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ETF Insights.

Prepared for clients of EasyEquities

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FNB Top 40 ETF (FNBTOP40:JSE)

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Fund suitability

This ETF is suitable for investors seeking long-term capital gains from SA equities.

Fees

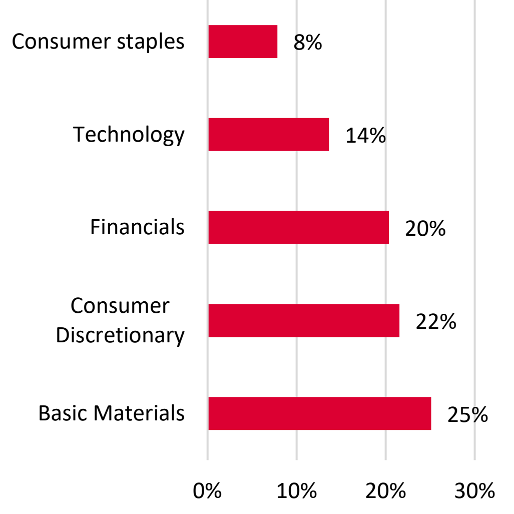
The fund has an estimated total investment cost of 0.18%.

Alternative funds

Satrix Top 40 (0.14%)
Sygnia Itrix Top 40 (0.26%)
1nvest Top 40 (0.29%)

"The FNB Top 40 ETF (and its peers) has one trick up its sleeve – the list of top 40 companies is dominated by firms that generate earnings offshore, where economic prospects are stronger."

Top 5 sectors (%)



The FNB Top 40 ETF, which was part of our picks for March, provides investors with broad exposure to SA equities by investing in the 40 biggest companies listed on the JSE based on their market capitalisation. It is one of four top 40 ETFs listed on the JSE and in this note we compare it to its peers: the Satrix, 1nvest and Sygnia Itrix Top 40 ETFs.

From an investment perspective, top 40 ETFs are one of the simplest ways to invest in SA equities – all the funds track the performance of the FTSE/JSE Top 40 index. Company share weights are determined by the "vanilla" or traditional market capitalisation method. Therefore, the highest performing shares are assigned higher weights, and underperformers lower weights.

The Satrix Top 40 is the largest of the group – it was worth a sizeable R13.3bn at end-February 2023. The FNB Top 40 ETF had R2.5bn in assets at the same date and peers 1nvest and Sygnia Itrix were worth R623m and R501m. The differences in assets under management are mainly related to fund history given that the Satrix Top 40 was launched in November 2000, making it one of the oldest ETFs listed on the JSE. FNB Top 40, 1nvest and Sygnia Itrix were launched in 2008, 2010 and 2017.

The size advantages of Satrix and FNB show in that the former is the cheapest of the group with a total expense ratio (TER) of 0.14%, followed by the latter, which costs 0.18%. Sygnia Itrix and 1nvest cost 0.26% and 0.29%, which is expensive given the nature of top 40 ETFs. However, these costs may decrease as fund size increases.

Given that the investment process of these ETFs is one of the simplest, we believe that the fund managers behind these ETFs need to be highly efficient at tracking the FTSE/JSE Top 40 index. Indeed, the Satrix Top 40 is the leader of the pack, with an estimated tracking error (annualised over three years) of just 0.09%, which suggests that it is highly efficient at tracking the benchmark. The FNB Top 40 is second, at 0.10%, followed by its relatively inefficient Sygnia Itrix (0.21%) and 1nvest (0.26%) peers.

From a dividend yield perspective, the funds are close and average 3.8%. The 1nvest and Sygnia Itrix Top 40 ETFs yield 4% and 3.9% respectively, with the Satrix and FNB Top 40 ETFs yielding 3.7%. However, we believe that the differences are negligible due to the former two funds having slightly lower net asset values, which increases their yields given that the funds should have similar income or dividend levels.

More importantly, the 3.8% average yield across the four funds is a slight disadvantage given that SA's consumer inflation rate is 7%, which is a real decrease in the purchasing power of dividends. As such, ETF investors will have to rely on the capital gains generated by the FNB Top 40 ETF to make up for the real decrease in the gain from income.

Accordingly, the FNB Top 40 ETF's long-term performance has been strong – it returned 20.2% compounded annually over three years and a lower but decent 10.5% compounded annually over five years. However, the companies that underpin the performance of the ETF will have to generate inflation-beating returns in a local economy with bleak prospects.

Specifically, SA's stubborn consumer inflation, which has led to a rising repo rate (which increased by a cumulative 425 basis points to 7.75% in March) means that companies exposed to SA's strained consumer are at risk of generating lower profitability and cash flow, especially if they lack pricing power.

This is particularly important, given that final household consumption spending made up 67% of real GDP expenditure in SA (2022), highlighting the importance of consumer financial health in SA.

However, the FNB Top 40 ETF (and its peers) has one trick up its sleeve – the list of top 40 companies is dominated by firms that generate earnings offshore, where economic prospects are stronger. Combined with strong business models (that can boost company performances) this may translate into steady returns for ETF investors.

One such company is luxury goods giant Richemont, which is the leading company in the ETF. Richemont generated €19.2bn in revenue in FY22, with 41% coming out of the Asia Pacific region. We think that this region, which is driven by China, is positioned to benefit from the consumer recovery expected out of the Asian giant. In its sales report for the three months ended December 2022, Richemont's 8% sales growth (18% for the 9-month period) was led mainly by Japan, the Middle East and Africa and Europe, with China down 7%.

However, we think that China's recent 3.5% annual increase in retail sales in March (which beat expectations) points to a positive outlook ahead, albeit at a gradual pace. Dutch based bank ING, which expects Chinese retail sales to rebound by 8%-10% for 2023, forecasts a 5% growth rate in real GDP, driven (overall) by consumer spending.

However, as with all investments, the offshore exposure is not without risk, which in this case includes currency and geopolitical risk. As such, we think that the FNB Top 40 fund may be useful to investors as part of an overall ETF portfolio.

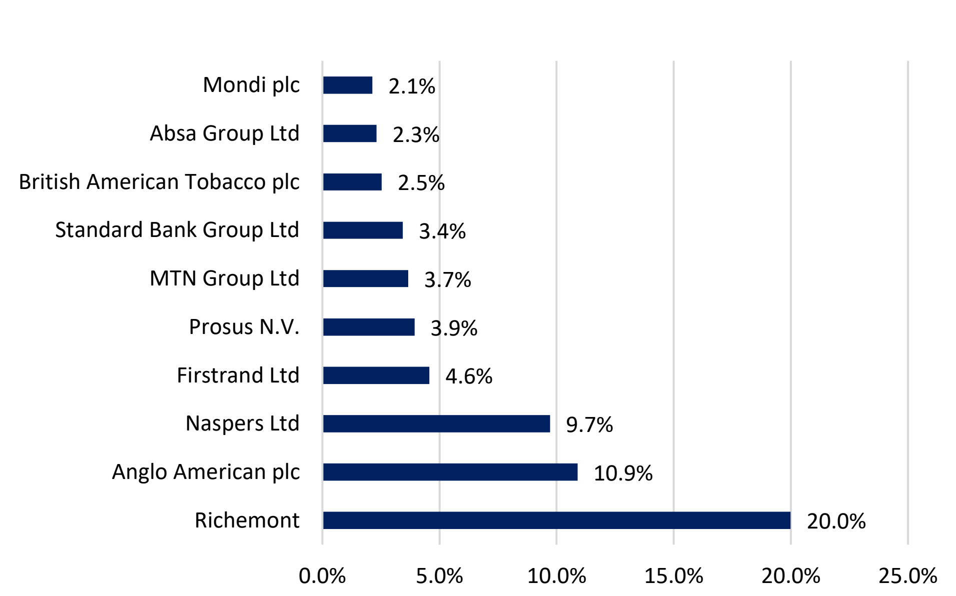
Investment term of the week: tracking error

Tracking error (of an ETF) is the annualised standard deviation of the return differences between that of the ETF and the index. All else equal, the lower the tracking error, the more efficient an ETF is at tracking its benchmark.

Investment approach and portfolio composition

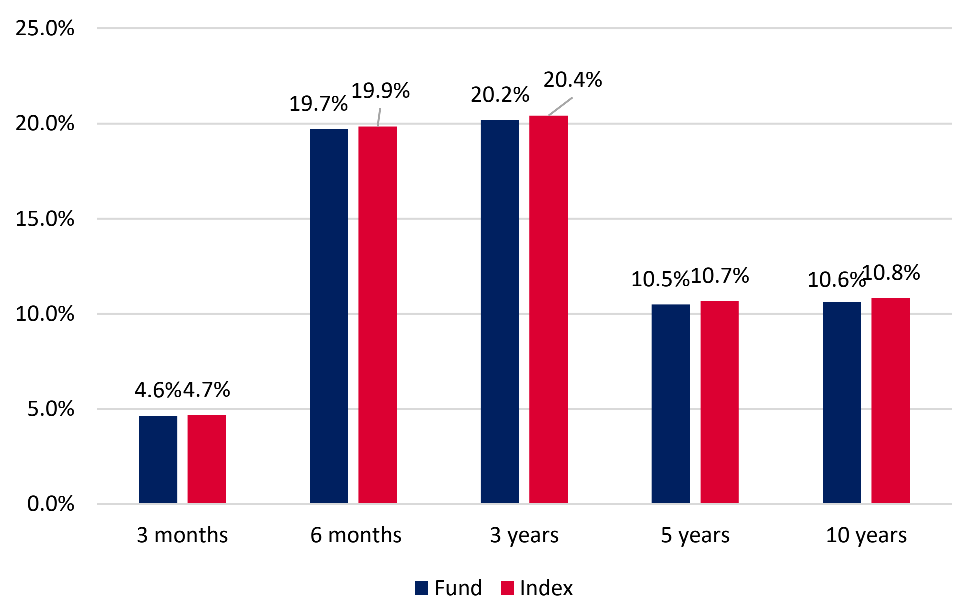
The FNB Top 40 ETF tracks the performance of the FTSE/JSE Top40 Index before fees and expenses.

Top holdings (%)



Performance

Fund and index performance to end-February 2023 (annualised for periods longer than one year).



Fund information: 28 February 2023

Launched on	146 October 2008
Trading symbol (JSE)	FNBTOP40
Total assets	R2.5bn
Estimated total investment cost	0.18%
Risk rating	High
Benchmark	FTSE/JSE Top 40 Index

Market data: 14 April 2023

Spot price	R74.37
One-year high	R77.00
One-year low	R57.29
Average monthly volume	240,827
Dividend yield	3.7%
Tracking error	0.10%

Source: Infront, yahoo finance