What Is an ETF?

An exchange-traded fund is a basket of securities — stocks, bonds, commodities or some combination of these — that you can buy and sell through a broker. ETFs offer the best attributes of two popular assets: They have the diversification benefits of mutual funds while mimicking the ease with which stocks are traded.

Like any financial product, ETFs aren't a one-size-fits-all solution. Evaluate them on their own merits, including management costs and commission fees (if any), how easily you can buy or sell them, and their investment quality.
ETF = 'Exchange-traded fund'

An exchange-traded fund — better known by the acronym "ETF" — is a fund that can be traded on an exchange like a stock (hence the name). ETFs give you a way to buy and sell a basket of assets without having to buy all the components individually.

An ETF works like this: The fund provider owns the underlying assets, designs a fund to track their performance and then sells shares in that fund to investors. Shareholders own a portion of an ETF, but they don't own the underlying assets in the fund. Even so, investors in an ETF that tracks a stock index get lump dividend payments, or reinvestments, for the stocks that make up the index. (Related: Learn how to invest in index funds.)

While ETFs are designed to track the value of an underlying asset — be it a commodity like gold or a basket of stocks such as the S&P 500 — they trade at market-determined prices that usually differ from that asset. What's more, because of things like expenses, longer-term returns for an ETF will vary from those of its underlying asset.

How ETFs work, in 3 steps

1) An ETF provider considers the universe of assets, including stocks, bonds, commodities or currencies, and creates a basket of them, with a unique ticker.

2) Investors can buy a share of that basket, just like buying shares of a company.

3) Buyers and sellers trade the ETF throughout the day on an exchange, much like a stock.

ETFs vs. mutual funds vs. stocks

Generally speaking, ETFs have lower fees than mutual funds — and this is a big part of their appeal. Whereas the average U.S. equity mutual fund charges 1.42% in annual administrative expenses — what's called an expense ratio — the fees on the average equity ETF are 0.53%, according to data from ETF.com, a subsidiary of the Chicago Board Options Exchange that's dedicated to these investments.

ETFs also offer tax-efficiency advantages to investors. There's generally more turnover within a mutual fund (especially those that are actively managed) relative to an ETF, and such buying and selling can result in capital gains. Similarly, when investors go to sell a mutual fund, the manager will need to raise cash by selling securities, which also can accrue capital gains. In either scenario, investors will be on the hook for those taxes.

ETFs are increasingly popular, but the number of available mutual funds still is higher. The two products also have different management structures (typically active for mutual funds, passive for ETFs).

Like stocks, ETFs can be traded on exchanges and have unique ticker symbols that let you track their price activity. There's SPY for one of the ETFs that track the S&P 500, and fun ones like HACK for a cyber-security fund and FONE for an ETF focused on smartphones. That's where the similarities end, however, because ETFs represent a basket of assets, whereas a stock represents just one company.

Pros of ETF investment

- **Diversification:** While it's easy to think of diversification in the sense of the broad market verticals — stocks, bonds or a particular commodity, for example — ETFs also let investors diversify across horizontals, like industries. It would take a lot of money and effort to buy all the components of a particular basket, but with the click of a button, an ETF delivers those benefits to your portfolio.
- **Transparency:** Anyone with internet access can search the price activity for a particular ETF on an exchange. In addition, a fund's holdings are disclosed each day to the public, whereas that happens monthly or quarterly with mutual funds.
- **Tax benefits:** Investors typically are taxed only upon selling the investment, whereas mutual funds incur such burdens over the course of the investment.

Cons of ETF investment

- **Trading costs:** ETF costs may not end with the expense ratio. Because ETFs are exchange-traded, they may be subject to commission fees from online brokers. Many brokers have decided to drop their ETF commissions to zero, but not all have.
- **Any buyers for the ETF?** As with any security, you'll be at the whim of the current market prices when it comes time to sell, but ETFs that aren't traded as frequently can be harder to unload.
- **Risk the ETF will close:** The primary reason this happens is that a fund hasn't brought in enough assets to cover administrative costs. The biggest inconvenience of a shuttered ETF is that investors must sell sooner than they may have intended — and possibly at a

loss. There’s also the annoyance of having to reinvest that money and the potential for an unexpected tax burden.

How to invest in ETFs

There are a variety of ways to invest in ETFs, how you do so largely comes down to preference. For hands-on investors, the world of ETF investing is but a few clicks away. These assets are a standard offering among the online brokers, though the number of offerings (and related fees) will vary by broker. On the other end of the spectrum, robo-advisors construct their portfolios out of low-cost ETFs, giving hands-off investors access to these assets.

For all their simplicity, ETFs have nuances that are important to understand. Armed with the basics, you can decide whether an ETF makes sense for your portfolio, embark on the exciting journey of finding one — or several.

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