Understanding Exchange-Traded Funds (ETFs)

By Gene C. Sulzberger

In the past 20 years, ETFs have become one of the most popular investment vehicles. They offer low-cost access to asset classes for investors. With over $1 trillion in assets under management, the ETF structure has become one of the fastest growing areas of the financial markets. There was one ETF in 1993 known as the SPDR (the S&P 500 Depository Receipt). Now there are over 2000 ETFs, representing many asset classes.

According to Investopedia: "Exchange-traded funds (ETF) are marketable securities that typically track an index or a basket of assets like an index fund. Unlike mutual funds, an ETF trades like a common stock on a stock exchange. ETFs experience price changes throughout the day as they are bought and sold. ETFs typically have higher daily liquidity and lower fees than mutual fund shares, making them an attractive alternative for individual investors."

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Comparison with Mutual Funds: Like mutual funds, ETFs pool the assets of multiple investors and invests those assets according to the fund's investment objective. Also, ETFs are regulated by the Securities and Exchange Commission (SEC) under the Investment Company Act of 1940, like mutual funds. However, mutual fund shares can only be purchased or sold at the fund's net asset value which is calculated at the end of the trading day, unlike ETFs which trade throughout the trading day.

ETFs are described as more transparent than mutual funds because they are required to provide information about the composition of their portfolios daily. Often, ETFs full portfolios can be found on the internet. Mutual funds, however, only require quarterly portfolio disclosures, with a 30-day lag.

Tax Efficiency of ETFs: ETFs are also often described as more tax efficient than mutual funds. Many equity-oriented ETFs have very little turnover and amass fewer capital gains than an actively managed equity mutual funds. Also, investors delay paying capital gains until an ETF is sold. Capital gains taxes are realized on an ETF when the entire investment is sold. With mutual funds, an investor may owe capital gains taxes while they hold the mutual fund to account for trades made within the fund during each year, even though the mutual fund has not been sold by the investor. Mutual funds typically incur more capital gains taxes than ETFs due to the frequency of trading activity within a mutual fund.

It is important to note that while ETFs reduce capital gains distributions, the investor ultimately pays taxes on any capital gains when they sell their ETF shares. ETF strategies may enable tax efficiency, but not tax avoidance.

Expenses and Minimums: In addition, the expenses within ETFs are typically lower than mutual funds, sometimes significantly. There are also no minimum deposit requirements with ETFs. An investor can purchase as little as one ETF share. Many mutual funds, on the other hand, have a minimum purchase amount of $1,000 or $2,500 or more.

Evaluating an ETF: An investor may wish to evaluate an ETF's performance against its stated benchmark or objective. For an index-based ETF, this is known as the ETF's tracking difference. The tracking difference is the extent to which the ETF's return deviates from the return of its benchmark index. This difference is usually attributable to factors including the ETF's operating expenses and how regularly index rebalancing is done by the fund.

Also, when buying or selling ETFs on the secondary market, there is typically a difference between the highest price a buyer is willing to pay for an ETF (the Bid) and the lowest price a seller will accept to sell an ETF (the Ask). Bid/ask spreads are typically lower for larger ETFs that are highly liquid. Thus, an investor may buy an ETF for slightly over market price.

As with any financial product, an investor should understand the objectives and risks associated with an ETF before investing. Investors are encouraged to read the ETF's prospectus for information on the fund's risks and objectives. Professional financial advisors can educate investors about the appropriate use of ETFs and other financial products.