The aim of many investors is to at least outperform a market benchmark. Is there a reliable way to consistently achieve this?

A stock market index is a measure of the relative price of a stock market over time. It usually does not include all stocks, but rather stocks which would be sufficiently representative of the behavior of the market. Therefore, components of the index tend to be the biggest companies by market value (so-called blue chips) listed on the stock exchange. In Singapore, the FTSE Straits Times Index (STI) tracks the prices of 30 of the largest listed companies, such as Singtel and Singapore Airlines.

Mirroring a Stock Index

By buying STI-constituent shares in the same proportion as they constitute the STI, an investor would in theory be able to perform at the same level as the market benchmark. By reinvesting all the dividends he receives into the portfolio, the investor would even outperform the benchmark.

However, the reality is more complicated, for the constituents of the index regularly change when large companies decline and new ones take their places. Transaction costs in making the switch in the portfolio are thus incurred. Furthermore, small individual investors cannot fully replicate the portfolio without buying small lots of shares, which result in even higher transaction costs due to minimum broker commissions.

Exchange-Traded Funds

An Exchange trade fund (ETF), sometimes known as a tracker fund, is a professionally managed fund that also tries to mimic the performance of the index, but at a larger scale. An ETF is traded on a stock exchange, as one would trade a stock. Regular brokerage charges would thus apply.

In Singapore, the main funds that track the STI are the streetTRACKS STI ETF (ES3.SI) and the DBS STI ETF 100 (G3B.SI). The former contains 1,000 units per board lot while the latter has 100.

ETFs are increasingly popular with investors. As an indication, the streetTRACKS STI ETF currently has assets of over S$600 million under management. On the other hand, the Schroders Singapore Trust, a unit trust which invests in the Singapore market and has a strong performance track record, has just about S$500 million in assets.

Benefits

ETFs are created by financial institutions for the very reasons that make mirroring a stock index challenging for a small investor. By pooling together funds from many individuals, the transactions costs decrease significantly. Since the fund is passively managed (e.g. the ETF manager does not have to research on which stocks to buy or sell), the streetTRACKS STI ETF has a low management fee of 0.3%. This compares favorably to unit trusts which typically charge 2%.

The very nature of a stock index means that the risk that the failure of a single company will significantly affect an ETF is low. The price of an ETF is also much less volatile than the average investor’s portfolio of shares.

Like regular stocks, an ETF usually pays dividends twice a year, out of the dividends that are paid by the stocks comprising the fund. As an illustration, past dividends paid by streetTRACKS STI ETF are as follows:

- Final dividends for year ended 30 Jun 2008: S$0.06 paid on 4 Aug 2008
- Interim dividends for year ended 30 Jun 2009: S$0.05 paid on 6 Feb 2009

- Final dividends for year ended 30 Jun 2009: S$0.04 paid on 11 Aug 2008

For investors using Central Provident Funds (CPF), up to 100% of available funds in the Ordinary Account can be invested in an ETF, compared to 35% for CPF-approved stocks.

Although this article uses mainly the STI and the ST ETF as examples, ETFs of other markets are also available. By putting smaller sums into multiple ETFs, an investor can very effectively diversify his portfolio at a low cost.

Downsides

Although an ETF's management fee is low, there is still a perceptible expense in investing in an ETF. For instance, the dividends streetTRACKS ST ETF paid out in the last financial year ended 30 Jun 2009 amounted to 3.78%, compared to estimated dividends of over 4% if an investor had bought constituent stocks directly.

Closely mirroring a stock index necessarily means that one follows not only the rise, but also the fall of an index. Moreover, since an index usually comprises companies which are already established and past the phase of explosive growth, gains from a ETF would unlikely be spectacular.

Conclusion

To outperform a stock index, an investor could invest in an ETF and reinvest all dividends in more units of the ETF. Since a stock index like the STI only takes stock prices and not dividends into account, the above approach is almost guaranteed to outperform the STI.

However, the ETF is probably not suitable for investors who are looking for high-risks high-returns investments.