Diversifying your share portfolio with exchange traded funds

By Grant Meintjes

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Maintaining a well-diversified share portfolio is one of the best ways for any investor to preserve their wealth.

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Exchange traded funds (ETFs), are effective, simple and uncomplicated investment instruments. An ETF is a basket of securities (equities, bonds, commodities etc.) administered by an asset manager and listed and traded as one single share on the stock exchange. ETFs are passive investments and provide average performance of the asset class or index it tracks.

The pros of ETF investing

ETFs are a popular choice for investors who pay attention to costs, such as the total expense ratio (TER) of an investment. ETFs have a very low TER, considering how much equity exposure they offer. If you were to buy each of the underlying securities and hold them individually, the total cost would almost certainly exceed the cost of investing in an ETF. As they hold equities, ETFs usually pay a dividend to investors.

ETFs are a good option for young investors to kickstart their investment journey. They can also offer the more advanced investor exposure to sectors they might not have in their existing portfolio, as well as diversifying their investments in terms of geography by adding some offshore exposure. An ETF is also quite easily accessible and, due to their straightforward cost structure, most investors could manage their ETF investments themselves.

Their most attractive quality by far, however, is the combination of having a well-diversified portfolio, all wrapped up into one share, with the tradability and convenience of one share.

How to take advantage of ETF investing

ETFs can be the perfect stepping stone for novice investors with big ambitions. One investment approach, called a core-satellite approach, is a method of portfolio construction designed to minimise cost and volatility, while offering great diversification and the opportunity to outperform the rest of the stock exchange.

Using this approach, 50% of your investable assets are invested in your core ETF, while the rest is divided up between five or six other shares/securities, known as your satellites. In your core share, you track an index or asset class with an ETF, while the other groups will contain a mix – from large- to medium-sized to small cap investments. The idea of a core-satellite approach is to blend ETFs in a way that'll offer the most attractive returns at the lowest possible risk.

Slight variations on this are also possible and can be effective. The core, for instance, could make up less than 50% of your total assets, while certain satellites might be bigger than others to make up the difference.

The contents of your core can be many different things. Some investors might prefer value stocks specifically, while others would opt for growth. Some might choose to focus their core around listed property or government bonds or even commodities like platinum or palladium.

Buying an ETF holds less risk than buying an individual share as they have built-in diversification and the highest level of liquidity of any investable instrument on the market. Investing with ETFs is the easiest way to create a diversified portfolio in terms of geographic and sector spread at low costs, offering novice and advanced investors a solid building block for any portfolio.

ABOUT THE AUTHOR

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