Inside ETFs

This article originally appeared in the ***September 2014*** *issue of the* AAII Journal.

Like mutual funds, exchange-traded funds (ETFs) are a way for investors to participate in the stock, bond and commodity markets; achieve a diversified portfolio; and gain access to a broad array of investment strategies.

What are ETFs and how do they work?

The Investment Company Institute, a trade group for all types of regulated funds including exchange-traded funds, has put out a paper explaining how ETFs are created, what determines their price and how taxes on ETFs are treated. In addition, it discusses the similarities and differences between mutual funds and ETFs. The following is a condensed version of the report “Understanding Exchange-Traded Funds: How ETFs Work.”

An ETF is a pooled investment vehicle with shares that can be bought or sold throughout the day on a stock exchange at a market-determined price.

In most cases, an ETF is index-based—designed to track the performance of a specified index or, in some cases, a multiple, an inverse, or a multiple inverse of its index (commonly referred to as leveraged or inverse ETFs).

Actively managed ETFs, which do not seek to track the return of a particular index, have been available to investors only since 2008.

Several factors have contributed to the growing popularity of ETFs. Specific features of ETFs that investors find attractive include:

- Intraday tradability. An ETF is essentially a mutual fund that has a secondary market. This means that investors buy or sell existing ETFs shares at market-determined prices during trading hours on stock exchanges, in dark pools, or on other trading venues. This feature gives investors liquidity and quick access to different types of asset classes.
- Transparency. Generally, the price that an ETF trades at in the secondary market is a close approximation to the market value of the underlying securities that it holds in its portfolio. This fairly tight relationship makes ETFs a convenient and easy option for investors who want to minimize the possibility that the share price could trade at a substantial premium or

discount to the net asset value (NAV) of the fund (as can happen in a closed-end fund).
- Tax efficiency. As discussed below, investors have been attracted to ETFs because they typically do not distribute capital gains.

General trends that have contributed to the popularity of ETFs include:

- Access to specific markets or asset classes. Investors can gain exposure to specific markets or asset classes that would otherwise be difficult or impossible for them to attain. For example, some foreign markets require investors to have foreign-investor status, a local bank account and a local custodian to access their markets. Investors seeking to participate in these markets can simply buy an appropriate ETF as they would any other stock on an exchange: The ETF has either met all the requirements or achieved the exposure through other types of financial instruments that are not readily available to individual investors.
- The rising popularity of passive investments. Investor demand for index-oriented products, particularly in the domestic equity space, has been strong for the past decade.
- Increasing use of asset allocation models. More financial advisers are moving toward using third-party asset allocation models to manage their clients' assets, and they find ETFs to be an efficient and cost-effective way to rebalance their clients' portfolios to implement a change in an investment strategy.

How are ETFs created?

An ETF originates with a sponsor that chooses the investment objective of the fund. In the case of an index-based ETF, the sponsor chooses both an index and a method of tracking it. Index-based ETFs track their target index in various ways. Many early ETFs tracked traditional, mostly capitalization-weighted, indexes.

More recently launched index-based ETFs follow benchmarks that use a variety of index-construction methodologies, with weightings based on market capitalization or other fundamental factors, such as sales or book value. Others follow factor-based metrics: These indexes first screen potential securities for a variety of attributes—including value, growth, and dividend payouts—and then either equal-weight or market-cap-weight the selected securities. Other customized index approaches include screening, selecting and weighting securities to minimize volatility, maximize diversification or achieve a high or low degree of correlation with market movements.

An index-based ETF may replicate its index (that is, it may invest 100% of its assets proportionately in all the securities in the target index), or it may sample its index by investing in a representative sample of securities in the target index. Representative sampling is a practical solution for ETFs that track indexes containing securities that are too numerous (such as broad-based or total market stock indexes), that have restrictions on ownership or transferability (certain foreign securities) or that are difficult to obtain (some fixed-income securities).

The sponsor of an actively managed ETF determines the investment objectives of the fund and may trade securities at its discretion, much like an actively managed mutual fund. For instance, the sponsor may try to achieve an investment objective such as outperforming a segment of the market or investing in a particular sector through a portfolio of stocks, bonds or other assets.

The creation/redemption mechanism in the ETF structure allows the number of shares outstanding in an ETF to expand or contract based on demand. Figure 1 illustrates the creation process. The redemption process is simply the reverse.

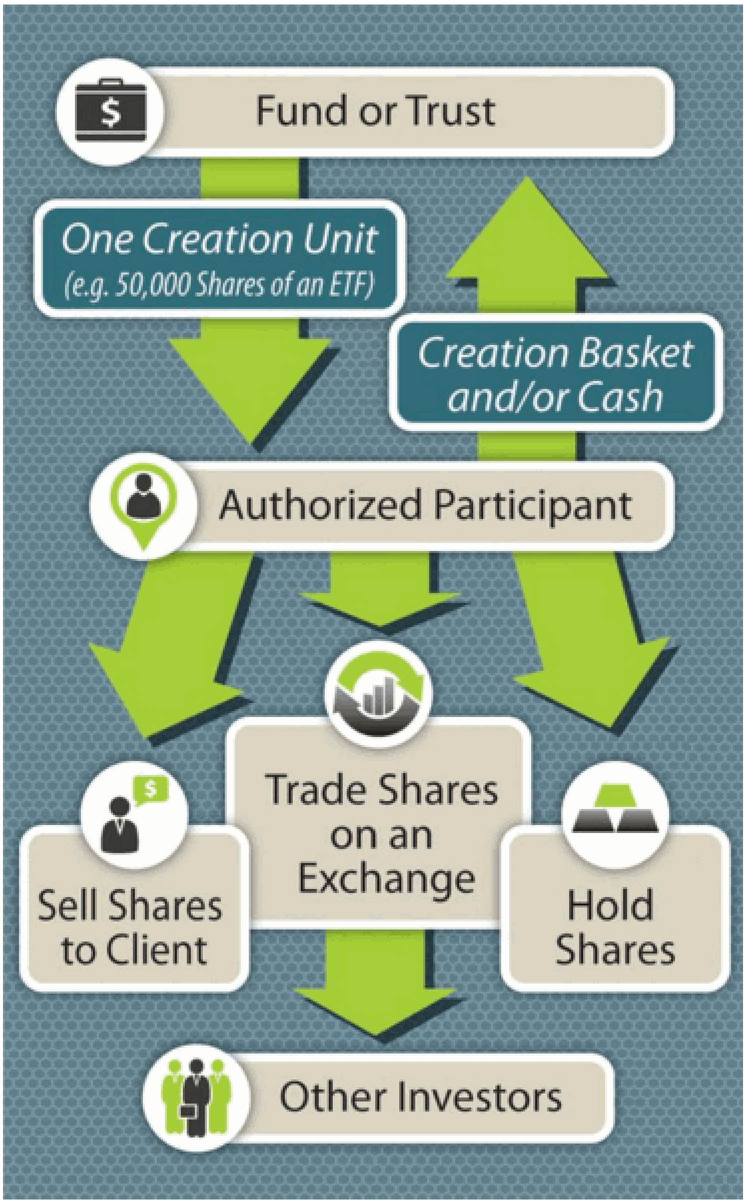

Figure 1. Creation of an ETF

Though ETFs share some basic characteristics with mutual funds, there are key operational and structural differences between the two types of investment products.

Key similarities to mutual funds: Both mutual funds and ETFs can provide the basic building blocks of investors' portfolios. An ETF is similar to a mutual fund in that it offers investors a proportionate share in a pool of stocks, bonds and other assets. Also, like mutual funds, new shares of ETFs can be created or redeemed at any time, and ETFs are required to post the marked-to-market net asset value of their portfolio at the end of each trading day.

Like mutual funds, ETFs are most commonly structured as open-end investment companies, and they are governed by the same regulations. The vast majority of ETFs are regulated by the Securities and Exchange Commission (SEC) in essentially the same way as mutual funds.

Key differences from mutual funds: One major difference between ETFs and mutual funds is that individual investors buy and sell ETF shares on a stock exchange through a broker-dealer, much as they would any other type of stock. In contrast, mutual fund shares are not listed on stock exchanges. Rather, investors buy and sell mutual fund shares through a variety of distribution channels, including through investment professionals (full-service brokers, independent financial planners, bank or savings institution representatives, or insurance agents) or directly from a fund company.

Mutual funds and ETFs are also priced differently. Mutual funds are "forward priced," meaning that, though investors can place orders to buy or sell shares throughout the day, all orders placed during the day will receive the same price—the fund's net asset value is usually computed as of 4:00 p.m. EST when the U.S. stock exchanges close. In contrast, the price of an ETF share is continuously determined through trading on a stock exchange. Consequently, the price at which investors buy and sell ETF shares on an exchange may not necessarily equal the net asset value of the portfolio of securities in the ETF. Two investors selling the same ETF shares at different times on the same day may receive different prices for their shares, both of which may differ from the ETF's net asset value.

How are ETFs taxed?

SEC-registered ETFs are subject to the same tax rules as mutual funds. To improve their tax efficiency, ETFs commonly employ two mechanisms that also are available to mutual funds: low portfolio turnover and in-kind redemptions. The relative tax efficiency of ETFs and mutual funds depends on the extent to which they use these mechanisms.

- Low portfolio turnover strategies: Like index-based mutual funds, index-based ETFs are less likely than actively managed funds to trade securities, thus reducing taxable gains that must be distributed.
- In-kind redemptions: ETFs that distribute securities to authorized participants that are redeeming ETF shares can reduce their unrealized gains (also known as tax overhang) by distributing securities that were purchased for less than their current value (so-called low-basis securities). Because these transactions are in-kind, the ETF does not incur any tax when the low-basis securities are distributed.

It is important to note that though these strategies can reduce capital gains distributions to investors while they are holding ETF shares, investors ultimately pay taxes on any capital gains when they sell their ETF shares. Thus, these strategies enable tax efficiency through tax deferral, but not tax avoidance.

To read the full report from the Investment Company Institute, “Understanding Exchange-Traded Funds: How ETFs Work,” go to **www.ici.org/etf**.

→ **Rochelle Antoniewicz** is a senior economist at the **Investment Company Institute** (ICI). **Jane Heinrichs** is a senior associate counsel at the **Investment Company Institute** (ICI).