GUIDE TO EXCHANGE TRADED FUNDS

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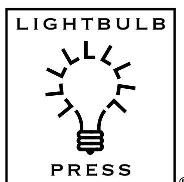

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Varieties of ETFs

Pick a market segment—any segment—and there's probably an investment to track it.

Sponsors, eager to meet investors' demand for more opportunities to diversify within an asset class by making a single purchase, have expanded the concept of exchange traded funds to encompass nearly all investment categories that you can purchase.

EQUITY ETFs

Equity ETFs hold baskets of stocks tracked by the domestic or international stock index to which the ETF is linked. That index may be broad-based or more narrowly focused on a sector, such as energy or telecommunications, a style of investing, such as growth or value, or the stock market of a specific country or region, such as Europe or South America. Or it may be a fundamental index whose components are weighted by a qualitative standard rather than by market capitalization.

The range of ways in which equity markets may be easily subdivided may be one of the reasons there are hundreds of stock ETFs. Another reason may be that stock ETFs have been around longer, so there has been more time to develop variations. Nor should you underestimate the fact that stocks are perhaps the best understood of the major asset classes and often the most attractive to individual investors despite the risk of potential losses.

COVERING THE TERRAIN

An exchange traded vehicle (ETV) is a publicly traded partnership or trust, not an investment company, that holds metals, currencies, or other commodities.

BOND ETFs

Bond ETFs link to indexes that track domestic investment-grade corporate bonds, US Treasury securities of varying maturities, agency bonds, including mortgage-backed securities, and municipal bonds.

One advantage of bond ETFs is the greater level of diversification you can achieve for less than it would cost to buy individual bonds. Among the risks with a bond ETF are that you don't receive a fixed rate of return or the promise of the return on principal—two of the primary attractions of bonds for buy-and-hold investors. And, with bond ETFs, as with any bond investment, there is also the risk of losing principal value.

While you do know the amount of commission you're paying—which isn't always the case with individual bonds—you also pay an annual management fee, which may make bond EFTs more expensive than bond mutual funds tracking the same indexes. In addition, investors may feel that actively managed bond funds provide stronger returns given credit risk, interest-rate risk, and potential lack of liquidity in the bond market as a whole.

REIT ETFs

To participate in the real estate market, you can buy shares in ETFs that track the performance of real estate investment trusts (REITs)—companies that invest in commercial and residential real estate. REIT ETFs are paired with indexes that

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track large publicly traded US REITs as well as global indexes that track REITs.

The appeal of real estate ETFs is diversification within the asset class without the complexity of having to select individual REITs. There's also the expectation of more income than other ETFs provide, plus the opportunity to add an investment that can be negatively correlated to the rest of your portfolio.

There are risks with real estate ETFs though. The underlying real estate market can be volatile. If buildings aren't full or tenants default, income drops. Poor management decisions, such as too much debt, can undercut profits. In addition, dividends are taxed as regular income.

COMMODITY ETFs

Commodity ETFs provide investors with access to what's happening in the markets where physical and financial commodities are traded.

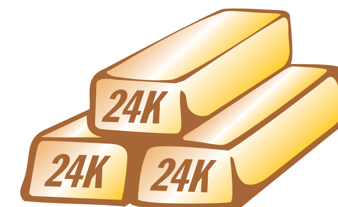
Some of these ETFs track an individual commodity, from oil and natural gas to grain and livestock, or from a precious metal to a world currency. Others track a broad-based commodity index for the greater diversification and reduced volatility it provides in comparison to a single product fund.

Most commodity ETFs, with the exception of precious metal trusts and the ETFs that own stock in companies that produce commodities, buy futures contracts on the product or index they track. As a result, the market value of the ETF differs from the spot price, which is more or less than a contract's strike price. In addition, to avoid taking physical possession of the tons or wheat or gallons of oil the contracts control, ETFs regularly offset the contacts they own before maturity.

One of the appeals of commodity ETFs is that commodity performance is not correlated to the performance of the equity and bond markets. So adding them to a portfolio increases its diversification. On the other hand, it's essential to remember that any commodity investment can be volatile, due not only to changes in supply and demand but also to the unpredictable impact of speculation. The result can be potentially major losses as well as major gains.

GOLD AND SILVER ETFs

Investors have long turned to precious metals, gold in particular, as a hedge against market uncertainty. Until the introduction of gold ETFs, the precious metal was generally available only in bullion form, which is costly to store and insure and difficult to sell quickly. Gold mining stocks and stock mutual funds were considered the best proxy for individual investors. However, these stocks and most of the funds largely reflect the performance of the mining companies and don't always mirror movements in the price of the commodity itself.

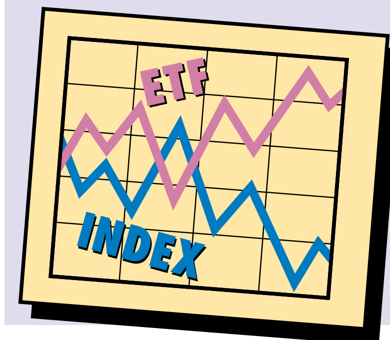


In contrast, each share of a gold ETF trust represents one-tenth of an ounce of gold backed by the bullion deposited in exchange for a basket of creation units, or shares. The value of each fund share is determined by the over-the-counter, or spot, price of gold, minus expenses. That value is transparent as gold is traded in the global market around the clock.

Precious metal ETFs differ in a number of important ways from other funds, including organization, regulation, and taxation. So it's important to investigate their risks and potential return carefully before investing.

INVERSE ETFs

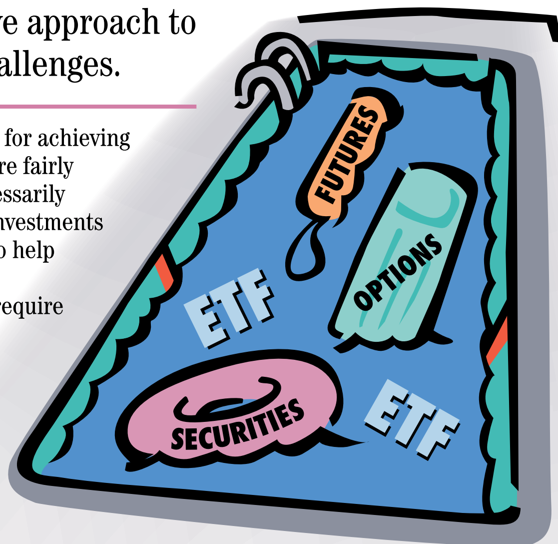
An inverse ETF moves contrary to the index it tracks. That means the ETF goes up when the index goes down and down when the index goes up. One reason to be extra wary is that its performance objective changes daily.



EXCHANGE TRADED FUNDS

Strategic Uses of ETFs

ETFs can be an effective approach to meeting investment challenges.



Investment strategies are plans for achieving specific results. Some strategies are fairly straightforward—though not necessarily simple—such as allocating your investments across a number of asset classes to help manage portfolio risk.

In other cases, a strategy may require two or more steps to produce the results you're after. For example, you might use an options spread, which involves purchasing one option and writing, or selling, another to achieve limited gains while protecting against serious losses.

ETFs can be useful tools in a variety of investment strategies. For starters, these funds are **transparent**, so you always know what you're buying. In addition, you can usually trade them easily and quickly. And since there are ETFs linked to a variety of investment products, you can also use them in combination with individual securities, options and futures contracts, or other ETFs.

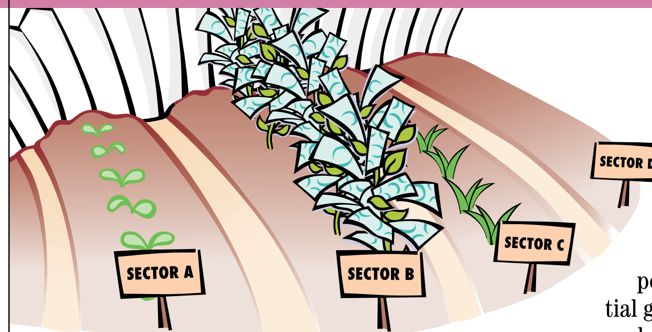
SHORT-TERM INVESTING

If you have a large amount of cash on hand—from a bonus, a retirement plan payout, or inheritance—you may decide to purchase shares in a stock ETF rather than putting your money into money market accounts or other short-term vehicles while you develop your long-term investment plan. There's a potential advantage but also some risks in this approach. On the plus side, you may realize a higher return.

But ETFs are less liquid than money market funds, so in a volatile equity market, your assets could lose value. You may pay commissions to buy and sell ETFs, which could offset any gains. And unlike CDs, which are another choice for short-term holdings, ETFs are not insured.

PICKING WINNERS (AND LOSERS)

In general, choosing an **asset allocation** for the bulk of your portfolio and sticking with it has a lot of merit as a long-term investment strategy. However, there are times when you might decide to change your allocation for tactical reasons by putting money into an individual investment or market sector that you expect to



outperform its historical average or the rest of the market.

ETFs are one of the easiest ways to put a **tactical allocation** into practice. For example, if you spot a positive trend in the retail sector but aren't sure exactly which individual stocks will gain most, an ETF linked to a retail index can help you invest in that sector while reducing the risk of investing in just one or two companies. Conversely, if the trend you spot suggests a certain sector is in for a rough period, selling short an ETF tracking that sector is much less risky and almost certainly cheaper than identifying and selling short the stocks you expect to take the biggest hits.

HANGING OUT THE WASH

As part of your investment strategy, you may decide to sell securities that have lost value in order to offset **capital gains** and reduce the tax you owe when you file your annual tax return. But what if, within a week after you sell, the security rebounds? You'd probably like to repurchase it to benefit from its potential for greater increases in value. But if you do, you won't qualify to take the loss when you calculate your taxes because of what's known in tax law as the **wash sale rule**.

According to this rule, if you purchase a "substantially identical" security within 30 days before or 30 days after a sale, you don't qualify to claim a loss on that sale. One alternative you might consider is to combine the sale of the security that has lost value with the purchase of an ETF linked to an index that tracks that security. Even if the security you sold accounts for 10% or more of the index, your ETF investment would be considered similar but not identical, and you would qualify to take the loss plus be in a position to benefit from potential gains. After 30 days, you could repurchase your original security and sell the ETF if you prefer.

A variation on this strategy is to replace an ETF you sell at a loss with an ETF linked to a different index in the same sector. Even if the two indexes overlap in some ways, they aren't identical—which you'll know because ETF portfolio holdings are transparent—so you'll be able to take the loss on the ETF that declined in value.

ONE STRATEGY TO AVOID

As a rule, **dollar cost averaging**, which requires investing the same amount in the same security on a regular schedule, is a good strategy. But it isn't always well suited for ETFs because of the cost of potential commissions. Even if you pay just $9.95 per trade, the rate on a $100 monthly purchase is nearly 10%.

But there may be solutions. For example, for a flat fee, calculated as a percentage of assets under management, you may be able to build an all-ETF portfolio without paying commissions on individual trades. Or you may use a firm that charges no commission at all on some ETFs. However, it's smart to check minimum balance requirements and the cost of selling shares before you decide.

You can invest for the short term in several ways. Here are some features you may want to look for.

- Low expense ratios
- Transparency and tight tracking to an underlying index
- Flexible trading, including using stop and limit orders
- Ability to invest flexible amounts of cash
- No expiration date or need to roll over a position to keep money invested

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