ETFs Tutorial

Lesson 1: Introduction to ETFs

ETFs in a nutshell

Created recently, Exchange Traded Funds are one of the most important and valuable products for institutional and individual investors alike. There are many advantages to use ETFs to achieve an investor's investment goals efficiently.

In a nutshell, an ETF consists of a basket of securities that can be purchased or sold on an exchange. ETFs span across nearly all asset classes including Equities, Foreign Exchange, Fixed Income, Commodities.

Some of the most notable attributes of ETFs include the ability to short markets, gain leverage and reduce short-term capital gains taxes.

ETFs became popular in the early 1990s and are now estimated to be over $1 trillion invested in ETFs and nearly 1000 ETF products traded on U.S. stock exchanges.

Lumped together with ETF, also noticeable are Exchange Traded Notes (ETNs). ETNs are issued by major banks as senior debt notes. This is different from an ETF which consists of securities or derivative contracts. When you buy an ETN, you receive a debt investment similar to a bond. Even though they carry credit risk, ETNs are backed by high credit rating banks so they are considered relatively safe investment products.

The different flavors of ETFs

- **Sector and Industry ETFs:** Provide exposure to an industry, such as pharmaceuticals, high-tech, or commodities.
- **Style ETFs:** Track an investment style or market capitalization focus, such as large-cap value or small –cap growth.
- **Market ETFs:** Designed to track a particular index like the S&P 500 or NASDAQ.
- **Bond ETFs:** Provide exposure to nearly every type of bond available including U.S. Treasury, Corporate, Municipal, International, High Yield and

more.

- **Commodity ETFs:** Track the price of a commodity, such as oil, gold or corn.
- **Foreign Market ETFs:** Designed to track non-U.S. markets, such as France's CAC 40 or German's DAX index
- **Inverse ETFs:** Increase in value when underlying market or index declines.
- **Actively Managed ETFs:** Designed to outperform an index rather than purely track an index
- **Exchange Traded Notes:** Exchange Traded Notes are in essence debt securities backed by the creditworthiness of the issuing bank. They were created to provide access to illiquid markets and have the added benefit of generating virtually no short-term capital gains taxes.
- **Alternative Investment ETFs:** Apply to more sophisticated products such as volatility or gain exposure to a particular investment strategy, such as currency carry or covered call writing.

How ETFs work

ETFs can be bought or sold on exchanges like a company stock. ETFs have ticker symbols and intraday price data are available during the course of the trading day.

One characteristic of ETFs, is that the number of shares outstanding can change on a daily basis due to continuous creation or redemption of new shares. Because issuing and redeeming shares is done on an ongoing basis, the market price of ETFs is in line with their underlying securities.

Even if designed for individual investors, institutional investors also play an important role in maintaining the liquidity and tracking integrity of the ETF through the purchase and sale of creation units, consisting of large blocks of ETF shares that can be exchanged for baskets of the underlying securities. If the ETF price deviates from the underlying asset value, institutions utilize the arbitrage mechanism afforded by creation units to bring the ETF price back in line with the underlying asset value.

Why ETFs are so popular

ETFs appeal to individual investors for multiple reasons:

- ETFs can be bought or sold at any time of the day as opposed to Mutual funds which settle after the market close.
- Fees tend to be lower than for Mutual funds as there is no sales load though brokerage commissions apply. Another reason for the lower fees, is that ETFs are meant to follow a particular index, not outperform it. Therefore, only minor adjustments are needed for the ETF, as opposed to an aggressively managed fund, which is looking for a higher return than its underlying asset. This in turn lowers risk and management fees for ETFs as well.
- Tax efficient: Investors have better control over when they pay capital gains tax
- Trading transactions: Because they are traded like stocks, investors can place a variety of types of orders (limit orders, stop-loss order, buy on margin) which are not possible with mutual funds.

Limitiations of ETFs

Even though ETFs look very advantageous, ETFs do have shortcomings, including:

- Transaction costs: for frequent investors, there may be lower-cost alternatives investing directly with a fund company such as a no-load fund.
- Liquidity issues might arise for some thinly traded ETFs with wide bid/ask spreads, which leads to buying at the high price and selling at the low price
- Tracking error due to technical issues: While ETFs generally track their underlying index fairly well, technical issues can lead ETFs to drift apart from the index they track
- 3-day settlement period: ETFs sales take three days to settle. This implies that the investor will have to wait 3 days before re-investing the investment in ETFs.

Trading Strategies

Investor objectives will lead the utilization of ETFs for gaining exposure to nearly geography, industry or market. Assets can be invested using equity index and bond ETFs, and the allocation should be adjusted in accordance with changes in the investor risk tolerance and return goals. Alternative assets, such as commodities, gold or emerging stock markets can also be used. You can move in and out of markets rather quickly, for short term gains, much like a hedge fund strategy. ETFs give the flexibility and diversity to fulfill the strategy of most investors.

What the Future Holds

ETFs have been evolving since since their inception in the early 1990s. This evolution continues and we constantly witness new type of ETFs as we go. It is important to note though that ETFs belong to a wide spectrum and two given ETFs can be quite different. As always investors should analyze ETFs carefully before investing, taking into account all factors to ensure that the ETF you choose is the best way to achieve investment goals.

Reference | Bibliography
