Exchange-Traded Funds (ETFs)

Please note - this page discusses only ETFs that are registered as open-end investment companies or unit investment trusts under the Investment Company Act of 1940. ***It does not address other types of exchange-traded products (/introduction-investing/investing-basics/glossary/exchange-traded-products-etps)****, such as exchange-traded commodity trusts or exchange-traded notes.*

What are ETFs?

An ETF is an exchange-traded investment product that must register with the SEC as an open-end investment company or a unit investment trust. ETFs pool money from many investors and invest the money in stocks, bonds, short-term money-market instruments, other securities or assets, or some combination of these investments. The combined holdings the ETF owns are known as its portfolio, which is usually managed by an SEC-registered investment adviser. Each ETF share represents an investor's part ownership of the ETF's portfolio and the income the portfolio generates.

Why do people buy ETFs?

ETFs are a popular choice among investors because they generally offer the following features:

- **Professional Management.** Most ETFs are typically managed by investment advisers who are registered with the SEC.
- **Diversification.** Many ETFs invest in a range of companies and industries rather than investing in one specific stock or bond. This helps to lower your risk if one company fails. However, some ETFs are less diverse than others. They may have fewer investments or may even track the performance of a single stock (/introduction-investing/investing-basics/glossary/single-stock-etfs) .

- **Low Minimum Investment.** ETF shares can be purchased on the market often for relatively low dollar amounts.
- **Liquidity.** ETF investors can trade their shares on the market at the market price whenever the market is open—minus any fees.
- **Tax Advantage.** Because many ETFs buy and sell portfolio securities in in-kind exchange (rather than for cash), they typically have fewer capital gains distributions – and thus lower taxes – than mutual funds.

How do I earn money from ETFs?

Investors can make money from their ETF investments in three ways:

- **Dividend Payments.** A fund may earn income from its portfolio – for example, dividends on stock or interest on bonds. The fund then pays the shareholders nearly all the income, less expenses, as a dividend payment.
- **Capital Gains Distributions.** The price of the securities a fund owns may increase. When a fund sells a security that has increased in price, the fund has a capital gain. At the end of the year, the fund distributes these capital gains, minus any capital losses, to investors.

- **Increased Market Price.** If the market value of an ETF's portfolio increases, after deduction of expenses and liabilities, then the net asset value (NAV) (https://www.investor.gov/introduction-investing/investing-basics/glossary/net-asset-value) of the ETF increases, and the market price of its shares may also increase.

If an ETF investor wants to reinvest a dividend payment or capital gains distribution, the process can be more complicated than it is with mutual funds. In addition, the investor may have to pay additional brokerage commissions. Investors should check with their ETF or investment professional.

What are the risks of investing in ETFs?

Like mutual funds, ETFs are not guaranteed or insured by the FDIC or any other government agency. They therefore all carry some level of risk. You may lose some or all of the money you invest because the securities held by a fund can go down in value. Dividends or interest payments may also change as market conditions change.

A fund's past performance is not as important as you might think because past performance does not predict future returns. But past performance can tell you how volatile or stable a fund has been over a period of time. The more volatile the fund, the higher the investment risk.

Different funds have different risks and rewards depending on their investment objectives. Generally, the higher the potential return, the higher the risk of loss.

What do I pay for my ETF?

As with any business, running an ETF involves costs. Funds pass along these costs to investors by deducting fees and expenses from NAV. That means you pay the fees and expenses indirectly.

Fees and expenses vary from fund to fund. It is important to understand what fees and expenses an ETF charges and how those fees and expenses impact your investment. Even small differences in fees and expenses can mean large differences in returns over time. In addition, a fund with high costs must perform better than a low-cost fund to generate the same returns for you.

Read Mutual Fund and ETF Fees and Expenses - Investor Bulletin (/introduction-investing/general-resources/news-alerts/alerts-bulletins/investor-

bulletins-20) to learn about some of the most common ETF fees and expenses. Also check out the Financial Industry Regulatory Authority (FINRA) Fund Analyzer (/financial-tools-calculators/financial-tools/mutual-fund-analyzer) to compute how the costs of different funds add up over time and eat into your returns.

What are some common ETF investing strategies?

- **Index Funds.** Index funds follow a passive investment strategy that is designed to achieve approximately the same return as a particular index before fees. An index fund will attempt to achieve its investment objective primarily by investing in the securities of companies that are included in a selected index. Passive management usually translates into less trading of the fund's portfolio (fewer transaction costs), more favorable income tax consequences (lower realized capital gains), and lower fees than actively managed funds.
- **Actively Managed Funds.** Actively managed funds are not based on an index. Instead, they seek to achieve a stated investment objective by investing in a portfolio of stocks, bonds, and other assets. An adviser of an actively managed fund may actively buy or sell

investments in the portfolio on a daily basis without regard to conformity with an index. But the trades must be consistent with the overall investment objective and strategies of the fund. An actively managed fund has the potential to outperform the market or its chosen benchmark, but its performance is heavily dependent on the skill of the manager.

What types of ETFs are there?

ETFs fall into several main categories. Each type has different features, risks, and rewards.

- Stock funds (/introduction-investing/investing-basics/glossary/stock-fund) invest primarily in stocks or equities. A stock is an instrument that represents an ownership interest (called equity) in a company and a proportional share in the company's assets and profits. The types of stocks owned by a stock fund depend upon the fund's investment objectives, policies, and strategies. A stock fund's value can rise and fall quickly (and dramatically) over the short term. The fund's performance depends, in part, on whether the underlying companies do well or not.

- Bond funds (/introduction-investing/investing-basics/glossary/bond-funds-and-income-funds) or income funds invest primarily in bonds or other types of debt securities. Depending on its investment objectives and policies, a bond fund may concentrate its investments in a particular type of bond or debt security or a mixture of types. The securities that bond funds hold will vary in terms of risk, return, duration, volatility and other features.
- Target date funds (/news-alerts/investor-bulletins/target-date-retirement-funds) typically hold a mix of stock funds, bond funds and other funds, and are created for individuals with a particular date for retirement or other goal in mind. Target date funds are designed to make investing for retirement or other goals more convenient by changing their investment mix as the target date gets closer. However, be aware that if a target date fund invests in other funds, it may have a double layer of fees.
- Money market fund ETFs (/introduction-investing/general-resources/news-alerts/alerts-bulletins/investor-bulletins/updated-12) invest in liquid, short-term debt securities, cash and cash equivalents.