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What You Should Know About Exchange Traded Funds

Exchange Traded Funds (ETFs) are frequently referenced in the media as an investment alternative to mutual funds. But what are they? And what do you need to know to protect yourself before you invest in one?

An ETF is similar to a mutual fund as it typically represents a basket of underlying securities. Unlike a mutual fund, however, an ETF trades like a stock and investors can buy and sell it throughout the trading day.

Over the past decade, ETFs have evolved from a product traded primarily by stock market professionals to a product that is easily accessible in wide varieties to retail investors. As measured by dollar assets and by number and type of products, ETFs have grown significantly. At the end of 1995, ETFs had accumulated just over $1 billion in assets, whereas by mid-year 2006, assets in ETFs totaled $335 billion, according to the Investment Company Institute.

The number of ETFs has increased from two in 1995 to 263 by mid-2006, with over 60 of those entering the market in the first six months of 2006 alone (these figures also come from the Investment Company Institute). Given this rapid growth, it is likely that an increasing number of retail investors will be exposed to ETF investment opportunities.

Most ETFs are passively managed funds that track U.S. equity indexes. Yet with growing popularity, new ETFs are increasingly complex and specialized.

Marketing materials and media coverage often portray ETFs as low-cost, diversified alternatives to more conventional products such as mutual funds. Cost and level of diversification, however, can vary significantly depending on the ETF.

While ETFs may offer valuable investment opportunities, investors should be aware that there are distinct risks associated with these investments. Investors, whether they are purchasing mutual funds, stocks, or some other investment, should research and evaluate the product they plan to purchase: this holds true for ETFs, as well. Investors should carefully review an ETF prospectus or product description and any other available material to ascertain fund-specific information about what the ETF derives its value from, as well as how the ETF is managed.

Questions to Ask

The following are some of the questions you should ask yourself, your registered representative or investment adviser to ensure the suitability of any ETF investment that you are considering:

Q. What are the costs associated with an Exchange Traded Fund investment?

A. ETFs charge an annual fee equal to a percentage of invested assets. While this fee, or "expense ratio," associated with an ETF can be relatively low, it can vary significantly from one ETF to another. Because ETFs trade like stocks, brokerage commissions typically apply to ETF purchases and sales depending on your account type. Understanding the total cost of an investment in an ETF is important in order to make an informed decision.

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Q. How do the costs of Exchange Traded Fund purchases compare with the costs of mutual fund purchases?

A. Brokerage commissions may have a significant impact on the total expenses associated with ETF investments. As an example, if you plan to make smaller investments on a regular basis (as opposed to making one large purchase), investing in a commission-free mutual fund might be a less expensive option than investing in an ETF. Investors should be aware that, particularly when multiple purchases and/or sales are involved, commissions associated with ETF transactions can drive up the costs of these investments.

In order to perform an accurate cost comparison, you should consider variables such as expense ratios, commissions, and investment timeframes (how long an investor plans to hold the investment). All of these variables will impact the relative costs of investing in an ETF versus a mutual fund.

Q. There are so many Exchange Traded Funds to choose from. How do I find the right ETF for me?

A. Some ETFs derive their value from broad market indexes, such as the S&P 500 Index, and others derive their value from stocks in particular industries, sectors or geographic regions. ETFs can also focus on certain investment styles, such as growth or value, or reflect the performance of certain bond indexes, commodity prices, or currency valuations. The number and type of ETFs available to investors have increased dramatically in recent years and this increase is likely to continue. Given all of the choices, you should ensure that you are comfortable with the ETF before purchasing by discussing it with your broker, reading the prospectus or product description, researching the ETF on the Internet, or consulting one of the many independent research and ratings services that track ETFs.

Q. How can I evaluate risks associated with an investment in an Exchange Traded Fund?

A. New ETFs have become increasingly complex and specialized. That correlates not only to new investment opportunities but also to new investment risks. The level and type of risk associated with ETFs may vary significantly from one ETF to another. It is important to have a complete understanding of the underlying product(s) from which an ETF derives its value in order to evaluate risks. Risks associated with an ETF that tracks the S&P 500, for example, may be significantly different than the risks associated with an ETF that tracks the price of a commodity such as oil.

ETFs that track commodity products or commodity indexes illustrate the trend toward specialization and complexity in the ETF space. Micro-cap ETFs that track indexes comprised of some of the very smallest publicly-traded companies are yet another example of this trend.

You should also consider an ETF's price volatility. That, in turn, depends on the volatility of its underlying securities or commodities. An ETF's historical performance, including adjustments for expenses, although not predictive of future performance, is another factor that should be considered.

Q. Is there anything else I should know before making an investment in an Exchange Traded Fund?

A. Investors should be aware of some of the more technical aspects and implications of ETF investing. For example, investors may be able to purchase ETFs on margin, meaning they may be able to use borrowed money to purchase an ETF. Using margin to purchase an ETF—or any other security—may significantly increase both the risk and reward related to the investment. ETFs can also be sold short, which is a strategy used primarily by market professionals and other sophisticated investors whereby an investor sells a security that he or she does not actually own. The investor borrows the security from a broker then sells it. Investors that use this strategy anticipate the price will decline and that they will be able to purchase the security for a lower price at a later date, thus making a profit when they return it. Investors should ensure that they fully understand the risks of buying on margin or selling short if they plan to use either strategy.

Additionally ETFs, like mutual funds, typically derive their value from an underlying basket of stocks. Because ETFs trade throughout the day like a stock, continuous supply and demand also impact the price. As a result, it is possible for an ETF to trade at a price that does not reflect the value of the underlying securities, and these risks may be magnified in more complex or specialized ETFs. The ETF's prospectus or product description may discuss these and other ETF specific risk.

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