Exchange-Traded Funds

For many investors, open-end mutual funds serve as a vital component of their investment tool kit. But these funds have a limitation in that they can only be bought from or sold to the issuing mutual fund at the net asset value (NAV) calculated at the end of the trading day. In comparison, shares in exchange-traded funds (ETFs), may be bought and sold through brokerage firms at the current market price, any time the exchange is open.

How Are Exchange-Traded Funds Structured?

In a traditional, open-end mutual fund, individual investors buy shares in the fund directly from the mutual fund itself. The money is then put to work according to the fund's investment goals. When an investor sells his or her shares, the mutual fund itself redeems those shares. If many shareholders redeem their shares at the same time, the fund may need to sell a portion of its portfolio to raise the cash needed to repay departing investors.

An ETF, however, does not deal directly with individual investors. Rather, "creation units", typically representing 50,000 shares, are "sold" to institutional investors like brokerage firms, in exchange for a portfolio of securities that match the ETF's investment goals. The institutional investor, in turn, can then sell the ETF shares to individual investors on the open market. If an individual wishes to sell shares, he or she can do so by selling to other individual investors on the open market. An institutional investor can "sell" a creation unit's worth of ETF shares back to the fund. To complete the redemption, the fund does not have to sell anything; it simply distributes the underlying securities to the institutional investor and then "destroys" the creation unit.

Types of Exchange-Traded Funds

There are several broad types of ETFs:

- **Index ETFs:** Index ETFs are structured to track an underlying index, to achieve investment returns that mirror, as much as possible, the return (up or down) of the chosen index. An Index ETF may seek to follow broad market averages (for example, the S&P 500), industry sectors, (such as healthcare or technology), or follow the

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securities of specific foreign countries or parts of the world economy. Index ETFs may also follow commodities such as oil and gas, precious metals such as gold or silver, currencies, or track debt instrument such as U.S. Treasury or corporate bonds.

- **Actively-Managed ETFs:** While Index ETFs use a passive strategy, Actively-Managed ETFs use an active, hands-on investment strategy to achieve a specific investment objective. Actively-managed ETFs generally strive to "beat the market" by frequently buying and selling parts of the portfolio as market conditions change. Like Index ETFs, Actively-Managed ETFs may follow stock indices, industry sectors, commodities, or debt instruments.

- **Leveraged and Inverse ETFs:** These types of ETFs typically seek to deliver a return that is a "multiple" (2x or 3x) of an index or benchmark. For example, a Leveraged ETF (a "Bull" fund) looks for a particular index or benchmark to rise and seeks to achieve a return that is a multiple of the change in the underlying index. Leveraged ETFs gain when the index rises and lose when the index falls. An Inverse ETF (a "Bear" fund) looks for a particular index to fall and seeks to deliver the opposite, -2x or -3x, of the change in the underlying index. An Inverse ETF gains when the index falls and loses when the index rises.

  Such ETFs typically hold large amounts of cash (leverage) and are characterized by their use of esoteric financial instruments. Leveraged and Inverse ETFs measure their results on a daily basis; their performance over time may vary significantly from that of the underlying index.

Advantages of Exchange-Traded Funds

- **Generally lower operating costs:** Because they do not have to deal with a large number of individual investors, many ETFs have very low annual expense ratios. In a mutual fund, the need to provide shareholder services is an additional expense.

- **Tax efficiency:** The underlying structure of an ETF, using "creation units," is regarded as being very tax efficient. The low turnover, buy-and-hold approach of many Index ETFs adds to this tax efficiency. Individual investors will generally realize a gain or loss only when they sell their own ETF shares.

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- **Trading flexibility:** Because ETF shares are bought and sold on the open market, an investor can use trading tools such as limit or stop-loss orders, "sell short" the ETF shares, or even trade the shares on margin, using borrowed money.
- **No required minimum purchases:** No minimum purchase requirements are needed to buy shares in an ETF. Many mutual funds have minimum purchase requirements.

Disadvantages of Exchange-Traded Funds

- **Commission charges:** To buy or sell shares in many ETFs, the individual investor must pay a commission. Some financial services firms make available commission-free ETFs and allow commission-free ETF trades; certain restrictions or limitations may apply.
- **Client services:** Most mutual funds provide client services such as automatic dividend reinvestment or keeping track of average cost basis for tax purposes. For investors in ETFs, these services may be available from the broker, sometimes for an extra fee.

Exchange-Traded Funds vs. Mutual Funds

ETFs are frequently seen as a competing alternative to mutual funds. ETFs can provide trading flexibility, but often at the cost of paying commission charges. ETFs also typically have lower operating expense ratios and are usually more tax efficient than mutual funds. Mutual funds provide many investor services but have a more limited ability to be bought or sold.

One way to approach this question is to compare the total cost of owning an ETF with the total cost of owning a mutual fund. The Financial Industry Regulatory Authority (FINRA) makes available on its website a mutual fund and ETF analyzer which allows you to compare the different funds or share classes and estimate the impact that the various expense and fees can have over time. This calculator automatically provides the fee and expense data for you. The calculator can be found on the internet at:

https://tools.finra.org/fund_analyzer/

Seek Professional Guidance

The guidance of trained professionals can be helpful both in selecting the right investment and in monitoring the investment for any needed changes.

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