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HEAD-TO-HEAD: BMO vs Deutsche - ETFs

By Imogene Wong | 7th April 2017

FSA compares the strategy of two exchange-traded funds, the BMO Asia High Dividend ETF and the DB x-trackers MSCI AC Asia Ex Japan High Dividend Yield Index Ucits ETF.

Asia ex-Japan dividend ETFs

Asian investors clamour for income and they tend to have a home bias when investing, as HSBC GAM, Mirae and JP Morgan and others have noted.

Yet only 10 funds investing in Asia with a dividend focus are SFC-authorised funds for sale in Hong Kong. Three of those are ETFs.

ETFs carry substantially lower fees and tend to deliver better performance over multiple time periods than the majority of active funds, studies from Morningstar, and S&P have shown.

That leads to the active versus passive debate. Although it hasn't yet become loud in Asia like it has in the US, interest in passive is gradually growing.

Therefore *FSA* this week takes a look at two of the ETFs that are both Asian equity and dividend focused: the BMO Asia High Dividend ETF and the DB X-Trackers MSCI AC Asia Ex Japan High Dividend Yield UCITS ETF.

Luke Ng, senior vice president of research at FE Advisory Asia, provides a comparative analysis.

Increasing vs stable dividends

The two ETFs are similar in the sense that they invest in the same ten countries that are Asia excluding Japan, and both have a focus on dividend yield, Ng said.

However, the two passive products have key differences.

First, the BMO is a physical ETF and the DB product is synthetic, a topic which Ng will turn to later.

"Another key differentiation is that the BMO product focuses on dividend growth, while the Deutsche Bank ETF looks for steady yield," Ng said.

The BMO ETF, listed in the SAR in November 2014, tracks the NASDAQ Asia ex-Japan Dividend Achievers Index, which has companies with at least three consecutive years of increasing dividend payments.

The BMO product invests in about 140 companies with an average annualised dividend yield of 2.81% (as of March 2017). The average yield of the index itself is not provided, Ng added.

The Deutsche product was cross-listed in Hong Kong back in March 2013. It replicates the performance of the MSCI AC Asia ex-Japan High Dividend Yield Index, which is comprised of medium-to-large sized companies with a dividend level at least 30% higher than the MSCI AC Asia ex-Japan Index.

The dividend level of the DB ETF reached 4.47% as of January, the latest available data, Ng noted.

The difference between the two ETF strategies (dividend growth versus dividend yield) results in a substantial difference in country weightings, as well as some slight variations in sector allocation, Ng noted.

One example is South Korea, which is the top country holding for the BMO fund (20.6%) versus the seventh largest for the DB product (1.3%).

“The average dividend yield for South Korean companies is not considered high. However, the government has been pushing corporate reform and comapnies are gradually more willing to share the profits with shareholders through dividend payouts.”

This context fits with the BMO ETF focus on dividend growth.

The BMO fund also has more holdings in the consumer goods sector (25.7% vs DB’s 7.17%) and less in sectors that traditionally pay higher dividends, such as telecommunications companies (1.9% vs DB’s 9.62%).

Ng pointed out that the valuations of high-dividend stocks have turned expensive in the past few years amid popular demand.

“The strategy of pursuing dividend growth [as opposed to seeking high dividends] is more suitable in the current market environment,” he said.

Technical differences

Performance of the two ETFs with their respective indices are shown above, according to data from FE.

Comparative features

	BMO	DB
Tracking method	Physical	Synthetic
Rolling one-year tracking error*	0.32%	0.05%
Rolling one-year tracking difference^	-0.96%	-1.16%
Review of index weightings	Annually in March	Semi-annually in May and November

Source: FE, fund websites
**Tracking difference is the return difference between an ETF and its underlying benchmark/index over a certain period of time.*
^Tracking error measures how consistently an ETF follows its benchmark/index. It is the volatility measured by standard deviation of that return difference.

Ng points out that the BMO product is a physical ETF while Deutsche Bank's is a synthetic product.

That means that the BMO ETF will hold the actual underlying securities of the index. But the synthetic DB ETF will use a counterparty to invest in derivatives called “funded swaps”.

“The counterparty will be responsible for delivering the return of the index,” he explained, adding that the positions in these derivatives are fully collateralised, serving as a kind of insurance for DB.

In extreme cases, there are counterpary risks which involve the counterparty being unable to deliver the return as promised. “In that case, the collateral will be liquidated to cash to send to the ETF investors.”

A synthetic strategy normally provides minimal tracking error with lower cost than the physical strategy, he added.

On the other hand, the BMO ETF, as a physical product, has a simpler strategy that buys the actual securities. This strategy may incur high transaction costs as the index conducts an annual rebalancing of the underlying holdings in March, Ng said.

“Because the index is designed to include companies that have three consecutive years of dividend growth, it might occur that a company with a large weighting does not meet the requirement the following year and is removed from the index,” he explained.

“It would thus involve a large repositioning of the portfolio. The ongoing charges do not reflect the transaction costs. The repositioning might also impact the ETF's tracking accuracy, resulting in an increase in the tracking error.”

	BMO	DB
OCF	0.45%	0.65%
AUM ($m)	60.4	7.9
Average daily turnover in 2016	HK$56,000 ($7,200)	HK$2,000 ($257)

Source: FE, fund websites, HKEx

Although the DB ETF uses a synthetic strategy which should translate into low costs, the small fund size leads to ongoing charges of 0.65% a year, Ng said.

“There is also a concern about its continuity. The small fund size reflects the ETF’s attractiveness to investors, and by extension its competitiveness to other products available in the market.”

Ng prefers the BMO ETF mainly due to the better outlook for dividend growth stocks compared to companies that offer a stable stream of income.

The latter have turned more expensive, but the dividend growers have comparatively lower valuations, he said.

“It is also a trend seen in Asia, where not only South Korea, but some companies in China are more willing to pay out dividends as a means of sharing profits with shareholders.”

“The DB ETF suits investors who are more interested in steady and stable dividend yield,” he added.