ETF Report

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What Is an ETF?

Offering low-cost access to virtually every corner of the market, ETFs allow investors big and small to build institutional-caliber portfolios with lower costs and better transparency than ever before.

But what exactly is an ETF? And how does it provide these benefits?

WANT TO KNOW HOW ETFs WORK? FIRST UNDERSTAND HOW MUTUAL FUNDS WORK

To understand how ETFs work, the best place to start is with something familiar, like a traditional mutual fund.

Imagine half a dozen investors, sitting at home, each trying to figure out the best way to invest in the stock market. They could each go out and buy a few stocks on their own, but who has the time or resources to manage a portfolio of 50 or 100 stocks?

Instead, they decide to band together. They pool all of their money and hire a professional investment manager to invest it for them.

To keep track of who invested what, each investor receives "shares," representing their stake in the total investment.

Because it's your money, you want to know how much your investment is worth ... every day. So every day, the mutual fund tallies up the value of everything it owns, and divides it by the number of shares that exist. Whammo-presto: You know exactly what each share is worth.

If you want to buy more shares, you know the amount of cash to send the mutual fund for each share. If you want to sell shares, you know exactly how much cash to expect in return.

It's an elegant system, and mutual funds have existed for close to 100 years. They currently provide exposure to stocks, bonds, commodities and other assets.

BUT WHAT ABOUT ETFs?

All that's great, but you're not reading this to learn about mutual funds. You want to learn about ETFs.

So what is an ETF? Well, it's a mutual fund too. It's a pooled investment vehicle that offers diversified exposure to a particular area of the market. It can invest in stocks, bonds, commodities, currencies, options or a blend of assets. Investors buy shares, which represent a proportional interest in the pooled assets.

It's a mutual fund in every aspect ... except one.

And that's a big one, which is hinted at in its very name: *exchange-traded* funds.

BEING EXCHANGE-TRADED

You buy shares in an ETF directly from any brokerage account. Just like you buy shares in a stock, you can enter a buy order in your Schwab or Fidelity account and buy any ETF you want.

You can also do it whenever you want. Whereas orders to buy or sell a traditional mutual fund can be processed only once per day (after the close of trading), ETF trades can take place any time the market is open. You can buy shares in the morning and sell them in the afternoon. You can buy them at 10 a.m., sell them at 11 a.m. and buy them again after lunch if you want.

You can also perform all sorts of stocklike strategies with ETFs that you never could with mutual funds: selling short, placing stop-loss or limit orders, even buying on margin.

And that's just the beginning: The fact that ETFs are "exchange-traded" creates a series of other benefits that, according to many market observers, make them a better overall choice than traditional mutual funds for many reasons: lower costs, better tax efficiency and more. Of course, in other situations, they can be worse: commissions, trading spreads and other risks.

In sum, an ETF is a tool that allows investors to access different corners of the market—everything from U.K. equities to Chinese tech stocks to high-yield bonds, spot gold bullion and more—at low costs, from the comfort of a traditional brokerage account.

It's like a mutual fund 2.0.

AN ETF ...

- **... IS STRUCTURED AS A MUTUAL FUND**
- **... CAN BE LISTED AND TRADED ON AN EXCHANGE, LIKE A STOCK**
- **... CAN BE TRADED INTRADAY, SHORTED AND BOUGHT ON MARGIN**
- **... GENERALLY INVOLVES LOWER COSTS AND BETTER TAX EFFICIENCY**

What Is an ETN?

Investors typically use the term "ETF" to mean a lot of things that aren't technically "exchange-traded funds": commodity pools, grantor trusts and debt securities.

We're guilty of this too: After all, this is ETFR, but we cover all types of products. It's the term of art, so we'll roll with it.

The most important of these structures to understand is the exchange-traded note (ETN).

ETNs are debt notes issued by a bank. When you buy an ETN, the bank promises to pay you a certain pattern of return. If you buy an ETN linked to the price of gold, for instance, the value of that ETN will increase if the gold price goes up.

The beauty of the ETN structure is that it can be linked to anything. There are ETNs that track commodities, and ETNs that track hard-to-reach corners of the equity market. They sometimes combine stock or bond positions with options overlays, or use other sophisticated strategies that would be difficult to package into a traditional ETF. In the commodity space, the ETN also offers significant long-term tax advantages compared with most ETFs.

The downside of an ETN is that if the underlying bank goes bankrupt, you lose essentially all of your money. There were, for instance, a few ETNs backed by Lehman Brothers. While most investors in Lehman's ETNs fled before the firm shut down, anyone who held to the bitter end probably still has a bad taste in their mouth.

The good news is that this credit risk in most situations is minor. Institutional investors can "redeem" (get their money back) from the underwriter of ETN daily. While anything can happen, you usually see major bank defaults coming more than a day or two ahead.

The even-better news is credit risk is easily monitored. ETF.com monitors and reports on the credit risk of every ETN daily. It does that by watching the cost of credit default swaps (CDS) on the underwriting banks each day. CDS are like insurance—investors buy them to protect themselves against a company's default—so they are the best possible view of the likelihood a bank will go down.

How do you check? Just pull up the Efficiency Tab on any ETN (e.g., www.etf.com/AMJ) and check out the ETN Counterparty Risk measure. If it says "Low," you're OK. If it says "High," run for the hills.

10 LARGEST ETNs

TICKER	FUND	ISSUER	ER	AUM
AMJ	J.P. Morgan Alerian MLP Index ETN	JPMORGAN	0.85%	$2.95B
FLGE	Credit Suisse FI Large Cap Growth Enhanced ETN	CREDIT SUISSE	1.52%	$1.94B
FIHD	UBS AG FI Enhanced Global High Yield ETN	UBS	1.65%	$1.54B
FIYY	Barclays ETN+ FI Enhanced Global High Yield ETN Series B	BARCLAYS BANK PLC	0.93%	$1.54B
FBGX	UBS AG FI Enhanced Large Cap Growth ETN	UBS	1.29%	$1.47B
MLPI	ETRACS Alerian MLP Infrastructure Index ETN	UBS	0.85%	$1.39B
VXX	iPath S&P 500 VIX Short-Term Futures ETN	BARCLAYS BANK PLC	0.89%	$892.41M
DJP	iPath Bloomberg Commodity Index Total Return ETN	BARCLAYS BANK PLC	0.70%	$819.79M
UGAZ	VelocityShares 3X Long Natural Gas ETN	CREDIT SUISSE	1.65%	$780.30M
FFEU	Barclays ETN+ FI Enhanced Europe 50 ETN Series C	BARCLAYS BANK PLC	1.05%	$674.37M

Source: FactSet, ETF.com as of 12/5/2018