Vanguard ETF quarterly report

June quarter 2019

In this edition:

- Australian ETF industry passes $50 billion
- Vanguard lowers the MER on the Vanguard Australian Shares Index ETF (VAS) to 10bps
- Fixed interest ETFs attract a third of total cash flows

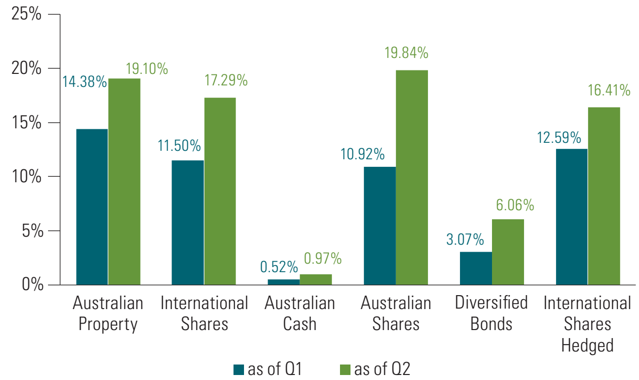
Quarterly economic and market review

Anyone hoping for an eventful second quarter was not disappointed.

The US yield curve flirted with inversion, China's economic data softened, and both the RBA and RBNZ cut cash rates. The Brexit plan became more uncertain, markets began speculating about potential 'insurance' rate cuts by the Federal Reserve, and trade tensions continued to simmer.

One would be forgiven for looking at the year-to-date market returns in disbelief. Even after a couple of volatile trading days, returns through 30 June for international and Australian shares were just shy of 20%. Market returns — except cash — do not appear drastically different from what they are in good economic times.

Figure 1: 2019 Q1–Q2 market returns for shares may surprise investors



Notes: Australian Property represented by the S&P/ASX 300 A-REIT Index, International Shares by the MSCI World ex-Australia Index, Australian Cash by the Bloomberg AusBond Bank Bill Index, Australia Shares by the S&P/ASX 300 Index, Diversified Bonds by a composite (30% Bloomberg AusBond Composite 0+ Yr Index, 70% Bloomberg Barclays Global Aggregate Float-Adjusted Index hedged to AUD), and International Shares Hedged by the MSCI World ex-Australia Index hedged to AUD. Source: Vanguard.

Not much has changed from the last quarter: unemployment rates are still low and inflation is below most central banks' targets. Trade activity has deteriorated as businesses pull back and watch the US-China trade dispute unfold.

Locally, the same story holds. Interestingly, while the uptick in the unemployment rate (from 5% to 5.2%) is seen as a bearish signal, labour force participation reaching an historical high (66%) is cast aside in the haste to join the chorus of negativity.

While steady declines in residential property prices garner widespread attention, the volume of property transactions has not. Fewer properties are changing hands, depressing stamp duties, brokerage commissions, and other business revenues. While high household leverage and tighter credit are likely factors, we wonder if the market is still working off the multi-year construction boom. In thinking of property as an investment, the data suggests that few buyers are willing to pay for property at current price levels.

Beyond the near term, we should continue to anticipate surprises. Slight changes in long-term return forecasts are not sufficient to justify a wholesale change to portfolio strategy. We'd caution investors against taking the bait and timing markets, lest one emotional decision compounds into a costly habit.

When the urge to change is strongest, the benefit is usually the weakest.

Australian ETF update

The Australian ETF market has grown its assets under management by $10 billion or 25% over the first half of 2019, to pass $50 billion in assets. The $4.6 billion of new cash flows received during the first half is the biggest first half on record and puts the Australian ETF industry on track to surpass the $8.1 billion in cash flows it received in 2017.

$4.6B

ETF new cash flows this year

Investors continued to embrace fixed income ETFs this year, with over a third of total cash flows going to fixed income ETFs. The potential reasons for investors moving into fixed income ETFs are numerous including: declining interest rates, concerns about the global economy, equity markets at record highs, and investors embracing the diversification benefits that fixed income ETFs add to their portfolios.

International equity ETFs were also very popular over the first half of 2019, albeit slightly less so in the second quarter compared to the first quarter. Cash flows dropped from 35% in Q1 to 28% in Q2. Within the asset class, investors have preferred to invest in broad based diversified products, rather than single country or specific sector exposures. The Vanguard MSCI Index International Shares ETF (VGS) continues to be the most popular exposure in the asset class, having attracted just under 30% of the total flows to the asset class this year.

From the industry perspective, domestic equity ETFs had only a slight uptick in cash flows from Q1 to Q2, however Vanguard's cash flows displayed a different story with 29% of its second quarter cash flows going to the asset class. VAS received $186 million of new cash flows for the quarter making it Vanguard's most popular product during the second quarter. Around $150 million of the flows into VAS came after the federal election indicating that investors decided to re-weight their portfolios back to domestic equities to take advantage of the Coalition government not changing the franking credit rules.

Vanguard continues to attract the most cash flows across the industry, with 38% of total cash flows going to Vanguard's ETFs. The large cash flows helped Vanguard's ETF AUM grow to $15.7 billion as at 30 June, up 30% from the $12.1 billion as at 31 December 2018.

During the quarter Vanguard lowered the expense ratio on VAS (Vanguard Australian Shares Index ETF) from 0.14% to 0.10%. This year alone, Vanguard has lowered the MER on VAS, VTS (Total US Market Shares) from 0.04% to 0.03% and VEU (All-World Ex-US) from 0.11% to 0.09%, which means investors can gain exposure to equity markets across the globe at a reduced rate.

Industry cash flow by asset class

Asset class	Quarter ($m)	Quarter %
Australian Equity	582	20.8
Global Equity	784	27.9
Infrastructure	88	3.1
Australian Fixed Income	739	26.3
Global Fixed Income	152	5.4
Australian Property	161	5.7
Global Property	9	0.3
Commodity	–7	–0.3
Currency	–41	–1.5
Mixed	113	4.0
TOTAL	2,805	

Source: ASX Monthly Report and Vanguard.

YTD cash flow and AUM by issuer

Issuer	Cash flow $m	Cash flow %	AUM $m
Active X	9.0	0.2	15.8
AMP/BetaShares	–4.0	–0.1	72.0
Beta Shares	924.3	19.8	6,886.8
ETFS	37.1	0.8	1,289.9
Fidante	7.1	0.2	15.8
Fidelity	10.7	0.2	22.4
InvestSMART	15.6	0.3	55.4
iShares	831.6	17.8	13,012.5
K2	–9.2	–0.2	22.5
Legg Mason/BetaShares	57.5	1.2	131.0
Magellan	191.2	4.1	1,897.3
Montgomery	3.4	0.1	98.9
Perennial	–1.2	0.0	20.6
Antipodes	2.0	0.0	23.3
Russell	57.4	1.2	773.5
Schroders	–2.4	–0.1	55.9
State Street	171.4	3.7	6,396.0
Switzer	4.6	0.1	145.3
The Perth Mint	5.3	0.1	192.8
Platinum	37.4	0.8	479.7
UBS	–7.0	–0.1	284.3
VanEck	547.3	11.7	3,034.7
Vanguard	1,782.3	38	15,679.2
Total	**4,671**	**100.0%**	**50,605.6**

Source: ASX Monthly Report and Vanguard.

Vanguard product summary

Asset Class	ASX Ticker	Last Price#	MER	Quarter Return	1 Year Return	3 Year Return (p.a.)	Quarterly Cash Flow ($m)	FUM ($m)
Australian Equity ETFs								
Broad Market	VAS	$84.60	0.10%	8.00%	11.24%	12.69%	$185.6	$3,884.7
Property	VAP	$92.50	0.23%	4.13%	19.26%	8.37%	$109.7	$1,436.0
High Yield	VHY	$62.40	0.25%	8.89%	14.22%	11.10%	$31.1	$1,234.8
Large Companies	VLC	$69.20	0.20%	8.89%	14.45%	12.59%	$1.5	$92.5
Small Companies	VSO	$58.95	0.30%	4.43%	4.50%	11.40%	$7.0	$254.7
International Equity ETFs								
Developed Markets	VGS	$75.21	0.18%	5.25%	12.10%	14.11%	$120.7	$1,670.1
Developed (AUD hedged)	VGAD	$68.82	0.21%	3.47%	6.40%	12.63%	$48.6	$619.1
All world Ex US	VEU	$72.43	0.09%	4.19%	6.79%	11.35%	$34.0	$1,438.8
Total US Market	VTS	$212.80	0.03%	5.37%	14.78%	16.32%	$33.1	$1,620.4
Developed Europe	VEQ	$56.65	0.35%	5.18%	5.71%	10.45%	$3.9	$238.5
Asia ex Japan	VAE	$66.75	0.40%	0.60%	4.72%	12.56%	$26.2	$170.2
Emerging Markets	VGE	$68.00	0.48%	1.79%	8.20%	10.63%	$32.9	$317.2
Global Infrastructure	VBLD	$57.30	0.47%	4.32%	n/a	n/a	$10.5	$16.9
International Small Companies	VISM	$52.35	0.32%	3.21%	n/a	n/a	$4.2	$10.5
ESG	VESG	$51.74	0.18%	5.55%	n/a	n/a	$11.5	$29.8
Minimum Volatility – Active	VMIN	$56.01	0.28%	3.90%	8.59%	n/a	$0.0	$10.4
Global Value – Active	VVLU	$48.37	0.28%	1.53%	–1.83%	n/a	$1.0	$13.6
Multi Factor – Active	VGMF	$50.58	0.33%	n/a	n/a	n/a	$14.2	$14.4
Fixed Income ETFs								
Australian Composite	VAF	$52.08	0.20%	3.02%	9.40%	4.07%	$88.4	$1,019.9
Australian Government	VGB	$53.04	0.20%	3.21%	10.07%	4.01%	$93.9	$296.2
Australian Corporate	VACF	$53.07	0.26%	2.61%	7.79%	4.72%	$77.0	$262.1
International Treasury (AUD hedged)	VIF	$50.16	0.20%	2.58%	6.86%	2.57%	$52.7	$322.4
International Credit (AUD hedged)	VCF	$49.71	0.30%	3.24%	8.22%	3.87%	$35.8	$125.7
Global Aggregate (AUD hedged)	VBND	$52.66	0.20%	2.82%	7.44%	n/a	$17.5	$74.0
ESG	VEFI	$53.26	0.26%	2.60%	n/a	n/a	$2.6	$4.3
Diversified ETFs								
Conservative	VDCO	$54.25	0.27%	3.51%	8.06%	n/a	$18.3	$54.6
Balanced	VDBA	$55.08	0.27%	4.29%	8.99%	n/a	$39.6	$135.4
Growth	VDGR	$55.13	0.27%	4.85%	9.32%	n/a	$33.7	$135.2
High Growth	VDHG	$55.43	0.27%	5.43%	9.60%	n/a	$23.2	$176.5
							$1,158	**$15,679**

Returns assume that an investor purchased shares at Net Asset Value and does not reflect transaction costs imposed on the creation and redemption of ETF units, the brokerage or the bid ask spread that investors pay to buy and sell ETF securities on the Australian Securities Exchange. Total returns are after management costs.
Source: Vanguard and Bloomberg

What to look for in a fixed income ETF

A growing awareness of the benefits of fixed income exchange-traded funds (ETFs) has led to rapid expansion of the market in recent years.

As a result of this growth, investors are now faced with a much wider choice of bond ETFs and ETF providers.

Growing demand

Combining the diversification and professional management of mutual funds with the continuous pricing and liquidity of individual shares, global ETF assets have burgeoned in recent years.

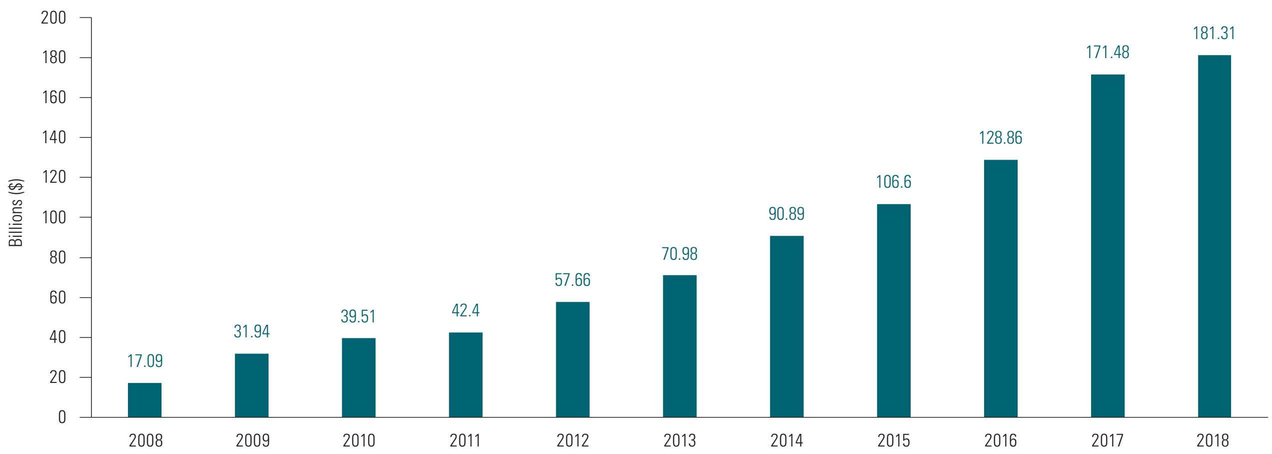
Market conditions have fuelled this demand, with interest rates still at low levels by historical standards.

For many types of investors, ETFs offer the most versatile and transparent route to access low-cost passive fixed income investments. And while there is already a wide variety of fixed income exposures available through ETFs, the range is growing by the month.

Expanding choice

In Europe alone, as of the end of June, there were around 350 fixed income ETFs with more than $180 billions in assets (data sourced from Morningstar). This is up from around 270 fixed income ETFs with around $130 billions in assets at the end of 2016.

Figure 2: Growth of global fixed income ETF assets



Source: ETFGI

Given this broad choice, it is important for investors to make informed decisions about which ETF, and which ETF manager, is right for them.

Choose your benchmark wisely

A single fixed income ETF can give investors access to a portfolio of hundreds if not thousands of bonds, diversified by issuer, by credit quality and by term structure. But it is important to select a bond ETF that tracks a benchmark reflecting the investor's true opportunity set. This can help investors ensure they are getting appropriate exposure that matches their risk appetite.

Good indices should reflect the investment universe available to all investors, both active and passive.

This can be a challenge in fixed income, where the universe is much broader than is the case with equities. And yet despite this, the availability of some bond issues may be limited. This is why it is especially important for investors to choose a fixed income ETF with an index methodology that is clear and easy to access.

The index inclusion criteria drive the number of constituents, and usually include a minimum issuance size and maturity requirement. The constituents, in turn, drive the risk, return and yield characteristics of the index, and more diversified indices tend to have lower duration risk than less diversified indices but similar yields.

Investors should select a strategy that is aligned with helping them achieve their investment objectives.

It is also a good idea to track an index with a proven track record, one that has demonstrated consistency not just in its construction but also in its exposure over time.

Scale and expertise

Building such a well-diversified bond portfolio requires an ETF provider to have sufficient scale and experience to enable them to assemble and manage large portfolios.

The scale of the provider is a key consideration for investors in fixed income ETFs when it comes to costs, too. As larger ETF managers typically place larger trades than smaller providers, they can secure lower execution costs. This gives them access to narrower spreads on trades.

ETF providers with economies of scale typically have considerable bargaining power in the bond markets as they have access to a wide variety of dealers and counterparties. This can lead to more favourable pricing.

Providers also need multiple authorized participants and market makers for their ETFs and an experienced capital markets team who have the expertise to place large trades, add new issues and reinvest income efficiently and effectively.

The best ETF providers will have the experience and skill to develop and deliver the best products for investors. These providers will consistently be investing in the talent and technology to improve their products and will have a strong network of relationships within the ETF ecosystem.

Costs matter

The rise of fixed income ETFs shows no signs of abating.

In a world of low yields, investing costs matter a lot. This is especially true for bond markets, where in recent years yields have been below their historical averages and costs erode a larger share of returns than they have in the past.

Choosing a low-cost fixed income ETF in this environment makes sense. All else being equal, lower costs should translate into higher net returns and better performance.

For more information visit our website, email adviserservices@vanguard.com.au or call 1300 655 205.

For more information

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