

Exchange-Traded Funds (ETFs)

As regulated open-end investment companies, exchange-traded funds are, with a few exceptions, open-end investment companies that trade throughout the day like stock. More specifically, ETFs are a basket of securities that follow common indexes or a group of securities created by the sponsor of the ETF. For example, there are ETFs that track, among others, the S&P 500 index, the Dow Jones Industrial Average, and many industry funds. As such, they are passively managed, because they follow the indexes and are, with a few exceptions, not actively managed (the first actively managed ETF, an ultrashort bond fund, began trading March 25, 2008; and as of December 1, 2009, there were 13 active ETFs). Investors like the transparency of ETFs in that they disclose their holdings daily, a feature that active ETFs don't like for fear that some investors might use that information to their advantage. When following an index, the ETF might not track the index exactly (called "tracking error") due to trading costs, fund expenses, and situations in which an ETF uses a sample of the securities in an index rather than buying all the securities in that index.

As the popularity of ETFs has increased, the sectors covered by ETFs have become more specialized and have expanded greatly to include styles (large-, mid-, and small-cap growth and value) and even one that tracks the 25 largest and most liquid Chinese stocks. In addition, more ETFs are being offered to give investors the ability to take leveraged or short positions in various sectors. Most ETFs are stock portfolios, but there are some bond ETFs. There now are also inverse ETFs and leveraged ETFs. Inverse ETFs increase when the benchmark decreases and leveraged ETFs, called double-beta ETFs, provide twice the performance of their benchmark. There is also the possibility of more actively managed ETFs being offered in the next year or so.

Because they trade like stock, they offer trading flexibility desired by both individuals and institutions: ETFs can be bought on margin and sold short. Also, some ETFs have options on them.

Expenses

Most, but not all, ETFs have very low annual expenses, in the range of 9 to 20 basis points (100 basis points equals 1%). These expenses are usually slightly less than those of index funds because ETFs do not have the expenses involving shareholder services. As more and more ETFs come to market, in some cases those that are more specialized in particular have had higher annual expenses approaching 1%. Therefore the expenses of a specific ETF should be identified and not just assumed to be low

ETF shares are like any other stock trade, thus there are commissions when shares are bought or sold. Because of these commissions, the ETF's cost advantage can be offset with frequent trades, depending on the cost of trading. Commissions on trades range widely; and may be inexpensive or expensive (especially on small trades). If the commissions are high, ETFs might not be conducive to dollar cost averaging.

Tax Efficiency

A major attraction of ETFs is that they generally are very tax-efficient (although there are exceptions to this, such as taxable bond ETFs and ETFs that directly hold precious metals, which are taxed as collectibles at a 28% rate, and ETFs that use derivatives extensively like "inverse" ETFs). Tax inefficiency of a mutual fund is a function of the taxable income from the underlying securities and the sale of securities in the fund at a profit. These sales are primarily due to the portfolio manager changing securities or making sales due to shareholder redemptions. Because they are generally index funds, ETFs usually have only a limited number of sales when adjusting to changes in the indexes they follow.

Also, shareholders cannot redeem shares with the investment company; rather, they must sell their shares on the exchange. Therefore, there are no forced sales by the portfolio manager due to heavy redemptions. An exception to this is large investors, called “authorized participants,” who can redeem shares from the fund in blocks of, typically, 50,000 shares. If they redeem shares, they are paid with shares of the underlying stocks (called an exchange “in-kind”), so the fund does not have to sell securities to meet those redemptions (large investors can also buy shares in 50,000 blocks by exchanging shares of the underlying stocks for shares of the ETFs).

Also, the ETF manager in this way can exchange those securities with the lowest cost basis, thereby being more tax-efficient. ETFs, however, can and do make capital gains distributions due to rebalancing the portfolios, usually by selling stocks that are taken out of the underlying indexes and replacing them with shares of stocks added to the indexes. Although most of these distributions are modest, in a few instances these distributions have been significant.

Dividends

ETFs can also pay nonqualified dividends, which are taxed at regular income tax rates, if they sell or redeem stocks that do not meet the qualified dividend holding period requirement. To be “qualified” the stock must be held for at least 61 days of the 121-day period that begins 60 days before the ex-dividend date. Small ETFs are more likely to pay nonqualified dividends because as the demand for them decreases, they are more likely to have to sell stock that does not meet this holding period requirement. In contrast, larger ETFs have more shares and therefore can sell those that have been held for longer periods.

Net Asset Value

Most of the time, ETFs trade at or near their net asset values (NAV); usually within 0.50% of the NAV. However, they can vary more from NAV during unsettled times because the price of an ETF is determined by supply and demand like any traded security. For example, on February 27, 2007, after stocks fell in the Chinese market, one ETF that tracks the Chinese market fell 9.9%, even though the index it was tracking had fallen 2.1% during Chinese trading hours. Another example occurred on September 18, 2008, when a high-yield bond ETF closed at an 8.4% discount to the value of its securities. These divergences from the NAV are exceptions but yet can occur (of course, the buyer of this ETF would benefit from this situation).

Also, corporate bond ETFs tend to vary from NAV because corporate bonds have much less liquidity than Treasury securities. In the first quarter of 2009, one high-yield bond ETF traded from a premium of 12% to a discount of 4.9%. Nevertheless, the value of the underlying securities is by far the major factor in determining an ETF's price. The Amex updates an intraday indicative value, or IIV, as a reference value (called "intraday value" for domestic funds and "indicative optimized portfolio value" for non-U.S. portfolios, which reflects changes in foreign exchange rates) for each ETF at 15-second intervals during the trading day. This value is determined by calculating the last sales price of each of the stocks in the ETF.

Bid/Ask Spread

Another factor to consider when trading ETFs is the bid-ask spread on them. These spreads can increase depending on market conditions. Factors increasing these spreads are general market volatility, amount of trading volume in the ETF (wider for small ETFs), amount of trading in the underlying investments, as well as whether some of those securities are overseas where their trading is closed for the day. Spreads can be as low as .02% for very active ETFs to over 1% for tiny ETFs.