ETFs: WHAT DO YOU NEED TO KNOW?

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Exchange Traded Funds. We've all heard of them, but what exactly are they and why have they become so popular?

ETF assets under management are growing fast. Let's take a look at what they are and what is fueling that fantastic growth.

Exchange Traded Funds are exactly what the name implies - they are funds that trade on exchanges. Just like any other fund, they hold a portfolio of securities, usually securities replicating an investment strategy and they issue shares to investors on a regular basis through an open-ended subscription process.

Unlike mutual funds, however, those shares are listed on stock exchanges, which means they can be bought and sold throughout the day rather than just at the end of each trading day. That allows investors to react more quickly to market changes. And because they are listed securities, ETFs give investors more options than mutual funds such as the ability to short, buy on margin or in many cases, trade options on the ETF.

ETFs have both a primary market where shares are created in bulk and issued to a primary investor known as an authorized participant, and a secondary market where investors can buy and sell those shares on a stock exchange in any quantity. This combines the open-ended issuance of shares by a mutual fund with the tradeability of a stock in the secondary market. Just like any other stock on the exchange, the role of the market maker is crucial.

Authorized participants often act as market makers to ETFs, holding an inventory of the ETF shares and creating a liquid market. If demand for the ETF rises, the authorized participants can create additional shares by subscribing in cash or by submitting the portfolio or securities they hold. If demand falls, it can return issue ETF shares to the fund in exchange for the portfolio of securities or cash, which is called a redemption. This ability to create and redeem to reflect demand and supply in the secondary market helps keep the price of the ETF close to the fair value.

The ETF structure carries four significant improvements over more traditional investment vehicles.

1. It is more transparent because investors can easily access the portfolio holding and the market price throughout the trading day.

2. ETFs can often provide lower total cost of ownership. On average, ETFs are offered at a lower total expense ratio than traditional funds. ETFs typically do not pay distribution fees, often called 12b-1 fees and other retail transfer agency fees. For more thinly-traded ETFs, it is important to factor secondary market bid-ask spreads in your total cost of ownership. Those costs include portfolio management fees, administrative expenses, marketing and distribution costs.

3. ETFs offer portfolio diversification and portfolio risk management. Investors use ETFs to quickly gain portfolio exposure to specific sectors styles industries, or countries. ETFs are now traded on virtually every major asset class, commodity and currency in the world and innovative new ETFs target a specific investment or trading strategy.

4. ETFs are genuinely more tax efficient than mutual funds. Due to structural differences, mutual funds typically incur more capital gains taxes than ETFs. ETFs leverage the creation and redemption process as a way to manage tax in the event the fund needs to sell securities to raise cash.

Add all of that up, and it's little surprise that they have become so popular. ETFs, complexity made simple.

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