CONFUSION ABOUT UNIT TRUSTS AND EXCHANGE TRADED FUNDS (ETFs)

Mike Brown, etfSA.co.za

Some investors, even financial advisors, believe that unit trusts and ETFs are completely different types of products. Therefore, only unit trusts or only ETFs, can be considered appropriate for a typical portfolio, when in truth, both products have very similar characteristics and structures and should be considered side by side, rather than in opposition to each other, when picking the right investment products.

SIMILARITIES

Regulatory Control

Both ETFs and Unit Trusts are registered as Collective Investment Schemes. The requirements of CISCA, FAIS and FICA are exactly the same for both products. A FSP, licensed under Category 1.14 of FAIS can offer both unit trusts and ETFs to their clients.

Structures

All underlying assets, in either unit trusts or ETFs are held in Trusts, with FSB approved Trustees and custodians responsible for the oversee and reporting on these assets. The Collective Investment Scheme trust structure allows income, expenses and distributions to pass through the structures in a tax efficient manner and also enables daily reporting on NAVs, asset/liability matching and pricing for both unit trusts and ETFs.

Investment Avenues

As CIS products, both unit trusts and ETFs qualify for inclusion in retirement funds, plus institutional and other prudential portfolios. Because of their unitised nature, both products also suit retail investors and recurring savers.

DISSIMILARITIES

Listing on JSE

As ETFs are not only Collective Investment Schemes, but are also listed on the JSE, this makes them more transparent, able to trade throughout the day and highly liquid – as there is continuous trade on the exchange and compulsory market makers to ensure liquidity.

Investment Mandates

Unit Trusts typically have **active management** mandates, where the asset manager tries to outperform the benchmark index. This can have performance benefits for the investor and can widen the choice and flexibility of assets chosen by the manager.

ETFs have **passive investment** mandates, as the JSE requires that the underlying component of the portfolio must be known to investors at all times, so only market indices meet this requirement. The passive mandate has the benefit of lower costs, complete transparency and relatively low risk.

Risk

Risk for the investor is normally measured by the risk adjusted return, which calculates the risk as the deviation, or volatility, of the fund against a benchmark index. Actively managed unit trusts can typically have their risk measured and monitored on this basis. Index tracking ETFs deliver the benchmark, at low cost, and therefore their standard deviation against the beta measurement is not material, i.e. it is difficult to measure their risk in the traditional way. However, an ETF which only seeks to deliver the benchmark (or average) market return has inherently low risk.

Access

Unit Trusts can only be transacted through the issuing Manco, or through LISPS. ETFs can be transacted with stockbrokers or through specialised service providers, such as etfSA Investor Plan, who utilise administrators which have the required systems to deal with JSE rules, systems and dealing requirements.