bad sign? Does that mean I won't be able to buy and sell in the future?"

Kate:
And I guess you answered that question because different ETFs aren't always as popular on individual days, but because of that market maker and the liquidity, it doesn't really reflect necessarily that the ETF is not a good ETF just because there was one trade yesterday.

Evan:
Yeah. Exactly. When ETFs trade a little bit thinly as well, sometimes market makers aren't always showing the sharpest prices. So I think it's quite often worth contacting an ETF issuer in that case because there's potentially opportunity to get some better pricing in the market if there hasn't been much activity for a little while in some of those funds.

Owen:
Yeah. And just to confirm what Kate said there, you can check that by looking in your brokerage account and seeing how many buyers and how many sales there are, and seeing the trade history there as well. Evan, there's lots to unpack there, but I guess the one kind of actor that we haven't really focused on is the ETF issuer. So like ETF securities. What's the incentive for an ETF provider or ETF issuer and how do you guys get paid?

Evan:
Yeah. We're definitely a business like every other. So our revenue is the management fee of the ETF effectively. And that's not obviously straight profit. So there's a lot of costs and things that go in to running an ETF. So there's a whole range of direct costs that are really associated with a particular ETF. So they can be things like fees for custodial services, fund administrators.

Evan:
We need to have a registrar to communicate with investors, exchange fees. So trading on the ASX or CIBO markets. Quite often, ETFs will track an index. Those indices aren't free either. So there's index providers that charge fees as well. And then there's a whole other range of services, like auditing, legal tax, all those sort of things.

Evan:
So they're kind of what you would think about as being the direct costs that the funds management fee would pay for. And then indirect costs would be things like an ETF official would need to run a portfolio management team and have systems and things in place to

successfully run the underlying portfolios. They also have distribution staff and marketing and those sort of things to promote the ETFs. And then of course, there's usual business overheads and then an element of profit margin as well at the end of all that.

Kate:
That's interesting because we often using management fees to compare ETFs, but we don't often think about all the different costs involved, including the cost to actually replicate an index, which can be quite expensive depending on which index you're copying.

Evan:
Yeah, absolutely. Absolutely. And different fees are applicable for different types of funds as well. So there's certain cases an index might be more specialised than a sort of plain vanilla index. So it may have higher index fees.

Evan:
In other cases, that may be that you're trading in jurisdictions that are more expensive from a transaction cost perspective and a custody perspective as well. So it could be to do with the actual cost of holding and trading the underlying assets. But there's definitely a range of different inputs that determine what goes into the management fee and why certain management fees are higher and lower than others.

Kate:
Absolutely. Now Evan, this is probably a topic that people don't really like to talk about. And I don't see many discussions about it, but what actually happens if the ETF provider something goes wrong and maybe the ETF provider does close down? What happens to your money invested in those ETFs?

Evan:
Yeah. Well, fortunately, we've not had that situation in the history of the ETF market in Australia. I don't see [crosstalk 00:14:57] in theory. So as with any other managed investment, the assets of an ETF are effectively segregated. So they're held by a custodian. That custodian is highly regulated entity that holds assets for ETFs and also for a range of other institutions, but those assets are segregated and they're held in accounts that are in the name of the ETF itself.

Evan:
So the issuer or the responsible entity for the ETF will have effectively functional access to those assets to be able to transact on them and to manage the ETF. But the actual beneficial owners of those assets are effectively the end unit holders of the ETF. So if the ETF issuer were to fall over and effectively disappear overnight, those assets remain in custody for the benefit of the end investors.

Kate:
And to clarify, the custodian is a separate entity to the ETF issuer.

Evan:
Yeah. In most cases, the custodian is a separate entity. There's certain types of, I've seen some things like some of the new crypto currency unlisted funds, not ETFs at this stage, that have self custody and things like that. But in that case as well, there will still be a segregation of assets. So yes, in general, 99% of the cases, it is a separate entity.

Owen:
And I think it's worth pointing out that ETFs are a very well regulated in Australia because we've got obviously asset, but then we've got the ASX as well sitting in between that. From what I can tell, it seems there are a lot of protections in place.

Evan:
Yeah. That's right. So ASX sets the general framework for regulation, and the exchanges are effectively the bodies that operate those markets. So they're in a way the institutions that kind of enforce the rules. So they have a remit of certain products that they're allowed to let onto the markets. They have their own internal policies as well.

Evan:
But yeah, you're right. There's a lot of regulation around, and there's definitely restrictions on the types of ETFs that can be listed, and the types of service providers and things that can be involved in ETFs as well. So there's a whole lot of due diligence done around the whole process of an ETF from the underlying investment all the way through to how the fund operates.

Kate:
And all that is fantastic for consumers, because we do have a more rigorously checked product in our financial services system. So you did mention that the holdings of the ETF are kept in a separate account with the custodians. So if the ETF issuer did fall over, would a new investment manager be appointed in this situation, or would a liquidator be appointed to wind up the holdings in that separate account and pay them to the unit holders, you and me, who are beneficiaries?

Evan:
Yeah. Both of those are options, really. So it depends upon the individual circumstances. It'll depend upon things like the terms of the constitution of the underlying funds and what's allowable in terms of change of responsible entity or change of ETF issuer or manager effectively. And it will also depend upon whether there is another manager that's interested in taking a particular ETF on board as well.

Evan:
So I presume you would appoint an administrator who would take over the ETF provider that's fallen over. And they would look for a replacement manager who could then slot in and effectively continue managing those assets. And that should be almost a seamless process from the end investor point of view. And the other alternative, as you say, is to liquidate the portfolio so they could sell the assets of the portfolio and return the funds directly to the end investors.

Evan:
So just because the ETF issue has fallen over, that shouldn't impact the value of the underlying assets. Of course, well, the investors don't get to choose the timing of their sale in that case, but they will receive 100% of the proceeds back, and there should be no slippage or no real transaction costs associated with that for the end investors.

Owen:
It's like a hypothetical thing. Isn't it talking about the actual ETF providers going under, like you said, that has happened, at least here in Australia. And it's very rare in any case. But the thing that has happened in Australia is some ETFs closed.

Owen:
And I think one of the fears is that people who buy into an ETF and they think, "Oh, this is a great ETF. I'm really excited about this opportunity", but it doesn't really seem to get much traction, like other investors aren't as excited about it, it doesn't really grow. And then they get news that the ETF is closing down. Can you just describe kind of what happens in that process? And maybe if, then we'll talk about how maybe we can identify those ETFs.

Evan:
Yeah. Sure, sure. Unfortunately, that's something that happens from time to time. So there's probably a couple of reasons that an issuer would look to close an ETF. One is due to a one off event. That's not really something that's happened much in Australia. But for example, 2020, we saw offshore, we saw a lot of things like leveraged oil ETFs. When COVID struck, oil price fell through the floor.

Evan:
And in fact, the near term futures contracts actually went into negative territory back in March 2020. So we saw some things like leveraged oil. Those funds just went to zero. So they were forced to terminate. We've got the situation at the moment of, again, offshore funds holding predominantly Russian assets at the moment are many of those are suspended and there's potential that they'll have to liquidate in the near future and potentially for very little value.

Evan:
But I guess the most common scenario is where an ETF's been launched, has sat on the shelf for a few years, failed to really get any traction with investors. It's not to say there's anything particularly wrong with the ETF, it's just hasn't either had the right market timing, or hasn't been promoted sufficiently in the right segments for one reason or another. There's not that much investor interest in the fund.

Evan:
And in that case, an ETF issuer can choose to close down the fund. But in doing that, in some way it's in the ETF issuer's interest, because they have costs and things associated with the

fund, but it's also in the investor's interest as well. So if you are sitting in a fund with very little activity in it, bit of a spreads are going to be wider than they would be on an active fund.

Evan:
So there's costs of getting in and out aren't necessarily in the investor's favour. There's things like any fixed costs in the fund over a very small fund will be larger in terms of percentage costs. So it's actually more costly and not really in the best interest of the end investor to continue on with certain funds at least.

Owen:
Now we saw a few ETFs in the last couple of years, particularly, and you talked about like investor interest. I think that's one of the big key things that I've I've noticed is not enough investors investing in the fund to make it profitable for the ETF provider.

Owen:
So it's just being aware, most of the big ETF providers, ETF security is included to put a lot of time in care, right into picking which ETFs to offer because of that because they don't want to launch a product and then it just kind of, no one really invests in it. That's kind of defeats the purpose.

Owen:
So one of the things that's interesting to know, Evan, is would investors have a chance to sell out? Would they get a notification to say, this ETF is going to be closed on X date? You can either sell it or you can hold onto it and then we'll give you the cash. Is that typically what happens?

Evan:
Yeah. So usually, and there's some discretion around this from ETF issuers and also there'll be some differences in terms of, again, the underlying sort of constitutions of funds and what they're allowed to do and what they aren't allowed to do. But from experience, what we've general seen in the market here is that the issuer will make an announcement.

Evan:
So that'll be a public announcement that goes out via the ASX and that will then get picked up by things like brokerage firms. So they'll display that on their pages for a particular security, for a particular ETF, and then news wires and things will pick that up as well. So it'll be in the public domain. Also, any existing investors will get notified by the registry.

Evan:
So they'll receive either an email or a letter communicating to them that the fund is going to terminate. What usually happens is that there's a period of, I guess, post announcement trading. So that'll be normal trading. Market makers will still be in place. They'll still be offering to buy and sell units at close to the nav at any point in time. So trading will carry on as normal.

Evan:
So people have the option to exit via the secondary market, so they can trade out on exchange to sell on their brokerage accounts. They have a certain window during which they can do that or they can stay in the fund and be liquidated when the fund terminates. So at that point, the ETF issuer will sell down all the remaining securities in the fund and determine the final liquidation value and then distribute that equally on a per unit basis to holders.

Owen:
So it's kind of like they give you a fair warning, then you have a choice, you can go on your brokerage account, sell it, or you can wait for them to liquidate it? I imagine most people would probably sell it if they're in that situation. And I imagine the key concern for people would be either capital gains or capital losses at that point. How do they manage that for their own affairs? So that's good to know.

Owen:
I think that the kind of key takeaway there is just be aware of what's being announced by the ETF issuer. And in your brokerage account, if you click that news and announcements tab, I think that's key there. Evan, this has been a really good episode because we've really got into the nitty gritty.

Owen:
We've talked about open-ended structures about market makers, authorised participants and how a lot of that liquidity is kind of predetermined by the quality of the market makers, but also the asset class, like as shares would be more liquid, meaning good, than say things that aren't as liquid in the underlying asset class. Kate, what are some of your takeaways?

Kate:
I think just reminding like how market makers and that open-ended structure works because it's quite a different way of operating than investing in individual companies is good. And I think it is helpful and it gives a lot of confidence to investors just knowing what happens if either the provider closes down or the individual ETF closes down, because we're all investing in ETFs but we often don't ask the questions about underneath.

Kate:
And we are very big on reading the product disclosure statement, actually having a look at all those details. You can even find out who the custodian and the registry and all of those details are before you invest as well. And Evan, I was just wondering, since you are running ETFs day in, day out, and you're getting lots of questions, are there any things that we didn't ask you in today's conversation that you get asked all the time about how ETFs work that you'd want to add for our listeners?

Evan:
That's an interesting one. I think you had a good point there around making sure you have a look at the product disclosure statement. That's something that I think a lot of people don't

necessarily look at too closely. So as you say, that will have all of the service providers listed. You'll be able to see where the assets are held.

Evan:
In some cases, for example, we run physical metals funds, physical precious metals funds, where you can see exactly which vaults those funds are held in or those bars are held in. So it's, I think, looking underneath the hood or either in the PDFs or on the issuers website is key to understanding how an ETF actually works.

Owen:
That's a fascinating one because I know there's like a Excel spreadsheet that you can get which shows you the gold bars. And it tells you how much is held. And we've [Canasio 00:27:10] on the show before, he talks about all the gold and the vault and how secure it is. He wears like a badge of pride, I think.

Evan:
Yeah. Exactly. You can see exactly who the refiner is, how much the bar weighs. There's a whole lot of detail there if you care to take a look.

Owen:
Yeah. Great. And I think the thing for me to take away from this episode too, is that there are a lot of protections in place. And at the end of the day, the end investor is the one who still owns assets. So in a normal market, should the worst happen, you are still the owner of the investments, and one way or another, that's yours.

Owen:
So I think that gives a lot of reassurance to people, Evan, who are now all of a sudden finding themselves accumulating a lot of wealth inside ETFs. And I think we spoke off air. That's probably going to happen more and more. People are going to build huge portfolios out of ETFs. So once again, thanks for taking some time to join Kate and I on the show. Really appreciate it.

Evan:
Fantastic. Thanks very much.