**Why not just use ETFs and index funds to get diversification?**

In recent months, we’ve received a number of emails from clients seeking our views on index funds and Exchange Traded Funds (ETFs) that track a share market benchmark index like the ASX 200. Investors are wondering whether index funds and ETFs are an effective substitute for investing in actively managed funds.

There is no denying that index funds (and ETFs in particular) have exploded in popularity. They are normally quite cheap and are considered by many as an easy way to invest. Supporters of index funds believe its best to simply ‘buy the market’ and gain ‘instant diversification’ rather than bother spending the time researching individual companies and running the risk of buying the wrong shares in the wrong industry.

In practice however, it isn’t quite that simple and while there are some advantages like lower cost and easy accessibility, there are also some disadvantages that are often overlooked. These include the risk of companies that form part of an index being more susceptible to overvaluation, as the larger a company gets, the larger its weight in the index becomes. In addition, index investing may result in an inadvertent bias to one or two industries. For example, the big four banks (financials) and two mining companies (resources) account for approximately one-third of the entire Australian share market. Index investing will guarantee a significant bias to these companies irrespective of their valuations. We think that this is a huge leap of faith on the Australian residential property market and the Chinese economy.

The key takeout is that sensible portfolio construction does not need to be black and white. You can get the best of both worlds by blending low cost broadly diversified indices and ETFs, along with actively managed funds and direct securities when you want a more specific portfolio characteristic. When there is an attractive investment opportunity, we always consider what the most effective and cost efficient way is to access the specific investment opportunity. At times we may purchase broad indices to get quick exposure to an opportunity, and later, following the completion of more detailed research, we may look to replace these with more specific active strategies. In accordance with our investment principle “Putting Investors First”, our focus at all times remains the preservation of investors’ capital in ‘real terms’ which means generating returns after inflation, fees and tax.