Exchange Traded Funds

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What They Are, What Sets Them Apart, and What to Consider When Choosing Them

What is an ETF?

Exchange Traded Funds are diversified investments that are much like mutual funds. Mutual funds can be actively managed, meaning designed to beat a benchmark index, or an index fund, meaning designed to replicate an index. Like a mutual fund, each share of an ETF represents a partial ownership in an underlying portfolio of securities intended to track a market index or beat a benchmark. This means that an investor holding shares in any ETF has a beneficial ownership interest in a portion of the investments in the underlying portfolio. Unlike mutual funds, shares of ETFs can be traded intraday, or at any time while the stock market is open. Given their efficiency, low-cost, trading flexibility, tax efficiency, and transparent design, the growth of ETFs has been significant.

What Sets Them Apart?

While there are some similarities between ETFs and traditional mutual funds, there are also meaningful distinctions. Both offer a way to gain diversified exposure to a broad market, market segment, asset class, style, or geographical region. To understand some of the differences, it is helpful to look at the actual mechanics of how an ETF works compared to traditional mutual funds.

A "market maker," a firm that stands ready to buy and sell a particular stock on a regular and continuous basis at a publicly quoted price, builds an ETF. The market maker builds the fund by acquiring, in proportion, all the underlying holdings in the index that the ETF is designed to track, thus replicating the index. A share of the ETF represents partial ownership in that basket of securities, and offers the benefits of passively investing in a broad range of equities.

So, when an investor purchases shares of an ETF, they are buying a vehicle that represents their ownership in a basket of securities. Unlike a traditional mutual fund, if one shareholder sells shares, the action does not create a sales event for other shareholders, because the assets are not commingled with the assets of all the other shareholders who own the ETF. This difference allows the ETF owner to more effectively manage and control tax efficiency.

Talk to your advisor for more information, and to see if ETFs might fit your investment plan.

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How are They Created?

An ETF is created when an authorized participant—generally a market maker, institutional investor, or a large financial institution—deposits a portfolio of securities into the applicable fund in exchange for a block of ETF shares. The Net Asset Value (NAV) generally represents the total value of all the investments that are in the fund, which is equal to the assets less the liabilities. The NAV represents the intrinsic value of all securities held by the ETF, though the price of the ETF shares on the market may fluctuate during the trading day (e.g., because of normal forces of supply and demand).

Though demand exceeding the amount the market is offering is the primary cause, the decision to create ETF shares is based on a number of factors, including the need to fill orders, to create inventory, or to possibly take advantage of arbitrage opportunities that arise.

Passive vs. Active Management

ETFs are typically considered passive investment vehicles, because they are designed to track a particular index and match the benchmark's performance before fees and expenses. The objective for an actively managed mutual fund is usually to beat the market benchmark by selecting investments the manager feels will outperform. Therefore, an actively managed fund has the opportunity to outperform (and runs the risk of underperforming) its benchmark, while the ETF can only match it. Because there is now a wide variety of ETFs, the investor needs to decide not only to what segment of the market she wants exposure—such as large cap equities, for example—but also which definition of that segment best suits her investment goals, because various companies offer indexes that track essentially the same market segments, but with some variance from each other. For instance, Standard & Poors, and Russell each define a large cap index, but do that using the largest 500 companies, and largest 1000, respectively.

Increased Control Over Tax Implications

Investors' assets are not commingled in an ETF as in a traditional mutual fund can make ETFs relatively more tax efficient. In a traditional mutual fund, the investor may be impacted by the actions of other shareholders, as capital gains are distributed equally to all investors, regardless of how much of that gain the investor participated in. However, the structure of the ETF can give an investor much the same control over purchases and sales as an owner of a stock, because the market maker delivers a basket of securities to the fund manager in exchange for ETF shares that are then delivered to the investor.

Factors to Consider When Choosing ETFs:

ETF Structure and Underlying Index – Key factors include: the index's concentration, style, capitalization, and regional exposure; Liquidity of underlying holdings and if the index represents the intended exposure; Consideration from low tracking error to the index.

The Decision: Go Active or Passive – Determine if the ETF follows an active or passive approach and determine which one has the potential to outperform.

Costs – Some would say that all things being equal, they would prefer the ETF with the lower expense ratio.

Bid-Ask Spread – The bid-ask spread is the difference between the market price for buying the ETF and the market price for selling the ETF. ETF's with a wider spread normally implies greater transaction costs.

Trading Volume, Net Assets, and Liquidity – An ETF with low average daily trading volume and consequently lower liquidity may lead to a wider bid-ask spread. Be sure to review the average shares traded, and, the amount of assets in the ETF to ensure liquidity levels.

Premium or Discount to NAV – In some cases demand or lack of demand for the ETF may cause a price premium or price discount relative to its underlying NAV.

Leveraged or Inverse – ETFs are no longer just long products. With the proliferation of ETFs, have come leveraged, inverse, and leveraged inverse ETFs. These ETFs can be used to be more opportunistic with an investment or can be used to hedge portions of a portfolio. When considering whether to use these products or traditional ETFs, consider very carefully the additional risk these products add to the portfolio. Regardless of the usage, these products are more volatile than their traditional counterparts. Many of these products reset daily—with some resetting monthly. The indicated returns—of 2x or -1x for example—are only for the reset period so the performance of these products relative to their underlying index should be monitored very closely. These products tend to have higher costs and higher tracking error than traditional products.

Given the vast number of ETFs available today, determining what is the appropriate ETF to invest in is an essential consideration. While a defined selection process is important, the actual implementation of that purchase should be considered, too.

What are Leveraged ETFs?

There are a variety of ETFs available. Some are relatively simple while others have unique features and risks—such as leveraged or inverse ETFs. Leveraged ETFs are designed to provide a multiple, often double or even triple, of the daily returns of their underlying indices. For example, a double leveraged ETF might gain 2% in a day when the underlying index gains 1% that day. Inverse ETFs are designed to provide the opposite, or inverse, level of daily returns. For example, if the index declines 1% in a day, an inverse ETF would gain 1% that day.

On the surface, these ETF offerings may seem to be a good way to hedge a portfolio from market downturns. Although the concept of leveraged and inverse ETFs is easy to understand, the mechanics behind the makeup of returns are complex.

- As noted above, the leveraged funds are designed to provide a multiple of the index's daily return. Compounding of the daily returns can produce a wide divergence from the underlying index return over time. They are not designed to, an will not necessarily, track the underlying index or benchmark over a longer period of time.

- In highly volatile markets with large positive and negative swings, return distortions are magnified over time.
- Additionally, certain features of these funds may further add to the tracking error between the index and the ETF's return. Leverage is accomplished through a combination of short and/or long derivative positions, including futures, swaps and index options each with their own inherent costs. In fast moving markets, these ETFs need to rebalance* frequently the basket of derivatives to maintain proper leverage exposure. These continual adjustments may add to underlying costs and increase the divergence from the underlying index.

With all of the factors above at work, the longer the position is held, the greater the divergence from the target return can grow. Thus, leveraged and inverse ETFs do not seek to achieve their stated investment objective over a period of time greater than one day and must be monitored closely. Leveraged and inverse ETFs may be riskier than similarly benchmarked exchange-traded funds that do not use leverage. Accordingly, they are unsuitable for investors who plan to hold them longer than one trading session, particularly in volatile markets and should only be used by investors who understand the potential consequences of seeking daily leveraged investment results. They may be less tax-efficient than traditional ETFs because short-term capital gains may not be offset by a loss.

Summary

ETFs offer an efficient, low-cost and transparent way of obtaining targeted investment exposure.

ETFs offer an efficient, low-cost and transparent way of obtaining targeted investment exposure. While index mutual funds provide many of these benefits, ETFs offer the added advantage of intraday trading. Given their benefits, it is not surprising that there are literally hundreds of ETFs available and more are being created every day. Choice is great, but having a selection process that focuses on their structure, costs, risks, and liquidity can help narrow the choices.

Talk to Your Advisor

There are potential benefits to utilizing ETFs. ETFs offer investment exposure to a variety of indexes, asset classes, or sectors that might be difficult to achieve with other investments. In this way, ETFs can provide a unique investment exposure or can be used as a hedging tool. However, given their unique characteristics they may not make sense for all investors. As with all investments, please consult your financial advisor on how ETFs may meet your investment goals.

*Rebalancing may incur a taxable event.

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide or be construed as providing specific investment advice or recommendations for any individual. To determine which investments may be appropriate for you, consult your financial advisor prior to investing. All performance referenced is historical and is no guarantee of future results. All indices are unmanaged and cannot be invested into directly.

Exchange-trade-funds (ETFs) offer shares that trade in the secondary market. Because ETFs are listed on exchanges, individual ETF shares can be bought and sold throughout the trading day at the current market price. The general level of stock or bond prices may decline, thus affecting the value of an equity or fixed income exchange traded fund, respectively. Moreover, the overall depth and liquidity of the secondary market may also fluctuate. Therefore, value of the shares, when redeemed, may be worth more or less than their original cost. Due to market conditions, ETF shares trading on the exchange may be available for purchase at a premium or discount to NAV.

Although exchange traded funds are designed to provide investment results that generally correspond to the price and yield performance of their respective underlying indexes, the trusts may not be able to exactly replicate the performance of the indexes because of trust expenses and other factors.

Principal Risk: An investment in an Exchange Traded Fund (ETF), structured as a mutual fund or unit investment trust, involves the risk of losing money and should be considered as part of an overall program, not a complete investment program. An investment in ETFs involves additional risks: not diversified, the risks of price volatility, competitive industry pressure, international political and economic developments, possible trading halts, Index tracking error.

Investing in mutual funds involve risk, including possible loss of principal.

Leveraged ETFs, sometimes labeled "ultra" or "2x," for example, are designed to provide a multiple of the underlying index's return, typically on a daily basis. Inverse products are designed to provide the opposite of the return of the underlying index, typically on a daily basis. Compounding of the returns can produce a divergence from the underlying index over time, in particular for leveraged products. In highly volatile markets with large positive and negative swings, return distortions are magnified over time. Because of these distortions, these products should be actively monitored, as frequently as daily, and, are generally not appropriate as an intermediate or long-term holding. They may not be appropriate for investors who plan to hold them longer than one trading session, particularly in volatile markets. To accomplish their objectives, these products use a range of strategies, including swaps, futures contracts and other derivatives. These products may not be diversified and can be based on commodities or currencies. These products may have higher expense ratios and be less tax-efficient than more traditional ETFs.

Investors should consider the investment objectives, risks and charges and expenses of the investment company carefully before investing. The prospectus contains this and other information about the investment company. You can obtain a prospectus from you financial representative. Read the prospectus carefully before investing.