Finance

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What is an Exchange Traded Fund?

In the last issue, we reviewed mutual funds, which are extremely common tools for everyday investors. However, more and more people are now using exchange-traded funds, or ETFs. In this article, we will take a quick look at what these are.

As a reminder, with a mutual fund, the investor buys a share of an investment company and participates in the gains or losses of the investments held in the portfolio of that company. Likewise, an ETF is a basket of stocks, bonds, or other holdings that tracks an index, such as the S&P 500. The ETF is created, and then whole shares are actively traded on the open market. Thus, ETFs have price changes through the day as shares are bought and sold. This contrasts with mutual funds that are all priced and redeemed by the investment company at the end of the day.

Many mutual funds are actively managed in order to beat the performance of the index it is tracking, the fund manager is buying and selling to boost the returns of the fund. Most ETFs are created and then passively managed. The managers aim to mirror the index they are tracking rather than outperform it. This is known as passive management.

Using an example of the S&P 500, an active mutual fund would have stocks that are found in the S&P 500, but the managers of the fund would be trying to outperform the S&P 500. An index mutual fund, as we discussed before, would be an investment company that holds a portfolio that more closely matches the components of the S&P 500. These funds provide lower costs and lower turnover, which can decrease tax implications.

An ETF that tracks the S&P 500 would also have a portfolio built to mirror the S&P 500. However, it would be traded on the open market; and it may have less turnover than even an index fund, which may lead to lower taxable consequences.

Passive management of ETFs leads to lower fees since they take less man-power to manage, and it can also have some tax advantages. The active trading, or buying and selling, of equities in a mutual fund can lead to capital gains or losses. Mutual funds may trade to raise cash for redemption of shares, even in a passively managed fun. ETFs are bought and sold on the market, eliminating the need to trade to raise cash.

Since they have boomed in popularity, ETFs have emerged that track all sorts of indexes, such as the Dow Jones Industrial Average; the Nasdaq 100; commodities including oil and gold; sectors, such as financials and biotech; and foreign markets.

Along with their increased popularity, ETFs have become more complex. There are now actively managed ETFs. These have higher fees and more turnover, which blurs the distinction between a mutual fund and an ETF.

One caution with ETFs is that when investors buy or sell them, it may generate trading costs, or commissions, not seen with some mutual funds. So, investors must discuss the use of ETFs versus mutual funds carefully with their financial professional to see which is the better option for their portfolio.