

February 5, 2005

What the HECK is an ETF?

An exchange-traded fund (ETF) is an investment vehicle that is like both an individual stock and a mutual fund. ETFs have become increasingly popular with investors in recent years. The total amount of assets invested in ETFs has more than tripled since 2000, according to the Investment Company Institute. As of December 2004, the assets invested in ETF's totaled more than \$225 billion. Two widely-known examples of ETF's are the Barclays Global Investors iShares® and Vanguard's VIPERs®.

ETFs are essentially mutual funds that trade like individual stocks. Like mutual funds, ETFs offer investors a proportionate share in a professionally managed, diversified portfolio of securities. ETFs can be purchased to gain exposure to a wide range of investment styles, market segments, industry sectors and geographic regions. Unlike mutual funds, ETFs are listed on the major stock exchanges and can be bought or sold at up-to-the-minute prices during market hours. This characteristic makes them similar to individual stocks.

Perhaps the most attractive characteristic of ETFs, when compared to mutual funds, is their tax-efficiency. In a mutual fund, most transactions are conducted with cash: an investor purchases shares of a mutual fund with cash and an investor redeeming shares receives cash. These purchases and redemptions may require the fund manager to buy and sell securities in the portfolio to meet these inflows and outflows. During this process, transaction costs are incurred and taxable capital gains may be realized.

ETFs, however, do not generally experience cash flows into or out of the fund. This is because of the special way ETFs are structured. Only institutional investors (such as brokerage firms and market makers) are authorized to purchase or redeem securities directly with an ETF. When these institutional investors buy shares of an ETF (on behalf of an individual investor), they do so with securities, not cash. Instead of buying shares with cash, specific quantities of securities are transferred to the ETF in exchange for ETF shares. When they redeem shares, the ETF delivers to the institutional investors a low cost basis basket of securities, not cash. These cashless transactions benefit ETF shareholders in two ways: No transaction costs are incurred and the fund does not realize taxable capital gains.

Transaction costs and realized gains will only result if an ETF is forced to buy or sell a security in response to a reconstitution of the index it is designed to track. Even if reconstitution occurs (for example, when ABC company is removed from, and XYZ company is added to, the index) realized gains are kept to a minimum since the ETF is generally left with only the highest cost shares after distributing the low cost shares to satisfy prior redemptions.

Furthermore, the vast majority of ETFs are index investments. Like index mutual funds, ETFs typically seek to track the performance of a chosen market index rather than attempt to actively outperform it. Because of this characteristic, ETFs offer investors the same advantages index funds have over the average actively-managed mutual fund: lower costs, tax efficiency and potential for superior long-term returns.