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Exchange Traded Funds

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What is an exchange traded fund (ETF)?

Exchange traded funds (ETFs) are index-tracking funds that trade like stocks. Often referred to as a basket fund, an ETF is a collection of securities that mimics a particular index (e.g., Standard and Poor's 500 Composite Index). The intent of the fund is to track the index.

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.

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 more than 150 actively traded ETFs on the market.

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

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.

The popularity of ETFs is a result of the numerous advantages they provide to investors, both large and small. ETFs track groups of securities in different sectors of the market, providing investors with a convenient way to create a diversified portfolio.

ETF investors may also enjoy lower costs than mutual fund investors. Unlike a mutual fund purchased directly from a fund company, however, a brokerage commission must be paid when you buy shares of an ETF.

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 make in-kind redemptions. When an investor wants to liquidate an ETF, those shares are sold to other investors in the fund. As a result, the remaining shareholders' capital gains or losses are minimized (this is not so

for the investor who is liquidating). In general, the fund 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. Interestingly, short sales are one area where ETFs provide greater flexibility than individual stocks. A stock can only be sold short on an uptick (positive market trend), while an ETF can be sold short on a down tick (last trade was for a lower price than the prior trade). Although short selling is a popular investment strategy, keep in mind that the potential for unlimited losses makes it very risky.

Disadvantages of ETFs

ETFs must be purchased through a broker. An investor trading in and out of an ETF will incur brokerage fees, which can rapidly deplete the cost savings that ETFs have over mutual funds.

While an ETF offers broader diversification than shares of stock in individual companies, remember that ETFs are not broadly diversified. Rather, they tend to be comprised of securities that will move up and down as a group. ETFs can be combined with other ETFs and other types of investments to create a diversified portfolio.

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