NYSE Informed Investor

What You Should Know About Exchange Traded Funds

Exchange Traded Funds ("ETFs") are increasingly popular investment vehicles. Before you decide to invest, there are some basic questions you should consider in order to make an informed investment decision.

What are Exchange Traded Funds?

An ETF is an investment product that allows an investor to buy and sell shares in a single security that represents a fractional ownership of a portfolio of securities. Legally, ETFs are open-ended investment companies or unit investment trusts that are registered under the Investment Company Act of 1940.

ETFs are one type of structured exchange-traded product. There are other types as well, but they do not share all the characteristics of ETFs, even though they may be referred to as such in the popular press and on some websites. Examples of these other investment products include exchange traded notes (ETNs), equity linked notes, closed end funds and exchange traded vehicles (ETVs), among others.

What kinds of ETFs are available?

The first ETF, SPDR Trust, was listed in 1993 with an underlying portfolio designed essentially to replicate the performance of the S&P 500 index. Since then over 700 ETFs have been introduced that allow investors to gain exposure to a wide range of investment strategies including broad stock indexes, industry sectors, fixed income indexes and international and global indexes.

Recently, ETFs have introduced investment objectives that attempt to replicate a multiple or the inverse of the daily return of an underlying index. For example, one fund replicates twice the daily return of the Dow Jones Industrial Average. The "short" or "inverse" ETFs replicate the inverse of the daily returns of the underlying index. Leveraged and inverse ETFs are discussed in more detail later in this document.

Another new type of investment offered in the ETF structure is the actively managed portfolio. Unlike traditional ETFs, which are designed to track an index, actively managed ETFs permit the fund manager to buy and sell securities and derivatives according to a stated strategy, described in the prospectus. As a condition of operations, the portfolio or fund holdings are disclosed daily on the fund's website.

How are ETFs traded?

ETFs are listed on a national securities exchange; they can be bought and sold like common stocks throughout the trading day. Individual investors may purchase or sell an ETF through a stock brokerage account. Investors may enter the same types of orders that are placed for shares of stock (including, for example, market and limit orders). There are also listed options on some ETFs.

What are Creations and Redemptions and how are they done?

As stated above, shares of ETFs are bought and sold in the secondary market, such as on a stock exchange, just as shares of stock are bought and sold. Unlike most equities, however, an ETF can issue new shares and redeem existing shares on any trading day, in a process referred to as "creation" and "redemption", which is open to qualifying entities that register as Authorized Participants with the fund. This mechanism allows an Authorized Participant to exchange a portfolio of stocks and receive ETF shares in return (i.e., a "creation"). Similarly, an Authorized Participant can "redeem" ETF shares and receive the portfolio of stocks. An Authorized Participant is usually an institutional investor or market maker who has signed a participant agreement with an ETF sponsor or distributor. Becoming an Authorized Participant allows the entity to transact directly with the fund or trust on an "in-kind" basis.[1]

Creations may only take place in large blocks, called "creation units." The size varies, but is typically 50,000 shares. Both creations and redemptions occur at the net asset value ("NAV"), which is calculated based on the total assets of the ETF, subtracting expenses and dividing by the number of ETF shares outstanding.

Although there is no guarantee or assurance that ETF shares will always trade in the secondary market at a price that is equal to its NAV, the ability of Authorized Participants to create and redeem ETF shares helps to keep the ETF's price in line with its expected NAV. An ETF generally trades at a price that is close to the NAV, but there are times when an ETF can trade at a premium to (i.e., higher than) or at a discount to (i.e., lower than) the NAV. This can occur because of investor supply and demand or for other reasons detailed below.

Questions to Ask

Before investing in any financial instrument, you should understand its risks, costs, benefits and other characteristics. Investors should carefully read the prospectus and any other informational material available. ETF issuers' websites provide prospectuses, the statement of additional information and other information. Here are some of the questions you should ask yourself, your registered representative, and/or your investment advisor to determine if an ETF is an appropriate investment for you, how it would fit into your portfolio, and how much of your portfolio should be allocated to it.

Q. What are the costs associated with Exchange Traded Funds?

A. ETF issuers charge a management fee that is deducted directly from the assets of the ETF. As a result, the investment return of the ETF could be lower that that of the underlying benchmarked index. This fee may be referred to in the prospectus by such terms as an "expense ratio", "management fee", or "investor fee". It is expressed as an annualized percentage and currently ranges from less than 0.10% up to about 1.00%. The ETF's management fee is included in the daily published NAV and thus is incorporated in the bid and asked prices in the secondary market. It is important to refer to an ETF's prospectus for details on fees and how they are calculated.

Because ETFs trade like stocks, brokerage commissions and/or transaction costs typically apply to ETF purchases and sales, depending on the fee structure of your securities account. As with other investments, understanding the total cost of an investment in an ETF is important in order to make an informed decision.

Q. How can I determine the value of an ETF on an intra-day basis?

A. An ETF's NAV, as described above, is generally determined at the close of each trading day. This value is then used to price creation and redemption units and is disseminated to the public before the market opens the next day. During the day, however, ETF shares are bought and sold at prices, which are determined by the market forces of supply and demand. An ETF's market price is often closely related to its NAV, but it may differ. The following are some of the reasons why an ETF's market price may differ from its NAV:

- Because ETFs are bought and sold in transactions between investors, at times there may be insufficient liquidity in the marketplace which can result in an imbalance in buying and selling interest in an ETF. The creation/redemption process, however, is intended to mitigate pricing imbalances since professional traders may create new ETF shares and offer them for sale in the secondary market.
- The underlying components of the ETF (i.e., the basket of securities that comprise the ETF) may not be trading during the same hours as the ETF, or trading in a component security may be halted. In either event, the ETF may be priced to anticipate a future price in the underlying when it reopens for trading.
- The underlying components of the ETF may contain securities that trade infrequently or are based on relatively wide bid-ask spreads (e.g., corporate bonds or municipal securities) and are therefore difficult to price based on last sale data. This situation is not unusual for certain fixed income ETFs.

Q. Do ETFs provide current income?

A. Similar to a mutual fund, an ETF may distribute any net investment income that the fund earns in the form of a dividend. A fund's net investment income is earned from receiving dividends and short term distributions from the fund's holdings, less the fund's expenses. Until a potential payout date, dividends and capital gains awaiting distribution are included in the fund's daily NAV. All shareholders who hold shares of a fund on record date are eligible to receive any potential distributions.

Investors should read the prospectus carefully to understand the investment strategy of the ETF they are considering, as the strategy will have a significant impact on, among other things, current income.

[1]Certain specialty ETFs, such as those that seek to produce a short exposure to the market or to an index, may create and redeem in cash rather than in-kind.

Q. There are so many ETFs to choose from. If I choose to invest in an ETF, how do I select one?

A. It is important to read the prospectus and product description carefully and research the product to select an ETF whose risks and exposure characteristics are consistent with your investment goals, risk tolerance and portfolio. The level and type of risk associated with ETFs may vary significantly from one ETF to another. It is important to understand the underlying benchmark or portfolio of securities that the ETF is designed to replicate in order to evaluate the risks of investing in that ETF. Many issuers have a link to the ETF's prospectus on their website. You may also wish to consult with your registered representative, investment adviser or tax advisor.

Q. Where can I find more information on ETFs?

A. NYSE.com features an Exchange Traded Products Screener which allows investors to search for ETFs, ETNs (Exchange Traded Notes) and ETVs (Exchange Traded Vehicles) that trade on NYSE Arca. The Screener allows investors to search for an ETF using a keyword or symbol and provides a link to the issuer's website. ETFs may also be filtered by issuer and classification. The Screener can be found at http://www.nyse.com/screener/.

Specific to each ETF, NYSE.com also offers a profile page with a detailed description of the product, current and historical trading data, news announcements pertinent to the product and links to SEC filings. To access this information, type the symbol in the "get quote" search box located on the top, right-hand corner of the home page.

Two other informative links:

Corporate action postings, including new launches and dividend distribution information can be found at:

http://www.nyse.com/equities/nysearcaequities/1231845027892.html

A spreadsheet providing weekly updates of ETF trading volumes for each product can be found at:

http://www.nyse.com/attachment/Weekly_ETP_Volume.xls

This section will soon be enhanced with weekly updates to include data for each product on assets under management and net cash inflows and outflows. To subscribe to our free electronic distribution list to keep informed of ETF updates, please send an email to etf@nyx.com with your name and contact information.

Q. What are the risks associated with investing in ETFs?

A. ETF shareholders are subject to risks similar to those of holders of other portfolios, such as mutual funds. In addition to these general risks, there are risks specific to each ETF, which are described in the relevant prospectus. Risks may include the following:

- The general value of securities held may decline, thus adversely affecting the value of an ETF that represents an interest in those securities. This could occur with equities, commodities, fixed income, futures, or other investments the fund may hold on behalf of the shareholders.
- For ETFs for which the stated investment objective is to track a particular industry or asset sector, the fund may be adversely affected by the performance of that specific industry or sector.
- Fund holdings of international investments may involve risk of capital loss from unfavorable fluctuations in currency exchange rates, differences in generally accepted accounting principles, or economic or political instability in other nations.
- Although ETFs are designed to provide investment results that generally correspond to the price and yield performance of their respective underlying indexes, the trusts may not be able to exactly replicate that performance because of trust expenses and other factors. This is sometimes referred to as "tracking error".

Investors should refer to an ETF prospectus to obtain a complete discussion of the risks involved in that ETF before investing.

What You Should Know About Leveraged and Inverse ETFs

What are leveraged and inverse ETFs?

As described above, ETFs that seek to produce a return that is a multiple of the return of its benchmarked index are commonly known as “leveraged”. There are currently more than 100 different funds in this category with benchmarks that track commodities, currencies and various stock indexes. Some leveraged ETFs have multipliers of double or triple the benchmark (i.e., 2x or 3x), while others target returns that are based on the inverse of the benchmark (i.e., -1x, -2x or -3x). It is critical to understand the time period for which the leverage applies. Each fund explicitly states this time period in its prospectus.

At the time of this publication, all leveraged and inverse ETFs are designed to generate daily returns that are a positive or negative multiple of the daily return of a specified index. They are not designed to match the return for a holding period that is longer than the objective stated in the prospectus. Therefore, the daily compounded return of a leveraged ETF over one year, one month, one week, or even a two-day period may be significantly different from the returns produced by simply applying the stated multiple to the index’s total holding period return. Daily monitoring and adjustment (buying and selling) by the investor could modify the return to match its stated objective over time.[2]

Daily leveraged ETFs may be unsuitable for investors who seek an intermediate-term or long-term holding period. Instead, this type of leveraged ETF may be better suited to traders who wish to increase or hedge their market exposure over a short period of time. Investors are encouraged to consult with their financial advisors or registered representatives to help determine if leveraged or inverse ETFs are suitable for them.

What are the additional concerns an investor should review before investing in a leveraged or inverse ETF?

Inverse ETF fund managers may, at times, be unable to fully carry out their short-selling strategy as a result of difficulties in the derivatives markets, regulatory restrictions, or their inability to locate and borrow shares or for other reasons. This could cause the market price of the ETF to vary from its index target and NAV.[3]

Many leveraged ETFs (of both the long and the short varieties) rely on the use of futures, swaps and other derivative securities, along with other securities or commodities, to achieve their target returns. Some of these derivatives, such as swaps, are unlisted securities that depend on the swap issuer’s ability to pay. Therefore, the leveraged ETFs that depend on such swaps may not be able to achieve their stated returns if a swap counterparty should default.

Leveraged and inverse ETFs may be less tax efficient than other ETFs. It is possible for investors to have a tax liability, even in a year in which the leveraged or inverse ETF had a negative overall return. This outcome can result from the fund managers “rebalancing” the investments each day with derivatives to maintain the ETF’s multiple. Such rebalancing can produce realized taxable gains with no offsetting losses. As with any potential investment, an investor should consult with his or her tax advisor and carefully read the prospectus to understand the tax consequences of leveraged or inverse ETFs.

[2]As of the writing of this Informed Investor edition, all leveraged and inverse ETFs employ a “daily reset”, which means that their stated multiple will be valid only for holding periods of one day. Some ETF sponsors, however, are currently applying to the SEC to issue leveraged or inverse ETFs that will have reset periods longer than one day, such as one week or one month.

[3]For example, if fund managers are unable to carry out their short-selling strategy they may not be able to offer shares that are sufficient to satisfy market demand. This could cause the ETF shares to trade at a premium to (or higher than) the fund’s NAV.

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