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Exchange Traded Funds

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What is an exchange traded fund (ETF)?

Like a mutual fund, an exchange-traded fund pools the money of many investors and purchases a group of securities. Like index mutual funds, most ETFs are passively managed. Instead of having a portfolio manager who uses his or her judgment to select specific stocks, bonds, or other securities to buy and sell, both index mutual funds and exchange-traded funds attempt to replicate the performance of a specific index. However, a mutual fund is priced once a day, when the fund's net asset value is calculated after the market closes. If you buy after that, you will receive the next day's closing price. By contrast, an ETF is priced throughout the day and can be bought on margin or sold short--in other words, it's traded just as a stock is.

An ETF is expected to approximate the performance of the index it tracks, but it may slightly underperform the index due to administrative costs. Less heavily traded ETFs may actually have market values that are significantly higher or lower than the underlying values due to the principle of supply and demand. For example, if a particular sector has fallen out of favor, demand for shares of an ETF in that sector may fall out of favor as well. This could cause the ETF's price to fall further than the underlying value of the fund's actual shares. And, like all securities funds, past performance is no guarantee of future results.

> **Tip:** Though passively managed ETFs are far more common, there also are some actively managed ETFs on the market.

A brief history

The Investment Act of 1940 set up the rules that mutual funds must adhere to. The act says, among other things, that mutual funds cannot actively trade throughout the day. However, when Congress passed these laws, it granted exemption powers to the Securities and Exchange Commission (SEC). The SEC oversees all U.S. investment activity. Investment companies intending to offer ETFs must apply to the SEC in writing for the necessary exemptions.

In 1989, the Toronto Stock Exchange introduced Toronto Index Participation Units. These were the first ETFs to be traded on any exchange. Then, in 1993, the American Stock Exchange entered the game with its own ETF, Standard and Poor's Depositary Receipts (SPDRs, pronounced "spiders"). SPDRs track the performance of the S&P 500. The other major investment firms quickly followed suit, and today there are hundreds of actively traded ETFs on the market.

Technical differences between ETFs and mutual funds

From a technical standpoint, an ETF works a bit differently than a mutual fund does, even a passively managed mutual fund that tracks the same index as the ETF. Mutual funds essentially buy and sell securities for cash on the open market; the process for an ETF is more complex.

An ETF is created when a large institutional investor, often a bank, broker-dealer, or other financial services firm, assembles large holdings of securities into a portfolio that approximates a specific market index--for example, the Nasdaq 100. The financial institution, known as an authorized participant (AP), exchanges those securities with the ETF's manager, receiving in return large blocks of ETF shares. Those blocks, each of which may include anywhere from 10,000-100,000 ETF shares, are known as creation units. The authorized participant may hold those creation units in its portfolio(s), but it may also break them up and sell ETF shares in smaller quantities to other investors--for example, individual investors who buy and sell them on the open market as they might any other security.

The original basket of securities is held at a custodial bank and monitored by the ETF's manager. When an authorized participant wants or needs the individual securities rather than ETF creation units, it simply assembles enough ETF shares to make up a creation unit. It returns the creation unit to the ETF in exchange for the equivalent securities (based on the creation unit's net asset value), plus any cash accumulated from dividends. Those individual securities can then once again be sold on the open market, or if borrowed, returned to individual owners who loaned them to the authorized participant.

Creation units are constantly created and redeemed by an ETF, depending on supply and demand. The authorized participant's decision about whether to hold creation units or the shares they represent may be determined by their relative values. The AP may be able to profit by using arbitrage to take advantage of any difference between the value of the creation unit and the aggregated value of the underlying securities. However, competition typically tends to keep ETF prices relatively close to the NAV of the underlying securities.

The exchange of creation units for the securities that make up the ETF's index involves no cash and is considered an in-kind trade. As a result, it doesn't trigger any capital gains for the fund itself and in turn, individual investors in shares of the ETF. By contrast, when a mutual fund sells shares of the securities it holds--for example, to meet shareholder redemptions--it may incur capital gains. By law, those gains must be distributed each year to the mutual fund's shareholders, for whom that distribution is considered a taxable event.

The in-kind exchange of creation units for the underlying securities minimizes or eliminates internal capital gains for an ETF, which in turn results in tax efficiencies for the individual investor in it.

Who can buy ETFs?

When they were first introduced, ETFs were primarily made available to large investors. Over time, it has become easier for individual investors to add these funds to their portfolios. Individual investors can purchase ETFs through a broker, just as they would purchase stocks.

Advantages of ETFs

Traditional mutual funds are bought and sold based on their net asset value at the close of business each trading day, while ETFs can be traded throughout the day from market open to market close.

ETFs allow investors to diversify their holdings within a group of securities. For example, if you believe in the prospects of the biotechnology industry but would like to buy a diversified group of biotechnology stocks (rather than just one or two companies) for a relatively small sum, an ETF can help.

ETFs also may have lower costs than those of an actively managed mutual fund. Because of the passive management and structure of ETFs outlined above, it may have lower annual taxable distributions.

Because ETFs make the in-kind redemptions outlined above, an ETF doesn't need to hold on to cash, which can lead to cash lag and cause the realization of capital gains or losses, as seen in mutual funds.

Unlike traditional mutual funds, ETFs can be sold short by investors. Generally, an investor buys a stock expecting the value to increase. Short sales, however, are different. An investor who believes that a particular stock will decline in value can borrow shares of that stock from a brokerage firm (for a fee) in what is known as a short sale. If the value goes down, the investor makes money; if the value goes up, the investor loses money. Keep in mind that the potential for unlimited losses makes short selling very risky. An ETF also can be bought on margin or traded using stop orders or limits orders.

ETFs also have no minimum investment requirements, or redemption fees for brief holding periods.

Disadvantages of ETFs

ETFs must be purchased through a broker, and a brokerage commission must be paid when you buy shares of an ETF. An investor trading in and out of an ETF will incur trading costs, which can make ETFs less suited to systematic investing programs such as dollar cost averaging, and reduce or eliminate any cost efficiencies.

While an ETF offers a less expensive way to diversify among many securities, remember that an individual ETF tends to be comprised of securities in a given asset class, which may share similar behavior. ETFs can be combined with other ETFs and other types of investments to create a broadly diversified portfolio.

An ETF doesn't necessarily trade at its net asset value, and bid-ask spreads may be wide for thinly traded issues or in volatile markets.

Evaluating an ETF

There are many factors to consider in evaluating an exchange-traded fund. Because the differences between funds can be dramatic, you should carefully consider its investment objectives, risks, charges, and expenses, which are included in the prospectus available from the fund. Read it before investing.

- Look at the index it tracks. Understand what the index consists of and what rules it follows in selecting and weighting the securities in it. Two ETFs that seem to be similar may in fact be very different.
- Look at how long the fund and/or its underlying index have been in existence, and if possible, how both have performed in good times and bad.
- Look at the fund's expense ratios. The more straightforward its investing strategy and the more widely traded the securities in its index are, the lower expenses are likely to be. For example, an ETF using futures contracts is likely to have higher expenses than one that simply replicates the S&P 500.
- Check on how the fund's returns will be taxed. Depending on what it invests in and how the ETF is structured, returns may be taxed in a variety of ways. For example, an ETF that invests directly in gold bullion will be subject to the 28 percent maximum tax rate for collectibles. An ETF that uses futures contracts, as many commodity ETFs do, may distribute both long-term and short-term capital gains. A bond ETF pays interest, which is taxable as ordinary income.

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