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Investor Bulletin: Exchange-Traded Funds (ETFs)

What is an ETF?

An ETF is a type of exchange-traded investment product available for retail investors. In some ways ETFs are similar to mutual funds. For example, both are registered investment companies that can provide similar benefits such as professional management, investment diversification, and a low minimum required investment. But ETFs are structured differently than mutual funds, which creates different benefits and risks.

How are ETFs similar to mutual funds?

Like mutual funds:

- ETFs offer investors a way to pool their money in a fund that makes investments in stocks, bonds, other assets, or some combination of these investments, which helps retail investors with diversification.
- ETF investors receive an interest in that investment pool. This means each ETF share represents an investor's proportionate ownership of the fund's portfolio and the income the portfolio generates.
- ETFs are investment companies that must be registered with the SEC. This registration requires the ETFs to provide ongoing disclosures and information to investors, among other things. It also provides protections for investors, such as limits on illiquid or hard-to-sell investments in an ETF's portfolio and restrictions on an ETF's borrowings and debt.
- The combined securities and other assets the ETF owns are known as its investment portfolio, which is usually managed by an SEC-registered investment adviser.
- ETFs must calculate their net asset value or NAV per share (the value of all its assets minus all its liabilities divided by the number of shares) every business day. NAV is a measure of how much the ETF's investment portfolio is worth.
- ETFs can be index-based or actively managed. For an indexed-based ETF, the adviser seeks to track an underlying securities index and achieve returns that closely correspond to the returns of that index. For an actively managed ETF, the adviser buys or sells

investments in the portfolio without regard to conformity with an index. The trades must still be consistent with the overall investment objective of the fund.

How are ETFs different from mutual funds?

Unlike mutual funds:

- ETFs do not sell individual shares directly to, or redeem their individual shares directly from, retail investors.
- ETF shares are traded throughout the day on national stock exchanges and at market prices at the time the trade is placed.
- Most ETFs post their portfolio holdings on their websites daily.

How do ETFs work?

Market Transactions. Unlike with mutual fund shares, retail investors can only purchase and sell ETF shares in market transactions that occur on a stock exchange. This is because ETF sponsors enter contractual relationships with one or more financial institutions known as Authorized Participants. Authorized Participants typically are large broker-dealers. Typically, only Authorized Participants purchase and redeem shares directly from the ETF. In addition, they can do so only in large aggregations or blocks (e.g., 50,000 ETF shares) commonly called creation units, and they typically "pay" for the creation units in an in-kind exchange with a group or basket of securities and other assets that generally mirrors the ETF's portfolio.

Purchase creation units. To purchase shares from an ETF, an Authorized Participant assembles and deposits a designated basket of securities and cash with the ETF in exchange for which it receives ETF shares. Once the Authorized Participant receives the ETF shares, the Authorized Participant is free to sell the ETF shares on a national stock exchange to retail investors, institutions, or market makers in the ETF.

Redeem creation units. The redemption process is the reverse of the creation process. An Authorized Participant buys a large block of ETF shares on the open market and delivers those shares to the fund. In return, the Authorized Participant receives a pre-defined basket of individual securities, or the cash equivalent.

Market Prices versus NAV. Other investors, including retail investors, purchase and sell ETF shares in market transactions at market prices. An ETF's market price typically will be more or less than the fund's NAV per share (called selling at a premium or discount). This is because the ETF's market price fluctuates during the trading day because of a variety of factors, including the underlying prices of the ETF's assets and the demand for the ETF. An ETF's market price is generally kept close to the ETF's end-of-day NAV per share because of the arbitrage function inherent to the structure of the ETF.

Arbitrage. Arbitrage is the practice of taking advantage of a price differential between two or more markets. An arbitrage opportunity is inherent in the ETF structure because the ETF's market price fluctuates during the trading day. Due to this fluctuation, the ETF's market price may not equal the ETF's end-of-day NAV per share. Authorized Participants can arbitrage this difference (and make a profit) because they can trade directly with the ETF at NAV as well as on the market. The expected result of the arbitrage activity is that the market price of the ETF's shares moves back in line with the ETF's NAV per share and retail investors can buy ETF shares on an exchange at a price that is close to the ETF's NAV per share.

What are some of the potential risks and benefits of investing in ETFs?

Premium or Discount to NAV. Because of how ETFs trade, you may end up paying more or less for ETF shares than the underlying assets of the fund are worth. That is because ETF shares are traded throughout the day on national stock exchanges and at market prices that may or may not be the same as the NAV of the shares. The ability to trade shares throughout the day can give you some flexibility with your shares, but the market price for ETF shares may be higher or lower than the ETF's NAV per share and there is a risk that a trading market may not develop at all. Shares that sell at a price higher than the NAV per share are said to be sold at a premium, and shares that sell at a price lower than the NAV per share are said to be sold at a discount. The premiums and discounts for specific ETFs may vary over time. Information about an ETF's historical premiums and discounts can be found either in the ETF's full prospectus or more typically on its website.

Lower fees. ETFs have tended to be less expensive to operate than mutual funds that invest in a similar manner. This is because of differences in distribution and often lower transaction costs that ETFs pay and because ETFs require somewhat different services to operate than mutual funds. ETFs typically pass these savings on to the investor in the form of lower total fees. Information about an ETF's cost and fees can be found in the ETF's prospectus. In addition to ETF fees, you may pay brokerage commissions and additional trading costs when you buy and sell ETF shares.

Tax efficiency. ETFs can be tax efficient because many ETFs buy and sell portfolio securities in in-kind exchanges (rather than for cash). This means ETFs typically have fewer capital gain distributions than mutual funds. As a result, ETF shareholders may pay less in taxes on a similar investment.

Bid-ask spread. ETFs and other securities that trade on a securities market actually have two market prices—the bid price and the ask price. The term "bid" refers to the highest price a buyer will pay to buy a specified number of ETF shares at any given time. The term "ask" refers to the lowest price at which a seller will sell the ETF shares. The bid price will be lower than the ask price and the difference between two prices is called the spread. An example is an ETF share that is trading for $59.50/$60. The bid price is $59.50, the ask price is $60.00, and the spread is 50 cents. If an investor buys 200 ETF shares at the ask price of $60 and sells them immediately at the bid price of $59.50, the investor would incur a loss of $100. This example demonstrates the impact of the spread on an ETF investment. ETFs that are more liquid and have higher trading volume typically have tighter or smaller spreads. The spread can be thought of as a hidden cost to investors since spreads reduce potential returns. Information about an ETF's median bid-ask spread can be found on the ETF's website.

Invest more cash. Since ETFs do not sell individual shares directly to, or redeem their individual shares directly from, retail investors, ETF managers generally do not have the same concerns about constant redemptions as mutual fund managers do. This may give ETF managers more flexibility to invest more of their cash.

Before you invest in an ETF:

- Carefully read all of the fund's available information, including its summary prospectus and full prospectus. These documents provide detailed information on the ETF's investment objective, principal investment strategies, risks, costs, and historical performance (if any). You can get these documents by looking at the fund's filings on the SEC's EDGAR database, from your investment professional, or on the ETF's website.
- Visit the ETF's website to learn more about the ETF, including information about its NAV, closing market price, closing premium or discounts, portfolio holdings, its median bid-ask spread, and historic premiums and discounts all as of the close of the previous business day.
- Understand how the ETF achieves its stated investment objectives and whether those objectives are consistent with your financial goals.
- Be sure the risks associated with a particular ETF are within your tolerance for risk.
- Understand the fees and expenses you will pay for the ETF and compare them to other investment options. These fees and expenses could include brokerage commissions you may pay when buying and selling ETF shares, and annual operating fees and expenses.

Helpful Links

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