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STOCK MARKET MAGIC:

ETFS EXPLAINED

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From the founder's desk

As founder and CEO of Eclipse Advisory, I'm thrilled to unveil the newest addition to the Infohub library: an insightful new ebook covering, “Stock Market Magic: ETFs Explained”.

This resource is dedicated to empowering Australians with critical financial knowledge, aimed at enhancing decision-making. We believe that knowledge is the key to wealth creation. Our mission is to assist you in growing and protecting your wealth through improved understanding and strategic decision-making.

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I personally invite you to share your financial goals and offer a cost and obligation-free Discovery Consultation to explore how we can assist in making those goals a reality.

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STOCK MARKET MAGIC: ETFS EXPLAINED

Do you need help navigating the world of Exchange-Traded Funds (ETFs)? Our comprehensive guide simplifies complex concepts and provides expert advice on ETFs, shares, and managed funds. Equip yourself with the knowledge and tools to make confident, well-informed investment decisions.

Introduction

Investing can be daunting, especially with the myriad of options available today. As a financial planner and investment adviser, I understand the confusion and stress investors face when navigating the complex landscape of shares, ETFs, and managed funds. This e-book aims to demystify these investment vehicles and equip you with the knowledge and confidence to make informed decisions.

ETFs are one of the most exciting investment opportunities available today. But what exactly are they? ETFs, or Exchange-Traded Funds, are investment funds traded on stock exchanges, much like individual stocks. They offer the diversification of managed funds combined with the flexibility and liquidity of stocks. ETFs have been around since the early 1990s and have grown in popularity due to their simplicity and cost-effectiveness.

How ETFs Work

ETFs track an index, commodity, bonds, or a basket of assets like an index fund. They mirror the performance of these underlying assets. When you invest in an ETF, you buy a small portion of an extensive portfolio of securities. ETFs are created and redeemed in large blocks of shares known as creation units, which helps maintain their market price in line with the value of the underlying assets.

Unlike individual shares, investing in an ETF means you don't own the underlying assets; the ETF fund does. A fund manager oversees ETFs, monitoring a market index (e.g., the ASX200 or the S&P500) or a commodity like gold. For Index ETFs, the fund manager buys and sells assets to match the market performance of the monitored index or commodity.

ETF units can be bought and sold on the Australian Securities Exchange (ASX) or other securities markets worldwide. Many investors use online trading platforms for ETFs. Like shares, you pay brokerage fees on all ETF transactions.

When you buy or sell ETF units, trade settlement usually happens two days later. ETF unit prices are close to the fund's net asset value per unit (NAV). Some ETFs pay dividends/distribution income, while others do not, depending on the ETF type and fund provider policy.

Types of ETFs

ETFs offer diversification across various investment markets, specialising in different assets or asset classes. Here is a more informative and direct breakdown of the ETF types:

Equity ETFs: These are the foundation of the ETF world, providing broad exposure to stock markets like the S&P 500 or specific sectors like technology or healthcare. They offer various options, from weighting holdings by company size to giving equal weight to each stock. You can even invest internationally or target companies with consistent dividend payouts.

Fixed Income ETFs: If you prefer a more conservative approach, fixed income ETFs invest in bonds, essentially loans to governments or companies. Government bond ETFs offer stability, while corporate bond options can provide potentially higher returns with some added risk. High-yield bond ETFs are riskier but offer the chance of even greater returns. Municipal bond ETFs offer tax advantages depending on the situation.

Commodity ETFs: These ETFs delve into the world of raw materials, allowing you to invest in physical commodities like gold bars or contracts for future oil deliveries. Some track a basket of various commodities, while others focus on a single one.

Currency ETFs: Keep things straightforward with currency ETFs. They track the exchange rate between two currencies, such as US dollars and Euros. This helps you manage the risk associated with foreign exchange fluctuations.

Real Estate ETFs: Invest in the real estate market without becoming a landlord through real estate ETFs. They achieve this by investing in REITs, companies that own and operate income-generating real estate.

Specialty ETFs: These niche ETFs cater to specific investment goals or themes. For example, SRI ETFs target companies with strong environmental and social practices. You can also find ETFs focused on infrastructure projects or long-term trends like artificial intelligence.

Advantages of Investing ETFs

Investing in Exchange-Traded Funds (ETFs) offers numerous advantages, making them popular for building a diversified portfolio. Here is an expanded and detailed look at their benefits:

Diversification

One of the key advantages of ETFs is the immediate diversification they provide. By holding a collection of securities, ETFs allow you to spread your risk across a broad range of stocks, bonds, commodities, or other assets. This diversification reduces the risk associated with holding individual securities. For instance, a single equity ETF can include hundreds of stocks from various sectors, which helps to mitigate the impact of poor performance by any single stock.

Additionally, ETFs can target specific sectors or asset classes, such as technology, healthcare, or emerging markets, allowing you to tailor your portfolio to your investment preferences and risk tolerance. If you believe the technology sector will perform well, investing in a technology-focused ETF gives you targeted exposure.

Liquidity

ETFs are highly liquid and traded on stock exchanges during market hours. This means you can buy or sell shares at market prices whenever the market is open, providing greater flexibility than traditional managed funds that trade only once daily. The ability to trade ETFs throughout the day allows you to react swiftly to market news and events in real-time.

This intraday trading capability makes ETFs suitable for both short-term trading and long-term investing, enabling you to adjust your positions within the same trading day during periods of market volatility

Low Costs

ETFs typically have lower expense ratios compared to actively managed funds. This cost-effectiveness is mainly due to their passive management style, which tracks an index and requires less oversight. Lower expenses mean more of your returns stay in your pocket, significantly boosting your net returns. Moreover, ETFs generally have lower turnover and trading costs, reducing expenses. With less frequent trading than actively managed funds, ETFs incur fewer transaction costs, contributing to their overall cost efficiency.

Transparency

Another significant advantage of ETFs is transparency. They disclose their holdings daily, giving you clear access to the securities held within the fund. This transparency lets you make informed investment decisions and understand the underlying assets. Knowing what you own helps you manage risk and align your investments with your financial goals.

Flexibility

ETFs offer remarkable flexibility in terms of investment strategies and asset classes. You can choose from various ETFs covering sectors, regions, investment styles, and asset classes. This variety allows you to implement diverse strategies, from conservative to aggressive, depending on your investment objectives. Additionally, You can trade ETFs using various order types, such as market orders, limit orders, or stop orders, giving you additional control over the buying and selling process. For example, you can use limit orders to buy or sell at specific prices, helping to manage costs and optimise returns.

Tax Efficiency

ETFs are often more tax-efficient than conventional managed funds. Their unique creation and redemption process generally results in fewer capital gains distributions, helping you minimise taxes and maximise after-tax returns. Unlike managed funds, which may need to sell securities to meet redemptions and trigger capital gains, ETFs typically use in-kind exchanges to avoid these taxable events. Many ETFs are tax-efficient, which is beneficial for minimising tax liability and can lead to better overall returns when considering after-tax performance. You can also strategically use ETFs within tax-advantaged accounts, such as superannuation funds, to optimise your tax situation further.

Wide Investment Choices

The ETF market offers many options, from broad market ETFs tracking significant indexes like the ASX200 to niche sector-specific ETFs or those focused on specific geographic regions. This variety allows you to tailor your investment strategy to your risk tolerance and desired market exposure. Whether you're looking for global exposure, specific industry focus, or thematic investments, an ETF will likely meet your needs.

Trading Flexibility

ETFs offer the flexibility to trade like stocks. You can place limit orders, stop-loss orders, and other order types to manage your investment strategy and potentially minimise losses. This flexibility benefits active traders and those looking to implement sophisticated trading strategies. For example, you can use stop-loss orders to protect your investments from significant declines or take-profit orders to lock in gains at predetermined price levels.

Conclusion

ETFs provide several advantages, including diversification, liquidity, low costs, transparency, flexibility, tax efficiency, and a wide range of investment choices. These benefits make ETFs attractive for many investors looking to build a well-rounded, cost-effective portfolio. While there are some drawbacks to consider, such as potential tracking error and commission costs, the advantages often outweigh these considerations, making ETFs a powerful tool in any investor's arsenal.

Understanding and leveraging these advantages, you can create a diversified, efficient, and flexible investment portfolio that aligns with your financial goals and risk tolerance. With options like broad market ETFs tracking significant indexes such as the ASX200, you can gain broad exposure to the Australian market while enjoying the benefits of low costs and high liquidity. Investing in ETFs allows you to take a strategic approach, whether seeking long-term growth, income, or capital preservation.

ETFs suit many investors, from beginners to seasoned professionals looking to optimise their portfolios. Their versatility, cost-effectiveness, and transparency make them an excellent choice for achieving your investment objectives. As you continue your investment journey, consider incorporating ETFs to enhance your portfolio's diversification and performance while keeping costs in check.

Disadvantages of Investing in ETFs

While Exchange-Traded Funds (ETFs) offer many advantages, you should consider potential disadvantages before investing. Here are some detailed drawbacks associated with ETFs:

Market Volatility Risk

ETF prices can be volatile, just like individual stocks. If the underlying assets experience significant price swings, the value will fluctuate too. This can lead to losses. For instance, ETFs tracking indices like the ASX200 can see sharp declines during market downturns, mirroring the broader market.

Tracking Error

ETFs aim to replicate the performance of an underlying index or asset class, but they need to track their benchmark better. Factors like fees, trading costs, and replication techniques cause tracking errors. This can lead to underperformance relative to the index over time. For example, an ETF tracking the ASX200 might need to catch up to the index due to these factors.

Liquidity Risk

Most ETFs are highly liquid and trade on stock exchanges throughout the day. However, some ETFs have lower trading volumes and higher bid-ask spreads. This can make buying or selling shares at favourable prices harder, especially in volatile markets. Executing large trades without affecting the market price can be challenging.

Complexity

Some ETFs use complex strategies, such as leveraged, inverse, or actively managed ETFs. nverse ETFs profit from declines in an index but can underperform over time. Actively managed ETFs rely on the manager's expertise and may have higher fees.

Overlapping Holdings

Holding multiple ETFs can lead to overlapping holdings, causing excessive concentration in specific sectors, industries, or asset classes. This reduces diversification benefits. For example, holding an ETF tracking the ASX200 and a sector-specific ETF might result in overexposure to certain companies.

Expense Ratios

While ETFs generally have lower expense ratios than actively managed funds, some ETFs, mainly specialised or niche ETFs, have relatively high costs. These higher expenses can eat into returns over time. Compare expense ratios across different ETFs to ensure you get value for your investment.

Dividend Variability

ETF investors might experience variability in dividend payments. Dividends are passed through from the underlying securities. Changes in dividend policies of the underlying companies or fluctuations in interest rates can affect dividend yields and income distributions, making it harder for income-focused investors to predict cash flow.

Tax Considerations

ETFs are generally tax-efficient, but investors may still face capital gains taxes when selling ETF shares at a profit. Certain ETFs, such as those investing in commodities or foreign securities, may have unique tax implications. Be aware of these potential tax issues when making investment decisions. For instance, ETFs that distribute capital gains throughout the year can trigger tax liabilities even if you haven't sold your shares.

Market Concentration Risk

Some ETFs concentrate heavily on specific sectors, industries, or regions. This increases risk if those areas experience adverse developments or downturns.

For example, an ETF focused on the technology sector might suffer significant losses if that sector declines sharply. Consider the concentration risk of individual ETFs when constructing your portfolio.

Regulatory Risk

Changes in regulations or regulatory scrutiny can impact ETFs or their underlying assets. Stay informed about regulatory developments that may affect your ETF investments. New rules affecting financial markets or specific industries can directly impact the performance of related ETFs.

Lack of Control

ETFs represent a basket of holdings, so you don't control the specific companies within the ETF. The fund manager makes the investment decisions. This can be a disadvantage if you have strong convictions about particular stocks.

Fees and Costs

ETFs come with two main cost factors: expense ratios and bid-ask spreads. Expense ratios cover the management costs of the ETF and can reduce your returns. Bid-ask spreads, the difference between the buying and selling price, can affect your profits, especially for short-term trades.

Conclusion

ETFs offer many benefits, including diversification, liquidity, and low costs. However, they also come with potential disadvantages. Consider market volatility, tracking errors, liquidity issues, and other risks carefully. Understanding these drawbacks helps you make more informed decisions and manage your investment portfolio. Always align your ETF choices with your risk tolerance and investment goals.

Latest Trends and Developments in ETFs for 2024

The Exchange-Traded Funds' (ETFs) landscape continues to evolve, with several key landscape trends and developments expected to shape the market in 2024. Here are some of the most significant trends:

1. Growth of Active ETFs

Active ETFs have gained substantial traction. Investors are becoming more comfortable with active management within the ETF structure, which is booming in the US and gaining momentum in Europe. Expect this trend to continue, with many new active ETFs launching and drawing significant investor interest. There is a projection that active ETFs will grow at a compound annual growth rate (CAGR) of 37% over the next five years, outpacing passive ETFs. This shift reflects investor demand for tailored strategies that adapt to changing market conditions and offer higher returns.

2. Increased Focus on ESG ETFs

Environmental, Social, and Governance (ESG) ETFs continue to grow in popularity. Investors are increasingly looking for sustainable investment options that align with their values. The demand for ESG-focused ETFs is expected to rise, driven by regulatory pressures and investor preferences for sustainable investing.

3. The Rise of Thematic and Niche ETFs

Thematic ETFs, which focus on specific trends

such as artificial intelligence (AI), renewable energy, and blockchain, are attracting significant interest. These ETFs allow investors to target emerging sectors and capitalise on long-term trends. Niche ETFs, covering more specialised areas, also see growth as investors look for targeted exposure.

4. Adoption of Cryptocurrency ETFs

The approval and launch of cryptocurrency ETFs, particularly Bitcoin ETFs, are gaining attention. In the US, these products have started to attract significant inflows, and there is growing interest in similar products in Europe. This trend indicates a broader acceptance of digital assets within mainstream investment portfolios.

5. Cost Reductions and Fee Competition

Fee competition among ETF providers is intensifying, leading to lower investor costs. Significant providers are cutting fees to attract more assets, making ETFs even more cost-effective. This trend benefits investors looking to minimise expenses and maximise returns.

6. Innovations in ETF Structures

Innovations in ETF structures are becoming more common, such as introducing listed and unlisted share classes. These developments aim to enhance flexibility and provide more options for investors. The move towards T+1 settlement cycles in the US may impact the European ETF market, aligning settlement processes and potentially reducing transaction costs.

7. Expansion of Fixed Income ETFs

Fixed-income ETFs might see increased inflows driven by changing interest rate environments and investor demand for stable income sources. As global inflation trends influence interest rates, investors turn to fixed-income ETFs for diversification and yield.

8. AI and Active ETFs: The New Frontiers in Investment Strategy

Two pivotal trends are reshaping portfolio construction and management: AI-related ETFs and the increasing dominance of active ETFs. AI-related stocks have delivered spectacular performances, significantly outperforming traditional benchmarks such as the Nasdaq 100 and the S&P 500. This has spurred the growth of AI-related ETFs, providing investors with efficient access to a diversified portfolio of companies leading AI innovation. For example, a leading AI chip producer saw its stock rise by 46% this year after tripling in value the previous year.

Integrating AI insights and analytics into active ETF management allows portfolio managers to enhance decision-making processes and refine investment strategies. This convergence of AI and active management offers investors a unique opportunity to capitalise on rapid advancements within the AI sector.

Conclusion

The ETF market in 2024 is poised for continued growth and innovation. With trends such as the rise of active and ESG ETFs, the adoption of cryptocurrency ETFs, and ongoing fee competition, investors have more options than ever. The growing interest in AI-related and thematic ETFs reflects broader shifts within the asset management industry. Staying informed about these developments can help investors make better decisions and leverage the benefits of ETFs in their portfolios.

Comparing ETFs, Direct Shares, and Actively Managed Funds

Performance of ETFs vs. Direct Shares Over Five Years

Over the last five years, comparing ETFs to direct shares involves examining market conditions, sector performance, and stock selection. ETFs provide diversification by holding a basket of securities, while direct shares represent ownership in individual companies.

In a bull market, ETFs tracking indices often perform similarly or slightly better than individual shares, especially for those seeking broad market exposure. Individual shares in well-performing sectors might outperform ETFs during sector rotation or bear markets.

Performance varies with the specific ETFs and shares analysed. Some actively managed or thematic ETFs outperform broad market indices or individual shares by focusing on high-growth sectors or specific investment themes.

When evaluating ETFs versus direct shares, consider your objectives, risk tolerance, and time horizon—factor in fees, liquidity, and tax implications. Consulting with a financial advisor provides personalised guidance.

Reviewing the historical performance of ETFs and quality-managed funds over the past five years helps understand their performance in various market conditions. Choosing between ETFs and quality-managed funds depends on individual goals, risk tolerance, and preferences.

Some prefer the simplicity and lower fees of ETFs, while others value actively managed funds' potential outperformance and risk management. Eclipse Advisory can provide tailored advice regarding managed funds.

Differences Between Actively Managed ETFs, Passively Managed ETFs, and Actively Managed Funds

Actively managed ETFs have a fund manager who buys and sells securities to outperform a benchmark. Meanwhile, passively managed ETFs track a benchmark index (like the ASX200) and aim to mirror its performance. Actively managed funds, like actively managed ETFs, have a fund manager making investment decisions to beat a benchmark.

Passive ETFs generally have lower expense ratios due to less trading activity and management overhead. Actively managed ETFs often have higher expense ratios to cover the manager's salary and research costs. Actively managed funds typically have expense ratios higher than passively managed ETFs but lower than actively managed ETFs due to economies of scale.

Passive ETFs usually report holdings daily, while traditional actively managed ETFs report holdings daily, and semi-transparent ones report monthly or quarterly. Actively managed funds generally report holdings monthly or quarterly. Both passive and actively managed ETFs trade like stocks throughout the day, whereas investors can only trade actively managed funds after market hours.

Choosing the Right Investment

To make an informed decision, assess your investment objectives, time horizon, and risk tolerance. Research your options' historical performance, fee structures, and management styles. Diversifying your portfolio with a mix of ETFs, direct shares, and actively managed funds provides a balanced approach, blending broad market exposure, potential high returns from individual stocks, and the expertise of active fund management.

Given the complexity and variety of investment options, consulting with a financial advisor provides personalised advice tailored to your needs and goals. An advisor helps you navigate market intricacies, understand different investment strategies, and build a portfolio that aligns with your financial objectives.

Invest wisely by understanding each investment type and how it fits into your financial plan. The right mix of ETFs, direct shares, and actively managed funds can help you achieve your investment goals while managing risk effectively.

How to Choose the Right ETF: A Detailed Guide

Choosing the right Exchange-Traded Fund (ETF) requires careful consideration to ensure it aligns with your investment goals, risk tolerance, and preferences. Here's a clear step-by-step guide to help you make an informed decision:

Step 1: Define Your Investment Objectives

Identify your goals. Determine what you want to achieve with your investment. Are you aiming for long-term growth, regular income, or capital preservation? Your goals will guide your ETF choices.

Set your time horizon. Decide on your investment duration. Are you investing for the short term or long term? This will influence whether you choose aggressive or conservative ETFs.

Evaluate your risk tolerance. Understand your comfort level with risk. Can you handle market fluctuations, or do you prefer stability? Match your risk tolerance to the type of ETFs. Aggressive investors might choose sector-specific or emerging market ETFs, while conservative investors prefer broad market or bond ETFs.

Step 2: Determine Your Target Asset Allocation

Allocate your portfolio. Decide how much of your portfolio you will allocate to asset classes, like equities, fixed income, commodities, and real estate. This helps create a balanced and diversified portfolio.

Step 3: Research ETF Categories

Learn about types of ETFs. Familiarise yourself with various ETF categories, such as equity, fixed income, commodity, sector, international, and thematic ETFs. Each has its risks and potential returns.

Screen for suitable ETFs. Use screening tools on financial websites or brokerage platforms. Filter ETFs based on criteria like asset class, geographic region, sector, investment strategy, expense ratio, liquidity, and performance history. Narrow down your options to those that meet your criteria.

Step 4: Evaluate the Index or Strategy

Understand the ETFs basis. Learn about the underlying index or investment strategy the ETF tracks. Ensure it aligns with your investment objectives and desired exposure.

Step 5: Review Holdings and Weightings

Examine the ETFs' holdings and weightings. Ensure they are diversified and representative of the index or strategy.

Avoid ETFs with excessive concentration in individual securities.

Step 6: Evaluate Performance and Track Record

Look at performance. Examine the ETFs' past performance and historical track record. Compare it to its benchmark index and similar funds. Consider factors like long-term returns, volatility, consistency, and risk-adjusted performance.

Step 7: Check Costs and Fees

Compare expense ratios. Look at the expense ratios, management fees, and other costs of different ETFs. Lower expense ratios help minimise costs and enhance long-term returns, especially for passively managed index ETFs.

Step 8: Assess Liquidity and Trading Volume

Check liquidity. Ensure the ETF has high trading volume and liquidity. This allows you to buy and sell fair-priced shares with minimal bid-ask spreads. Choose ETFs with sufficient trading volume for efficient trading.

Step 9: Consider Tax Implications

Understand tax impact. Consider the tax implications of investing in the ETF, including dividend distributions and capital gains.

Look for ETFs with tax-efficient structures and strategies that match your tax situation and investment goals.

Step 10: Review Key Documents

Read the prospectus. Review the ETF prospectus, Product Disclosure Statement (PDS), and other critical documents from the issuer. Before investing, consider the ETFs' objectives, risks, fees, and policies.

Conclusion

Choosing the suitable ETF involves a detailed evaluation of your investment goals, risk tolerance, and ETF characteristics. Follow this step-by-step guide to make an informed decision that aligns with your financial objectives. This will help you build a diversified, efficient, robust investment portfolio. Compare multiple ETFs to ensure the best fit for your strategy and monitor your investments to stay aligned with your goals.

Closing Summary: Stock Market Magic: ETFs Explained

In "Stock Market Magic: ETFs Explained," we tackled the maze of investment options, highlighting the confusion and stress investors often face. Direct shares, actively managed funds, and ETFs can seem bewildering, making it challenging to know where to start.

We broke down the complexities of ETFs, showing how they work and the variety available—from index ETFs to sector-specific and thematic ones. We weighed the pros (like low costs and diversification) against the cons (like tracking errors and market risks), giving you a clear picture of what to expect.

Our step-by-step guide to choosing the right ETF aims to make the process straightforward. It covers critical factors like expense ratios and liquidity. We also examine ETF trends to help you stay ahead.

By comparing ETFs with direct shares and actively managed funds, we offered insights on performance, costs, and risks. We aim to give you the knowledge to make informed investment choices.

In a nutshell, this e-book has made investing a manageable and enjoyable endeavour. Remember, with the correct information, you can work your stock market magic.

Thank you for joining us on this journey, and may your investments be as magical as possible.

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Eclipse Advisory: Your Strategic Financial Partner

Eclipse Advisory offers bespoke financial and business advisory services. With a commitment to personalisation and strategic insight, our firm guides clients through financial complexities, ensuring tailored advice for every stage of their journey.

David Robson, CEO and Founder of Eclipse Advisory, brings more than 40 years of experience in financial advisory, specialising in wealth creation, financial planning, and taxation. His extensive professional accreditations and memberships underline his status as a trusted and skilled advisor in the financial sector.

Eclipse Advisory distinguishes itself through its commitment to quality service, powered by a solid advisory framework and a client-focused support system.

Our methodology guarantees strategic, personalised advice, complemented by consistent monitoring and reviews to achieve financial goals.

Our comprehensive suite of specialist services includes superannuation & SMSF, retirement & estate planning, bookkeeping & outsource CFO, and business & startup services.

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Invitation

Our objective is to furnish clients with actionable insights and strategies for informed decision-making and enhanced financial resilience.

We appreciate you taking the time to read our publication and hope you found it useful. Your feedback is important to us, as it helps us better serve your needs.

Now, let's take action on what you've learned.

Invitation: Cost & obligation-free

We invite you to book a cost and obligation-free Discovery consultation to discuss your financial goals and explore how we can help you achieve them.

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Contact Us

1300 978 077

admin@eclipseadvisory.com.au

eclipseadvisory.com.au

16a Karalta Plaza, 12 Karalta Road, Erina NSW 2250