

Exchange Traded Funds (ETFs) The Basics

By Joe Maas

The exchange traded fund (ETF) market has exploded over the last several years in both the number of funds available and the variety. The surge in ETF popularity can be attributed to four key benefits. ETFs are:

1. Inexpensive
2. Flexible
3. Tax efficient
4. Transparent

We introduce the reader to the basics ETFs by comparing them to open end mutual funds.

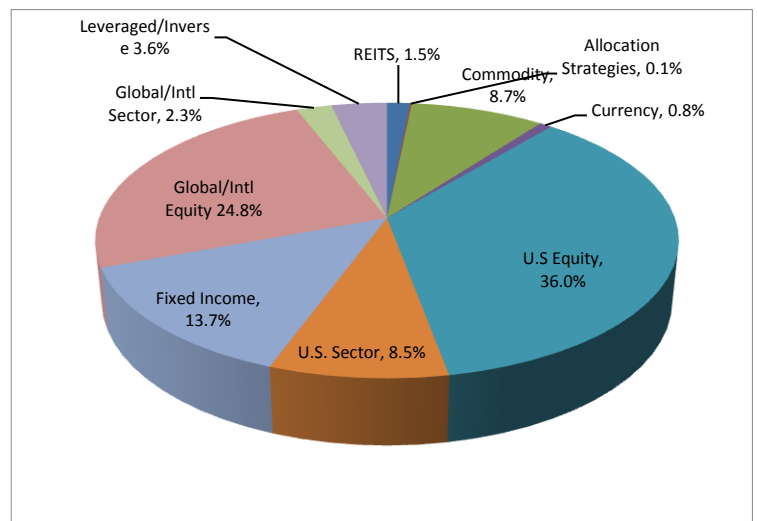
The Basics

Like mutual funds, ETFs are baskets of securities that are pooled together to provide diversified exposure to a desired investment objective or category. They help investors who do not have the time and/or skill to successfully select their own individual stocks and investors looking for index tracking products to use in an asset allocation or index strategy.

The process of categorizing ETFs can be daunting due to their proliferation and overlapping characteristics. Below are ten broad and common categories.

ETF Categories by Percentage of Assets (as of 1-14-10)
Source: Bloomberg

REITS	1.5%
Allocation Strategies	0.1%
Commodity	8.7%
Currency	0.8%
U.S Equity	36.0%
U.S. Sector	8.5%
Fixed Income	13.7%
Global/International Equity	24.8%
Global/International Sector	2.3%
Leveraged/Inverse	3.6%
	100.0%



Unlike mutual funds, ETFs trade throughout the day; hence their price fluctuates based on supply and demand. Like stocks, ETFs can trade with market orders, limit orders and stop loss orders. They can be

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purchased on margin (borrowing money to buy stock), and they also can be sold short (selling stock you do not own).

ETFs are inexpensive

ETF providers deal directly with a few large sponsors, thereby eliminating administrative costs that mutual funds must deal with. The reduction in overhead expenses is then passed along to the investors.

ETFs are flexible

Because ETFs can trade throughout the day, they offer more flexibility than mutual funds. Mutual fund share prices are set once at the end of the trading day. The buy and sell orders placed throughout the day are then executed at this price. ETFs, on the other hand, allow investors to buy and sell shares throughout the day.

In addition to trading flexibility, ETFs also provide investors with broader access to investment categories and to specific sectors of both the domestic and global markets.

ETFs are tax efficient

ETFs are more tax efficient than mutual funds, both at the investor level and at the fund level; ETFs are also less likely to make taxable capital gain distributions. Their ability to minimize taxes is primarily due to how shares are created and redeemed. A mutual fund will usually experience a tax event from selling portfolio securities in the open market. In contrast, ETFs use an "in-kind" process by exchanging a basket of securities to create and redeem shares. In the United States, this transaction is not taxable; so there is no distributed gain.

ETFs are transparent

ETFs are not susceptible to the kind of trading abuses and scandals that mutual funds have recently experienced because they trade throughout the day. Their prices are set by market supply and demand, mitigating the chance of late trading abuse. However, they can trade at a discount or premium to the fund's underlying asset values.

In summary, ETFs are an excellent investment vehicle for investors. They are appropriate for index trackers (beta seekers), investors trying to outperform a specific benchmark (alpha hunters), and for those who wish to increase returns and reduce risk through asset allocation strategies (modern portfolio theory).