**The Attractiveness of Exchange-traded Funds**

Exchange-traded funds (ETFs) are hybrid investment products which have a unique set of characteristics. ETFs offer investors the best of features of both unit trust funds and individual stocks. This article will look at the differences and similarities of ETFs compare with other types of investments.

**Comparison of ETFs with Other Investments**

Before we do a comparison, let us first understand what other common investment options are, namely unit trusts and stocks, as it can help to enhance investor's understanding of how ETFs are structured and how they are similar or different from these other investments.

An ETF is a collective investment scheme, listed and traded on a stock exchange. It is a collective investment scheme that tracks or follows the performance of a benchmark index. An index is made up by a basket of securities and usually reflects the movement of an entire market. This gives ETF investors the opportunity to invest in a pre-packaged basket of securities of an index rather than just an individual security. ETF can also be used as a tool to build one's investment portfolio.

Similar to ETFs, a unit trust fund is a vehicle which enables individuals, corporations and institutions with common investment objectives to pool their money for investment. Professional fund managers then use this pooled money to acquire investments which will help meet those objectives. These sort of investments can include investments which are not available to investors through direct investment, such as corporate bonds.

A more popular investment, stocks or equities are shares of ownership of a company. Stocks entitle the investor to receive profits from the operations of the company, usually by payment of a dividend, and to any voting rights attached to the stocks.

These three instruments are unique and can be compared in the following aspects: diversification; fees, charges and expenses; and tradeability in terms of liquidity and flexibility. Table 1 shows a summary of the comparison of these financial instruments.

**Table 1: Comparison of ETFs with Stocks and Unit Trusts**

| No | Instruments | ETFs | Stocks | Unit Trust |
|---|---|---|---|---|
| 1 | **Diversification** | √ | X | √ |
| 2 | **Fees and Charges** | | | |

| | | | | |
|---|---|---|---|---|
| | **Entry Charge** | X<br>Brokerage fees apply[1] | X<br>Brokerage fees apply[1] | Up to 6.0% of NAV per unit |
| | **Management Fees** | Less than 1% of the fund's NAV[1] | X | Up to 1.8% per annum |
| **3** | **Tradeabality** | | | |
| | **Intra-day Pricing** | √ | √ | X |
| | **Trading Flexibility** | √ | √ | X |
| | **Liquidity** | Intra-day | Intra-day | Intra-day |
| **4** | **Affordability** | √ | X | √ |

Note:Brokerage fee of up to 0.70%2, clearing fee of 0.03%1 and stamp duty are applicable when trading securities on Bursa Malaysia.

**1. Diversification**

ETF provides investor with a diversified portfolio of securities, all in a single fund. Each ETF unit follows the performance of its benchmark index. It is intended to provide investors with similar diversification benefits to the holdings of the benchmark index's many constituent stocks without having to invest in each of the stocks directly.

In comparison, stocks do not provide investors with any diversification as any investment going into a stock means the investor is buying into an individual company. Unit trusts, on the other hand, provide diversification but the diversification is based on the funds' investment strategies. Therefore, unit trust investors might not have the same benefit of an entire market diversification like ETF investors.

**2. Fees, Charges and Expenses**

ETF offers low fees, charges and expenses such as low transaction costs and management fees. It does not incur entry fees as compared to other unit trusts which charge fee of up to 6.0% of the net asset value (NAV) of a fund. ETFs incur transaction costs such as brokerage fee of up to 0.70%, clearing fee of up to 0.03% and stamp duty which are applicable when trading securities on Bursa Malaysia[1].

As a passively managed fund, an ETF incurs lower management fee of less than 1%[1], as compared to a managed fund's management fee of up to 1.8% per annum. Investments in stocks do not incur management fees as it does not involve any professional management.

For example, FBM KLCI etf investors only have to pay an annual management fee of less than 1% and no entry fee but subject to brokerage fees which are nominal. A similar index tracking unit trust fund will incur an entry fee of up to 6% of NAV per unit and up to 1.8% of NAV per annum for management fee.

These charges make ETF a cost-efficient investment to gain access to a diversified portfolio through a single transaction.

**3. Tradability**

ETFs experience price changes throughout the trading hours of the stock exchange as they are bought and sold. They are traded through regular brokerage account and settled like ordinary stocks. In addition, ETF investors do not need to worry about liquidity as market liquidity is enhanced with the presence of market makers. Market makers are always ready to buy and sell to investors.

On the other hand, transactions for unit trust can only be settled at the end of the day. It cannot be traded throughout the day like stocks as the NAV is only calculated at the end of the day. As such, unit trust does not offer trading flexibility like stocks and ETFs. Investors will not enjoy the liquidity benefit like the ETFs investors as there are no market players for unit trusts investments.

**4. Affordability**

ETFs are very affordable compare to stocks and unit trusts. The minimum trading board lot size is 100 units. If the FTSE Bursa Malaysia KLCI is at 1,052.26, an investor who wants to buy the FBM KLCI etf only has to pay RM1.05 to buy the minimum lot which means the investor has to only fork out RM105 to buy the ETF. The initial investment for unit trusts start from RM1000.

**5. Conclusion**

ETFs are attractive as alternative investment tools because they offer a unique combinations of the best features from both worlds of unit trusts and stocks. The unique attributes and benefits of ETFs appeal to both individual and institutional investors.

Investors who want to diversify their investment might want to consider ETF as it gives diversification through a diversified basket of securities, incurs lower fees, charges and expenses compared to other investments as well as offers trading flexibility and liquidity.

Sources:

[1]Bursa Malaysia (http://www.bursamalaysia.com/market/securities/education/faqs-on-exchange-traded-funds-etfs/) as at 29 April 2016.

[2]Bursa Malaysia (http://www.bursamalaysia.com/misc/system/assets/12517/schedule6.pdf) as at 29 April 2016.

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