ETFs

A BASIC GUIDE

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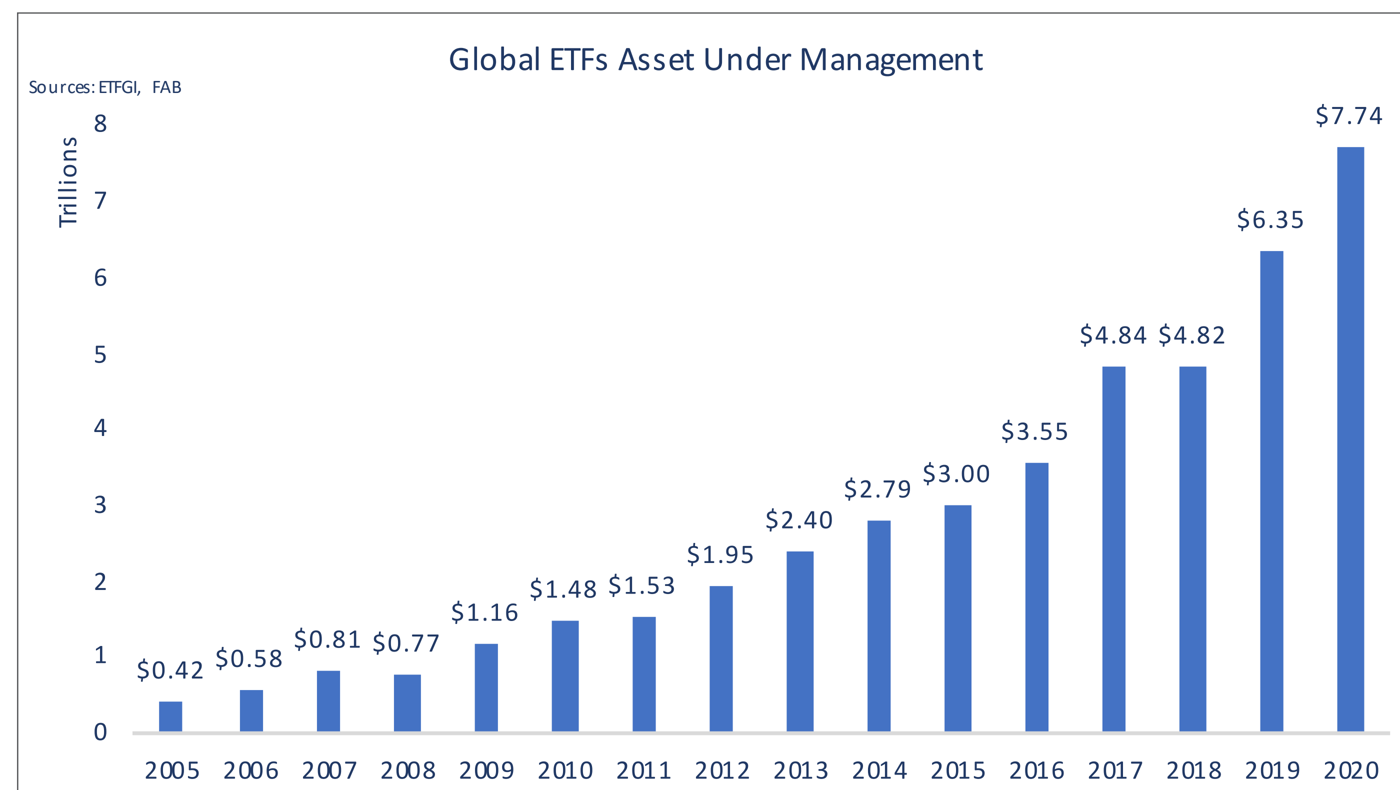
Exchange-traded funds (ETFs), as the name suggests, are hybrid investment products combining many investment features of mutual funds with the exchange trading associated with common stock. Because they trade on an exchange, ETF prices change throughout the day as and when they are bought and sold, and sometimes their market cap even deviates from the net asset value of their holdings.

The first ETFs were listed in the US in the early 1990s and were mostly focused on tracking stock indices, allowing investors to buy and sell an entire index in a day without spending much. Their existence, and associated options in some markets, also allowed more speculative short-term investments in some markets that were hard or expensive to place before.

Nowadays, however, there are ETFs and exchange-traded products for nearly everything, whether it is taking a leveraged position that the VIX S&P Volatility index will move up or down or even in bitcoin. They are also no longer simply passive vehicles; a growing number of vehicles that are traded have active and specific investment mandates.

This diversification of the nature and mandates of ETFs has helped to boost their participation in the overall market and, according to the Investment Company Institute, in the US alone their assets under management increased US$2.28 trillion in the 12 months leading to October 2021, when total assets of such funds in the country reached a record US$6.96 trillion.

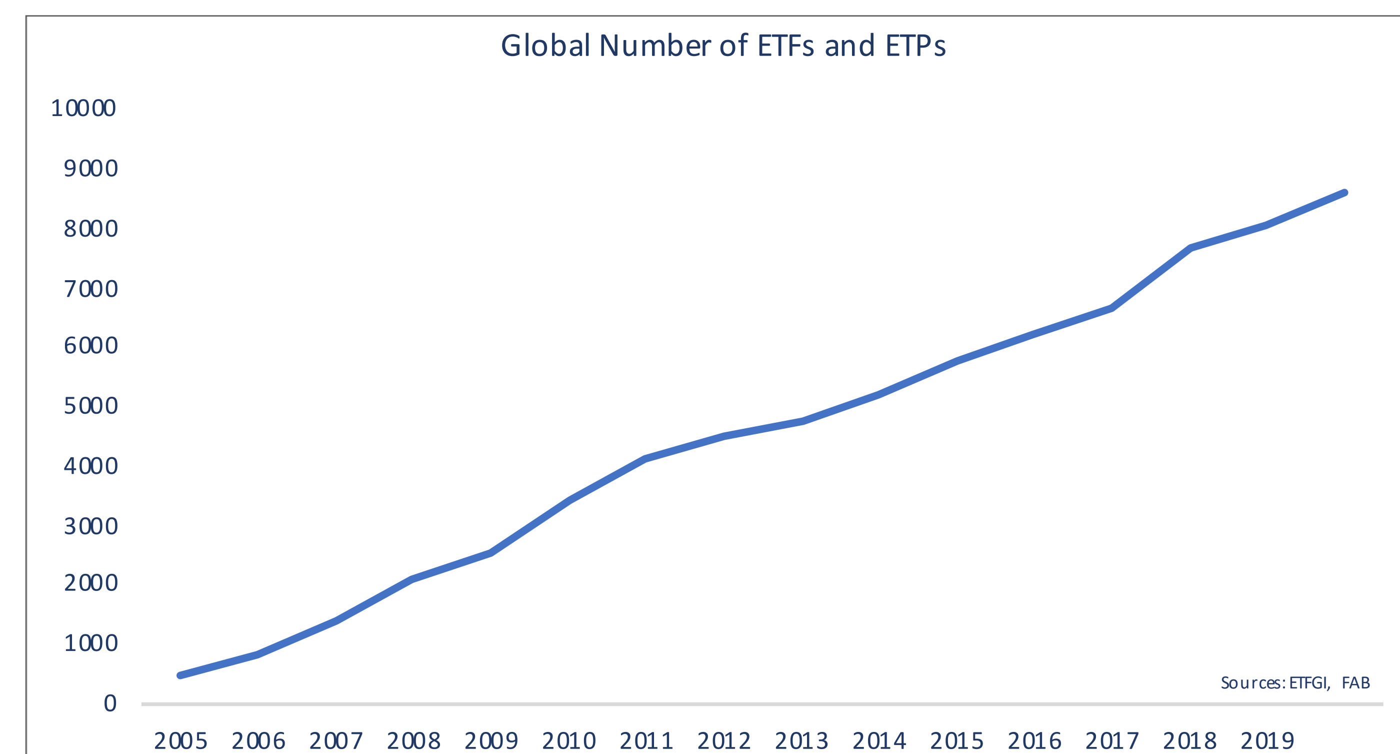


There are now nearly 9,000 different products with close to 18,000 listings across the globe, which means the number of ETFs and exchange-traded products has multiplied some 20 times in the past 15 years.

As a result, even investors with small amounts of savings can create almost any kind of diversified portfolio simply using exchange-traded products and funds. They can also do just about anything with an ETF that they can do with a normal stock, from short-selling to selling calls in the markets where options are available.

Nothing comes for free though. When an investor buys an ETF instead of the actual portfolio targeted, there are management costs aside from the normal trading expenses to buy or sell a stock. Plus, the ETF's own expenses will end up being charged to the ultimate investors.

That said, however, ETFs generally have lower management fees than traditional mutual funds in most like-for-like categories, partly because they tend to be able to achieve scale more easily given how simple it is to invest in an ETF.



Some advantages of ETFs

Lower cost: Index-tracking ETFs generally have lower management fees than their non-listed counterparts, although that is not always true. Some ETFs that offer exposure to certain kinds of futures markets, for instance, may have significant management fees and may incur high roll expenses that burden the investors.

Diversification: ETFs have low-cost units that can be bought through a simple brokerage account, allowing investors to create more diversified portfolios without having to commit large sums. There are broad-based ETFs that invest in 5,000 stocks and there are select industry ETFs that invest in 20 stocks, as well as active, thematic, futures-based, single commodity ETFs, and even ETFs of ETFs.

In addition, ETFs can be sold short and, in some cases, have inverse exposure as an investment objective; this feature makes access possible for those seeking to profit from decreases as well as increases in prices of a certain part of the market.

Because of their exchange-traded nature, ETFs offer a level playing field, providing all investors, regardless of the size of their investment holdings or time horizon, with access to a full suite of products across the financial marketplace.

Intraday trading: One of the drawbacks to investing in an open-ended mutual fund is that they are only priced once a day. With an ETF, investors can trade in or out of the fund at various times throughout the trading day.

Transparency: In certain jurisdictions, mutual funds are only required to disclose their holdings on a quarterly basis. Often, investors are left in the dark about what the fund is invested in until the quarterly or annual reports are released. With an ETF, the fund provider is required to post their holdings on their website on a regular basis, and that gives investors almost real-time access to the securities and weightings within the portfolio.

Caveats

While ETFs can be an excellent tool for any portfolio, there are some pitfalls investors need to be aware of.

Underlying liquidity and volatility: Some ETFs are thinly traded and, just like an illiquid stock, they can make it difficult for an investor to close a position. Because they are traded, sometimes ETFs deviate from their net asset value and can trade at a premium or a discount, though in most cases such anomalies are soon corrected by the market.

Some ETFs also invest in securities that are not nearly as liquid as themselves. Some fixed income ETFs, for instance, faced issues during the sell-off in March 2020 as redemptions vastly outpaced their ability to unload their holdings. This has drawn some regulatory scrutiny given the possibility that such ETFs could exacerbate downward movements as they are forced to fire-sell holdings to meet accelerating stock market-led redemptions.

Misunderstandings related to strategy: Some ETFs, which are seen as vehicles to gain exposure to certain commodities or strategies, may hold derivative positions that are expected to emulate the performance of that target investment. This means that the performance will not be exactly the same.

Some oil-based ETFs, for instance, hold futures, and therefore could underperform spot prices because of roll costs and differences in the performance of various derivative contracts. The first "bitcoin ETF" to be approved by the US Securities and Exchange Commission, for instance, does not buy the cryptocurrency; instead, it uses futures contracts traded in Chicago to mirror its performance.

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