

How To Build Your Exchange Traded Fund Portfolio *By Harold Toh*

Simple portfolio construction solutions for your ETFs.

EXCHANGE TRADED FUNDS BY
LYXOR

LYXOR ETF in collaboration with INVEST,
presents an ETF Education Series.

This is the final installment of an ETF educational series that was started about 10 months ago in collaboration with Lyxor Asset Management, the most prolific issuer with 18 Lyxor ETFs listed on the SGX. After looking at the various technical and practical aspects of ETFs in past articles, we hope to bring this venerable educational series to a conclusion by sharing with our readers some practical ideas on how to take advantage of the Singapore-listed ETFs.

One key lesson that investors have learned during the current financial crisis is the importance of diversification. The plight of such marquee names as Bear Sterns, Lehman Brothers, AIG and many other major financial institutions have highlighted the high risk of concentration. For those same reasons that ETFs were deployed to diversify risk during market declines, they are now being keenly employed to take advantage of the recovery in the markets. In both cases, diversification is at the core of the decision. As long as markets remain volatile, capturing market exposures efficiently and conveniently will be the key to investment success as individual stock and selective country specific risks continue to run high.

For investors who believe that the worst is over and are now looking towards benefiting from a market recovery, the diverse range of ETFs currently available in Singapore offer some very handy tools for customising portfolio construction. These ETF products cover not only most Asian markets, but also selective global markets and commodities. Please refer to Table 1 for the Year-to-date performance

of selective global markets. Note that many of the top performing markets in 2009, such as, Taiwan, India, Latin America, Vietnam, etc., are already represented by ETFs listed on the SGX. In short, given the right portfolio construction, global opportunities can be realised and diversification can be achieved through these ETFs.

THE CORE & SATELLITE INVESTMENT STRATEGY

The concept of Core & Satellite investing was introduced in an earlier article. To recap, the Core & Satellite strategy represents one of the most effective and widely used investment strategies in the investment world. Once off-limits to smaller investors due to its complexity and large capital requirement, the strategy can now be easily adopted even by small investors through the use of ETFs. This strategy is recognized to be one that would deliver a good balance of performance, risk and costs and is suitable for all type of investors.

The basic construction of the strategy involves dividing investments into a stable core portfolio and a satellite portfolio containing "higher risk/higher return" investments. The core portfolio is designed to deliver long-term performance with low active risks and costs, and is usually comprised of broad-based index products. Satellite investments, which are charged with delivering "Alpha" or out-performance, can be adjusted more frequently, and are supported through higher management fees. The split between the core and the satellite depends on the individual investor's risk/return appetite.

With 35 ETFs currently listed on the SGX covering both broadly diversified indices and specific indices on equities, fixed income, commodities and precious metals, ETFs are prime candidates for both the core and satellite portions of a Core & Satellite portfolio. More customised and complex investment portfolios can also be constructed when mixing and matching ETFs with other investments products, such as individual stocks, mutual funds, physical commodities, real estate, and even hedge funds.

This do-it-yourself approach can be an inexpensive way to build one's portfolio because of the low transaction costs. The main features of ETF's, namely their efficiency, flexibility, transparency and ease of trading make it possible for an investor to own a liquid, diversified portfolio at minimal cost and for an minimal amount.

Singapore investors should take comfort in the fact that ETFs are being increasingly embraced as evidenced by a 119 per cent jump in trading volume from 2007 to S\$2.52 billion, equivalent to a daily trading average of S\$12 million. Year-to-date, ETF trading volume has continued to pick up reflecting new product listings and increasing demand.

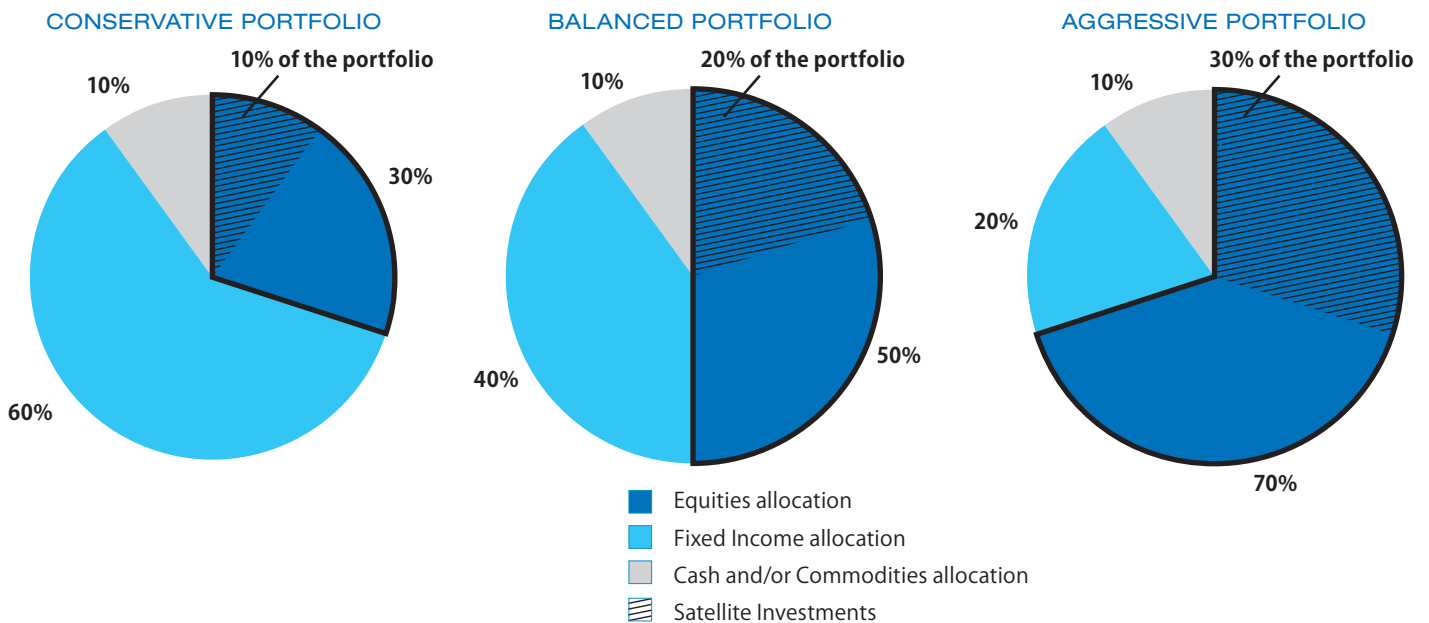
THINGS TO CONSIDER BEFORE CREATING A PORTFOLIO

Determining your risk profile and the types of investments most suitable for you are, perhaps, the most important steps to take. Moreover, as investments fluctuate in value, it might be prudent for you to be

Table 1: Year-to-date Market Performance Snapshot taken at 10am (HK time) on 26 May 2009.

Markets	Current	%YTD	ETF listed
Asia Pacific Indices:			
Hong Kong (HSI)	17050.34	13.35%	Yes
Korea (KOSPI)	1,386.32	19.78%	Yes*
Taiwan (TWSE)	6,767.77	44.05%	Yes*
Singapore (FSSTI)	2,267.46	23.92%	Yes
Shanghai SE A-shares	2,726.23	38.06%	-
India (SENSEX)	13,913.22	39.72%	Yes*
Thailand (SET50)	390.71	14.87%	Yes
Malaysia (KLCI)	1,053.14	17.75%	Yes*
Vietnam (VNINDEX)	421.75	34.60%	Yes*
MSCI Asia ex-Japan (MXAPJ)	309.94	23.19%	Yes
World Major Indices :			
NIKKEI 225	9,267.93	2.49%	Yes*
S&P 500	887.00	-4.81%	Yes
DJIA	8,277.32	-8.38%	Yes
NASDAQ	1,692.01	3.66%	Yes
DJ Euro Stoxx 50	2,440.23	-3.79%	-
MSCI World	942.67	-0.35%	Yes
MSCI Emerging Markets	274.18	29.93%	Yes
MSCI Russia	619.70	52.53%	-

Source: Bloomberg. * ETFs listed may track similar indices.



The three pie-charts show sample model portfolios of Conservative, Balanced and Aggressive asset allocation. In reality, the exact allocations among the different asset classes should be a function of an individual investor's own risk/return appetite. Investors should note that the risk/return profile of these portfolios can be further fine-tuned by the nature the underlying investments within the different asset classes. For example, the Conservative portfolio is expected to hold mostly bonds with good credit rating and a diversified equity portfolio whereas the Aggressive portfolio can be expected to contain emerging market bonds and single market equity exposures. Finally, please note that the Core & Satellite strategy can be superimposed on the portfolio construction with the shaded area representing satellite investments where they are typically higher risk/higher return in nature and can be traded relatively readily.

prepared to rebalance and take profits from your portfolio from time to time. Another variable is the investment time horizon. How long will it be before you need this money? Do you have sufficient holding power in the event the investments go through a “rough patch”? Can you remain invested for a reasonable period of time? The time horizon will also help to determine the overall risk profile. The longer the time frame, the more you will be able to take on risky assets.

If you need to access cash on a regular basis, you may want to include in your portfolio some bond investments which yield regular income or hold cash or near-cash investments such as money market funds.

Finally, you would need to answer such risk questions as: what is your tolerance for risk? Would you be able to sleep at night if the market were to fluctuate by 5 to 20 per cent in a single year? The greater the tolerance for risk, the higher the proportion that equities (equities are considered riskier than bonds and cash) may take in your portfolio. In terms of using ETFs as inflation hedges, there are commodity and precious metal ETFs. A word of caution: Discipline is perhaps the most important factor in determining if your portfolio will be successful or not. Don't overreact to short-term swings in market values.

PORTFOLIO CONSTRUCTION

The simplest portfolio can be constructed with a single ETF, especially one of those in which the underlying investments cover an entire market, a whole region or an entire asset class. For example, an investor with only local ambition can make use of the streetTrack STI ETF or the DBS STI ETF. An investor with a global ambition can take advantage of the Lyxor ETF MSCI World to gain exposure to global developed markets. If the same investor were to add the Lyxor ETF MSCI Emerging Markets to the mix, he would end up with a truly global exposure comprising both global developed markets and emerging markets. The split between the two ETFs is a function of the risk appetite of the investor.

This sample portfolio is considered relatively low risk among equity investments as it is extremely diversified and effectively covers over 40 markets and more than 3,000 stocks around the world. To push the portfolio construction envelope further, the overall risk of the portfolio can be further reduced by introducing a third ETF, say, the ABF Singapore Bond, representing a different asset class. By the same token, if the Lyxor ETF CRB Commodities were also included, the risk/return profile of the portfolio will again be changed as it now comprises three different asset classes, namely, equities, bonds and commodities.

What if you want to spice up the portfolio? Using the Core & Satellite concept, you can regard the sample portfolio that we have just constructed as core investments and invest up to, say, 70 per cent of your total investments. Now, you will have another 30 per cent of your total investments that you can choose from emerging markets ETFs like India, Taiwan, Latin America or even the Asia Pacific ex-Japan

to provide potentially higher risk-adjusted returns. In this case, you only need to have a view on whether emerging markets are going to outperform developed markets or whether Asian markets would recover the fastest among the global markets. If you are a confident stock picker among Singapore stocks, by all means add a few to your “spiced-up” portfolio to take advantage of your skill.

As can be seen with these examples, it is relatively easy to construct broad-based portfolios with the help of ETFs. Of course, we don't have to stop at ETFs when we try to customise portfolios that cater to our own needs. Individual stocks, bonds, mutual funds, and even cash deposits can all be thrown into the mix. However, we do need to properly recognize or classify these investments as core or satellite investments in order to build an investment strategy.

Generally speaking, cash is considered the least risky investment, followed by bonds, indexed mutual funds (including ETFs), active mutual funds, stocks and more exotic investments such as hedged funds. Of course, investors have to take note that emerging market bonds and equities are riskier than their developed market counterparts; and regional bonds and equities safer than single country bonds or equities. Moreover, investors need to take into account their age (investment horizon) when asset allocating the different components within a long-term investment portfolio.

For example, a young investor in his 20s will have more time to recover before he retires should there be a severe market downfall. In this case, his portfolio can afford to have a higher allocation of riskier assets comprised of equities or equity ETFs. In contrast, a 50 years old investor facing retirement in 10 years' time might have to adjust his portfolio to include a higher content of safe assets such as cash and bonds. Finally, a retired investor is likely to have most of his investments in income producing assets (as opposed to those that promise capital gains) so that he receives a regular stream of income for his living.

CONCLUSION

Investing is a life-long activity. An investment strategy which takes into account a prudent balance between return, risk and cost is essential to achieving long-term success. At the same time, the investment strategy needs to be flexible enough to cater to changing market conditions and investment horizons. The Core & Satellite strategy which divides up the portfolio constituents into core (long-term) and satellite (short-term, opportunistic) investments and with flexibility of adjusting the ratio between them, is one of the tried and true strategies traditionally used by the largest institutional investors. The advent of ETFs now allows small investors to tap into this same discipline and customise individual portfolios that cater to their own needs. With an increasing array of diverse ETFs (now standing at 35) listed on the SGX, investors are well advised to take full advantage of their presence to construct diversified and yet efficient investment portfolios. ■