# Exchange-Traded Funds: Do They Belong in Your Portfolio?

Exchange-traded funds (ETFs) have become increasingly popular since they were introduced in the United States in the mid-1990s. Their tax efficiencies and relatively low investing costs have attracted investors who like the idea of combining the diversification of mutual funds with the trading flexibility of stocks. ETFs can fill a unique role in your portfolio, but you need to understand just how they work and the differences among the dizzying variety of ETFs now available.

## What is an ETF?

Like a mutual fund, an exchange-traded fund pools the money of many investors and purchases a group of securities. Like index mutual funds, most ETFs are passively managed. Instead of having a portfolio manager who uses his or her judgment to select specific stocks, bonds, or other securities to buy and sell, both index mutual funds and exchange-traded funds attempt to replicate the performance of a specific index.

However, a mutual fund is priced once a day, when the fund's net asset value is calculated after the market closes. If you buy after that, you will receive the next day's closing price. By contrast, an ETF is priced throughout the day and can be bought on margin or sold short--in other words, it's traded just as a stock is.

## How ETFs invest

Since their inception, most ETFs have invested in stocks or bonds, buying the shares represented in a particular index. For example, an ETF might track the Nasdaq 100, the S&P 500, or a bond index. Other ETFs invest in hard assets--for example, gold. With the rapid proliferation of ETFs in recent years, if there's an index, there's a good chance there's an ETF that tracks it.

More and more new indexes are being introduced, many of which cover narrow niches of the market, or use novel rules to choose securities. Many so-called rules-based ETFs are beginning to take on aspects of actively managed funds--for example, by limiting the percentage of the fund that can be devoted to a single security or industry.

**Pros and Cons of Exchange-Traded Funds**

**Pros**

ETFs can be traded throughout the day as price fluctuates
ETFs can be bought on margin, sold short, or traded using stop orders and limit orders, just as stocks can
ETFs do not have to hold cash or buy and sell securities to meet redemption demands by fund investors
Annual expenses are often lower, which can be especially important for long-term investors
Because ETFs typically trade securities infrequently, they have lower annual taxable distributions than a mutual fund

**Cons**

Making frequent investments over time will require paying repeated commissions and will increase investing costs
If an ETF is organized as a unit investment trust, delays in reinvesting its dividends may hamper returns
An ETF doesn't necessarily trade at its net asset value, and bid-ask spreads may be wide for thinly traded issues or in volatile markets

## The new wave of ETFs

New and unique indexes are being developed every day. As a result, ETFs that might seem similar--for example, two funds that invest in large-cap stocks--can actually be quite different. Many indexes define which securities are included based on their market capitalization--the number of shares outstanding times the price per share. However, other indexes and the ETFs that mimic them may select or weight securities within the index based on fundamental factors, such as a stock's dividend yield.

Why is weighting important? Because it can affect the impact that individual securities have on the fund's result. For example, an index that is weighted by market cap will be more affected by underperformance at a large-cap company than it would be by an underperforming company with a smaller market cap. That's because the large-cap company would represent a larger share of the index. However, if the index weighted each security equally, each would have an equal impact on the index's performance.

## The cost advantages and tradeoffs of ETFs

As indicated above, one of the reasons ETFs have gained ground with investors is because of their low annual expenses. Passive index investing means an ETF doesn't require a portfolio manager or a research staff to select securities; that reduces the fund's overhead. Also, investing in an index means that trades are generally made only when the index itself changes. As a result, the trading costs required by frequent buying and selling of securities in the fund are minimized. (Note, though, that individuals cannot invest directly in any index.)

However, don't forget that you'll generally pay a commission with each ETF trade (depending on the type of account you have). That means a one-time lump-sum investment in an ETF will be more cost-effective than frequent, regular investments over time.

## ETFs and taxes

ETFs can be relatively tax efficient. Because it trades so infrequently, an ETF typically distributes few capital gains during the year. There can be times when some investors find themselves paying taxes on capital gains generated by a mutual fund, even though the value of their fund may actually have dropped. Though it's not impossible for an ETF to have capital gains, ETFs generally can minimize the ongoing capital gains taxes you'll pay.

Just how much impact can reducing taxes have over the long term? More than you might think. Even a 1% difference in your return can be significant. For example, if you invest $50,000 and earn an average annual return of 5% (compounded monthly), you would have a pretax amount of $82,350 after 10 years. Even a 1% increase in that return would give you $90,970 at the end of that time. (This hypothetical example is for illustrative purposes only and does not represent the performance of any particular investment. Actual results will vary.)

Make sure you consider how an ETF's returns will be taxed. Depending on how the fund is organized and what it invests in, returns could be taxed as short-term capital gains, ordinary income, or in the case of gold and silver ETFs, as collectibles; all are taxed at higher rates than long-term capital gains.

## What are some other reasons investors use ETFs?

- ***To get exposure to a particular industry or sector of the market.*** Because the minimum investment in an ETF is the cost of a single share, ETFs can be a low-cost way to make a diversified investment in alternative investments, a particular investing style, or geographic region.
- ***To limit losses.*** Being able to set a stop-loss limit on your ETF shares can help you manage potential losses. A stop-loss order instructs your broker to sell your position if the shares fall to a certain price. If the ETF's price falls, you've minimized your losses. If its price rises over time, you could increase the stop-loss figure accordingly. That lets you pursue potential gains while setting a limit on the amount you can lose.

## How to evaluate an ETF

1. Look at the index it tracks. Understand what the index consists of and what rules it follows in selecting and weighting the securities in it. Be aware that the performance of an unmanaged index is not indicative of the performance of any specific security. Individuals cannot invest directly in any index.
2. Look at how long the fund and/or its underlying index have been in existence, and if possible, how both have performed in good times and bad.
3. Look at the fund's expense ratios. The more straightforward its investing strategy, the lower expenses are likely to be. An index using futures contracts is likely to have higher expenses than one that simply replicates the S&P 500.

Your financial professional can help you decide how ETFs might fit your investing strategy.