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THE BASICS OF EXCHANGE TRADED FUNDS

Exchange Traded Funds (ETFs) are mutual funds that trade on a public exchange and track an index (such as the S&P 500 or Dow Jones Industrial), or another set of securities such as:

- Stocks from a single country or region, such as Asia or Europe
- Stocks concentrated in certain industries, such as telecommunications, utilities, or healthcare
- Company stock that has a specific market capitalization, such as large cap companies over the \$50 billion market cap, or mid-cap companies with a \$500 million to \$1 billion market cap
- Company stock based on fundamental aspects, such as a certain range of price-to-earnings ratios (P/E ratio) or a history of high dividends

Exchange Traded Funds are so named because the shares only trade on the various stock exchanges. In the U.S., most ETFs trade on the New York Stock Exchange (NYSE). Other characteristics of ETFs include:

- ETF shares are purchased on the floor of the exchange, whether they are new issues or shares trading in the secondary market.
- ETF shares do not carry a sales charge since they are purchased on the floor of the exchange; instead, the transaction carries a commission charge.
- A prospectus is issued when the ETF purchases new shares.
- ETF share transactions occur in the secondary market; these trades carry a commission, but a prospectus is not required.
- As exchange-traded securities, ETF shares can be purchased on margin.
- ETF share prices fluctuate with market movements like a stock, and are not based on the Net Asset Value (NAV) pricing method of traditional investment funds.
- ETFs offer diversification for the investor, since the investment represents a diversified portfolio of stocks that mimic an index or investment strategy.
- Originally, EFTs invested only in stocks, but some now invest in bonds or short-term corporate notes.

Costs of Investing

ETFs maintain a stable portfolio of securities, unlike actively managed funds, and buying and selling shares typically do not occur as frequently. Since the stocks are purchased and held, ETFs have relatively low expense ratios.

These lower operating expenses can be offset by a higher commission rate.

Types and Structure

Most ETFs are registered as investment companies and are issued as one of two types:

- Unit Investment Trusts — i.e., Standard and Poor's Depository Receipts, called Spiders (SPDRs)



- Open-End Investment Companies — continuously offer new shares

Note: ETFs that invest in commodities or currency cannot be registered as investment companies.

Some ETFs follow broad-based indexes. In this case, the stock shares are selected to duplicate the index they track:

- The Dow Jones Industrial Average Index, symbol DIA (known as “Diamonds”)
- The Nasdaq-100 Index, symbol QQQ (known as “the Cubes”)
- The S&P 500 Index, symbol SPY (known as “Spiders”)

A person or institution, usually a broker/dealer, sets up the ETF with its parameters. An ETF is formed as a trust, and *Creation Units* are developed from pooling a minimum of 50,000 shares of stock. The stock shares in the creation units are selected to duplicate the index they track.

Standard and Poor’s Depository Receipts — “Spiders”

Spiders (SPDRs) are the most popular type of ETF. They are based on the S&P 500 index. The characteristics of SPDRs include:

- A SPDR is an OPEN-END UIT and may be called an open-end investment company; the proper name is open-end UIT.
- SPDR ETFs trade on the NYSE.
- Like other ETFs, SPDRs are set up as a trust and split into creation units. Each creation unit contains 50,000 shares.
- Institutional investors, if purchasing a large amount of shares, may purchase an entire creation unit.
- Individual investors purchase parts of a creation unit in round lots of 100 shares.

Trading

When investors own shares of an ETF, they can sell them in one of two ways:

- Back to the creator of the trust at either the NAV or at the market price of the ETF on the exchange (usually at the discretion of the fund’s creator)
- To another investor on the floor of the exchange at the present market price of the ETF

ETFs can be bought and sold throughout the day by any brokerage firm. As with stocks, an investor can place limit or stop orders on ETF shares, sell short, or buy them on margin. The investor can buy as few as one share or in round-lots of 100 shares.

Similar to stocks, actively trading ETF shares subject investors to the bid-ask spread, which is the difference between the higher price that must be paid per share and the lower price at which investors can sell their shares on the open market.

Trading stops at 4:00 p.m. EST (Eastern Standard Time), but some continue up to 4:15 p.m. EST. The closing prices are shown in the major newspapers the next day.



Pricing

The creator of the fund determines the amount of shares to be purchased using one of two methods:

- Weighting by price with differing quantities of shares, if the ETF mimics an index
- Weighting by capitalization with equal amounts of shares, if the ETF is fundamentally determined, such as by comparing P/E ratios

Although the market price of an ETF at the end of the trading day is its Net Asset Value (NAV), the share price changes throughout the trading day as shares change hands. The share price can trade at a premium (above NAV) or at a discount (below NAV).

Taxation

Because the securities in an index-based ETF portfolio remain closely aligned with the index of the securities it follows, the tax liabilities associated with potential capital gains are less than with actively managed mutual funds, as the stocks within the ETF are not as frequently traded.

However, some ETFs, such as small-capitalization funds or certain market sector funds, have higher turnover rates, and thus are less tax efficient.

Dividends

An owner of an ETF share can receive dividends, if the stocks in the portfolio pay dividends (after the fees and expenses by management are deducted), but they are usually negligible. Depending on the broker, dividend reinvestment programs may be available; but unlike traditional mutual funds, this feature may come with a charge for the service.

Was this excerpt everything that you thought it would be? Are there EFT or product-related issues that FIRE could report on or investigate for you? FIRE would love to hear any and all feedback regarding this excerpt. Click [here](#) to let us know your thoughts.

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