

# Why ETFs are in urgent need of a makeover

Some key changes should be made to protect investors

CHRIS DIETERICH

Thursday, June 23, marked an anxious day for members of the exchange-traded-fund industry. While most of Wall Street anticipated the stockmarket's opening bell in the wake of the Brexit vote, ETF insiders had another worry: whether a sharply declining market could spark the same problems seen in last year's flash crash, the industry's biggest black eye to date.

Jenny Hadiaris, a stockmarket structure specialist at Deutsche Bank, wrote to big clients ahead of the British referendum: "Be aware that not a whole lot has changed in the 10 months since our last 'flash-crash' like event," she noted.

"Many of these cracks have yet to be filled." She was referring to the frenzied market open last August, in which many popular ETFs became temporarily unglued from the value of their underlying stocks.

Some big, blue-chip equity ETFs fell nearly 50 per cent in a few hours, even though the Standard & Poor's 500 index declined by only 5.2 per cent at its worst. The declines were brief, though unprecedented, and every major ETF provider was affected.

A post-Brexit crash never materialised — good news because most ETF companies say that investors are vulnerable without a broad series of fixes.

Now, let's be clear: this is not an industry in crisis, but it is an industry in transition. Though just over 20 years old, ETFs are in something of an adolescence.

Investors' love affair with indexing aside, it's the ETF structure that is most widely touted. ETFs can trade throughout the day, but that ease of trading, however, is where problems can crop up.

## FIVE THINGS YOU NEED TO KNOW

**1** For Australian investors, ETFs have primarily been used as a way to access overseas markets without taking bets on specific stocks. In fact, international share ETFs overtook Australian share ETFs for the first time last year.

**2** ETFs may be sold as funds that perfectly mirror the indices they aim to follow — such as Nasdaq or the Hang Seng — but they can vary from those index returns by as much as half a per cent due to fees. The gap can be even larger if they are designed to short the market and benefit from its decline.

**3** Locally listed ETFs can also vary immensely, even when it seems they are designed to achieve identical objectives: Last year there was a difference of more than five percentage points between the Vanguard Australian Shares High Yield fund and the iShares S&P/ASX Dividend Opportunities fund returns last year — yet both ETFs would have attracted investors looking for a similar service.

**4** In a relatively flat stockmarket, the ETF industry has been red hot: Stockspot's 2015 ETF sector report highlighted that in the 12 months to June last year, funds under management increased 66 per cent to \$17.8 billion.

**5** In seeking to use ETFs to access offshore markets, local investors should always check which currency the fund is held in — and also whether they fund includes the ability to "short" the market. Both these issues can greatly affect returns.

For investors to feel protected and the industry to thrive, some small but important changes need to be made. Here are the most crucial problems, and how to fix them.

**1. The problem:** ETFs can run into trouble in stressed markets when their holdings aren't trading. **The fix:** Exchanges need to synchronise how stocks and ETFs operate around the opening bell.

To fully understand what was causing ETF insiders such concern on June 23, investors must understand what happened during the flash crash. Exchange-traded funds are commonly referred to as baskets of securities that trade like stocks. That breezy description belies their complexity.

ETFs are structured in a way that incentivises "authorised participants" — trading firms and banks — to keep the prices of the funds in line with the value of the securities they own. Typically,

whenever an ETF's share price falls below the sum total of the price of its stocks, authorised participants buy those discounted ETF shares and exchange them for the individual securities, which they can then sell at a profit.

This arbitrage process is what keeps ETF prices closely in line with those of their holdings.

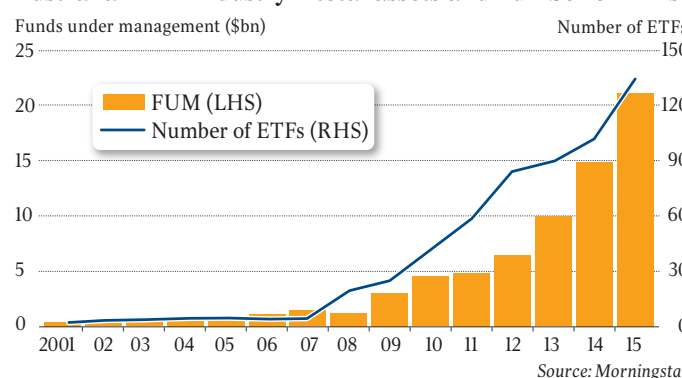
But for about an hour on the morning of August 24, 2015, amid a steep stock slide, this process broke down.

The morning of the flash crash, ETFs opened for trading long before large swathes of their underlying stocks were officially open. The New York Stock Exchange's all-electronic Arca exchange, where about 80 per cent of ETFs are listed, opened at 9.30am. The same was true for the ETFs listed on the Nasdaq Stock Market and Bats Global Markets.

But the NYSE, the primary



## Australian ETF industry – total assets and number of ETFs



market for the majority of big-cap stocks, required human traders on its exchange floor to help open stocks. Almost half of NYSE stocks, or 2 per cent of the S&P 500's components, didn't open by 9.40am.

Some small changes have been made: early in July, the Big Board

won permission to more easily open stocks electronically. That should help alleviate the problem, but not end it. For that, volatility must be addressed.

**2. The problem:** Exchanges halt trading in stocks and ETFs when volatility spikes, but that complicates how funds are priced.

**The fix:** Exchanges should finetune how stocks stop trading, and begin again.

Three years after the 2010 flash crash, the SEC directed exchanges to implement rules to address aberrant swings in individual stocks and ETFs. Since then stocks are typically allowed to trade only in a range 5 per cent above or below the average price over the past five minutes.

In their first major test last summer, the rules appear to have confounded the ETF arbitrage mechanism. Some action has been taken to recalibrate triggers for single-stock circuit breakers. Representatives from exchanges have been meeting regularly and agree that rules must be harmonised.

**3. The problem:** Not all exchange-traded products are exchange-traded funds.

**The fix:** Create clear product definitions. "ETF" has become a

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catch-all term for any basket of securities traded under a single ticker. But the differences among these products are important to understand.

**4. The problem:** Many ETFs don't trade much; for others, SEC approval takes too long, making launches of new funds very slow.

**The fix:** The SEC just announced new rules that will accelerate the launch of actively managed ETFs. But exchanges must be more diligent in delisting small and little-traded products.

**5. The problem:** Market orders are the default choice on all brokerage platforms.

**The fix:** Investor education, but brokerages could do more.

So what's an investor to do? In short, be wary of the "ET" in ETF. The ETF pricing mechanism works nearly all of the time, but hasty trading, especially in rocky markets, can quickly erode the benefits of low fees and tax efficiency.

Trading smarter means thinking not only about the composition of an ETF and management fees, but also what order types to employ to buy or sell. Investors who focus most on the "F" — the portfolio for stocks — will be served by the benefits of ETFs that will play out over the long term.

*This is an edited version of a feature which first appeared in Barrons.com*

## Understanding the definition of a super contribution can guide SMSFs to the right choices

MONICA RULE



What is a superannuation contribution? It's important to know what it is because it can have big implications for staying under the contributions cap.

The superannuation law does not define the term "contribution". However, in the Tax Office's publication, Tax Ruling 2010/1, it states a "contribution" is anything of value that increases the capital of a superannuation fund, provided by a person, whose purpose is to benefit one or more particular members of the fund or all of the

members in general. Not every increase in the capital of an SMSF is treated as a contribution. We must consider the probable consequences of a transaction to determine whether a contribution has been made. A person's objective purpose is taken into account and not their subjective intention. An increase in an SMSF's capital due to income, profits and gains arising from the use of the SMSF's assets, is not derived from someone whose purpose is to benefit the SMSF's members.

For example, an SMSF's bank's intent is that it pays interest on deposits due to obligations arising under the contract it has with the SMSF and not to benefit SMSF members; or a company pays a dividend to provide a return to its shareholders and not to benefit the members of a particular shareholder that happens to be a superannuation provider.

But there are other situations where a member may not realise they have made a contribution to their SMSF. For example:

- A member transfers an asset without consideration to their SMSF;

- A member satisfies an SMSF's loan obligation as a guarantor to the loan. The guarantor's payment extinguishes the SMSF's liability to the lender and increases the capital of the SMSF;

- A member adds a fixture to an SMSF's property;

- A member pays the SMSF's expenses. The payment of the expenses increases the capital of the SMSF because it extinguishes the liability of the SMSF.

The timing at which a contribution is made will determine whether the person who made the contribution is eligible to claim a tax deduction in a particular financial year, as well as whether they

have exceeded their contributions caps.

In accordance with Tax Ruling 2010/1, a contribution is made when the capital of a fund is increased, and the capital of the fund is increased when an amount is received, or ownership of an asset is obtained or the fund otherwise obtains the benefit of an amount. The ruling provides a range of examples.

Here are six key events to watch carefully:

### 1. Cash and EFT transfers

A cash contribution or a contribution made by an electronic funds transfer is made when the amount is received by the SMSF trustee or credited to the relevant SMSF bank account.

### 2. Cheques and promissory notes

A contribution by money order, cheque or promissory note is made when they are received by the

**We must consider the probable consequences of a transaction to determine whether a contribution has been made**

SMSF. If a cheque is postdated or a promissory note is payable on a date later than the day on which the note is received, then the contribution will be made on the later of the day the cheque or note is received and the date on which payment can be demanded as shown on the cheque or note. No contribution is made if the cheque or note is dishonoured.

### 3. Property transfers

A contribution by way of a property transfer is made when the SMSF obtains legal or beneficial ownership of the asset from

the contributor. Beneficial ownership may be acquired earlier than legal ownership in situations where an SMSF acquires physical possession of the property. However, ownership of property may also pass on the execution of a deed of transfer of the property notwithstanding there has been no change in the physical possession. Legal ownership of property is normally evidenced by a system of formal registration where the SMSF is registered as the owner. In the case of a sale and an acquisition of land, beneficial ownership normally passes when the purchase is settled and the buyer hands over the purchase price in exchange for a completed transfer in registrable form.

### 4. Share transfers

A contribution of shares in a company is made when the legal ownership of the shares is recognised by the SMSF's name being

registered in the company's share register. This is for shares in a publicly listed company processed through the Clearing House Electronic Sub-register System (CHESS). However, beneficial ownership of shares in an Australian Securities Exchange-listed company can be made through an off-market share transfer, when the SMSF obtains a properly executed off-market transfer in registrable form.

### 5. Improvements to an asset

A contribution is made when the capital of the SMSF is increased because of the increase in value of the SMSF's asset due to the improvements made.

### 6. Payment of a liability

A contribution is made when a person satisfies an SMSF's liability. Knowing whether and when a contribution has been made can prevent you paying excess tax.

In general, whether a contri-

bution is made when beneficial ownership of property or assets occurs is determined on a case-by-case basis. An SMSF trustee that seeks to argue that the contribution of property occurs when the beneficial — not legal ownership — of the asset passes to the SMSF, must retain sufficient evidence of the relevant transactions and events to precisely identify when the change of beneficial ownership occurs.

Evidence can include: trustee minutes, relevant transfer forms, and any other record of when the transfer occurred. Without evidence, the contribution will be considered made when the SMSF obtains legal ownership of the property.

*Monica Rule is an SMSF specialist and author of The Self Managed Super Handbook — [www.monicarule.com.au](http://www.monicarule.com.au)*

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