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INVESTMENT MANAGEMENT

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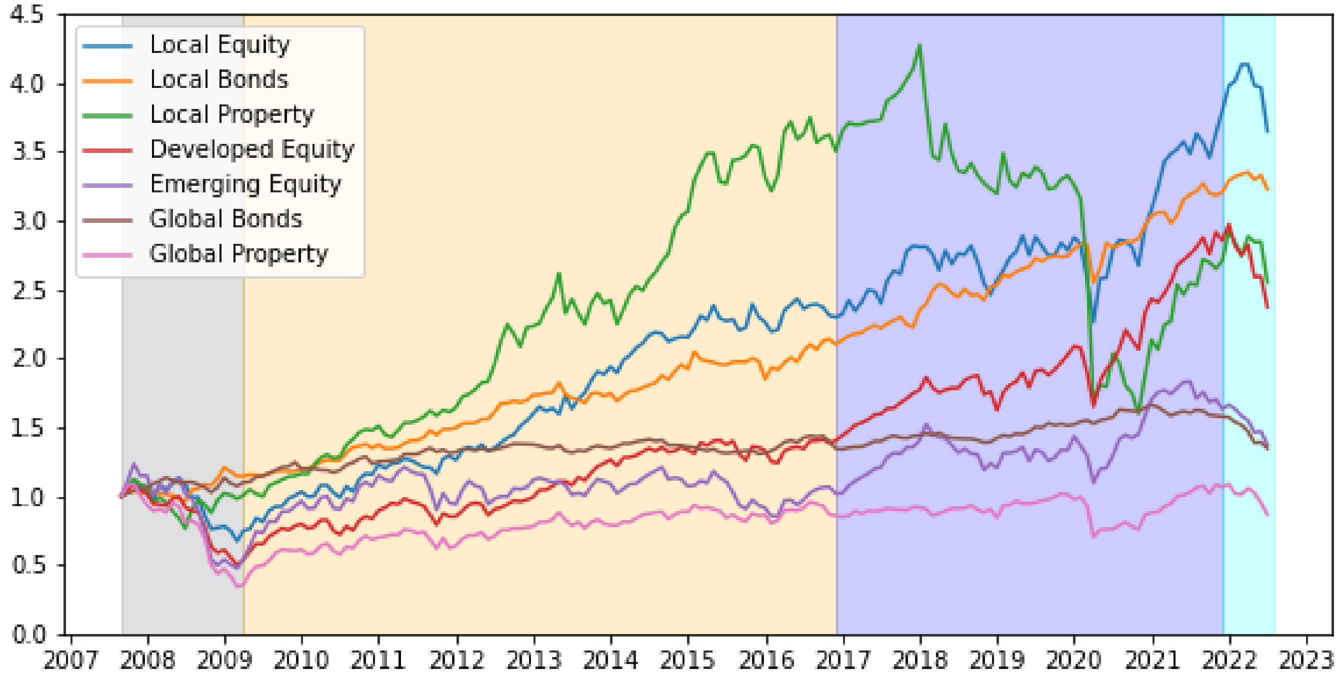
Asset Allocation - The Correct Use of ETFs

by Garrett Nel

The use of Exchange Traded Funds (ETFs) has gained increasing popularity over the last 20 years as an easy and cheap investment vehicle, especially as individuals realise the utility of owning a diversified market index. Between the period of 2002 and 2021, while the total AUM of US mutual funds had an annualised growth rate of 7.88% per year, US ETFs saw a growth rate of 25.1% per year over the same period.

While ETFs are an excellent way of gaining exposure to equity markets, they still limit investors to only one investment class out of the entire investible universe. There is significant further diversification benefit that may be taken advantage of when not limited only to equities, as well as through dynamic asset allocation to these different asset classes.

Consider the figure below illustrating the performance of seven different asset classes between August 2007 and June 2022 in ZAR. Over the entire period, Local Equity was the best performing asset class, with an annualised return of 9.06% per year. This gives merit to holding an ALSI ETF; however, this is a relatively arbitrary holding period, and investors could potentially have started investing at another time or may have exited the market sooner.



Sources: S&P Capital IQ Pro, IRESS

IIf, as indicated by the grey shaded area, an investor entered the equities market towards the end of 2007, they would have experienced the full force of the Global Financial Crisis, with the ALSI experiencing a loss of 32.5% in 19 months. As market psychology would dictate, many investors would sell during this period out of fear and end up worse off than they started. As a clear example of the benefits of diversification, during the same period, Local Bonds saw an increase of 14.5%. The same theme of winners and losers is prevalent throughout the entire period as asset classes take turns outshining the rest, as illustrated by the table below.

Period	Shading	Best Performer	Return (%)	Worst Performer	Return (%)
08/2007-02/2009	Grey	Local Bonds	14.5	Global Property	-65.5
02/2009-11/2016	Orange	Local Property	256.8	Global Bonds	25.21
11/2016-12/2021	Blue	Developed Equity	111.8	Local Property	-16.55
12/2021-06/2022	Light Blue	Local Bonds	-1.93	Developed Equity	-20.29

Investing with an outcomes-based approach is often a more appropriate goal than chasing after the best possible returns while taking on substantial risk. Although an individual asset class like equities may tend to outperform others in the long run, it does so with a level of inconsistency over shorter periods.

It is not realistic to expect that market swings can be predicted with enough accuracy to consistently outperform an index, however there is significant room for improvement from the naïve approach of holding one asset class through all its ups and downs. In this way, professional asset management is justified by adding value to a portfolio in the form of risk management through asset allocation. ETFs are a useful tool in portfolio management but should always be used strategically as a component of the larger portfolio.

Source: Statista

Written by Garrett Nel