Source: https://www.finra.org/investors/learn-to-invest/types-investments/investment-funds/exchange-traded-fund

Exchange-Traded Funds

Exchange-traded funds (ETFs) combine aspects of mutual funds and conventional stocks. Like a mutual fund, an ETF is a pooled investment fund that offers an investor an interest in a professionally managed, diversified portfolio of investments. But unlike mutual funds, ETF shares trade like stocks on stock exchanges and can be bought or sold throughout the trading day at fluctuating prices.

Are All ETFs Alike?

No. ETFs can vary in a number of ways:

- **Regulatory structure.** Most ETFs are registered with the SEC as investment companies under the Investment Company Act of 1940, and the shares they offer to the public are registered under the Securities Act of 1933. Some ETFs that invest in commodities, currencies or commodity- or currency-based instruments are not registered investment companies, although their publicly-offered shares are registered under the Securities Act.
- **Management style.** Many ETFs are designed to passively track a particular market index and are similar to index mutual funds. These ETFs aim to achieve the same return as the index that they track, by investing in all or a representative sample of the stocks included in the index. In recent years, actively managed ETFs have emerged as another choice for investors. The portfolio manager of an actively managed ETF buys and sells stocks in accordance with an investment strategy, rather than tracking an index.
- **Investment objective.** Investment objectives vary by ETF and the management style of a given ETF. The objective of passively managed ETFs is to replicate the performance of the index the ETF tracks. On the other hand, advisers of actively managed ETFs invest to achieve a particular investment objective by making investment decisions themselves. Some passively managed ETFs aim to earn a return that is a multiple or a reverse (inverse) multiple of the return of a particular stock index. These are referred to as leveraged or inverse ETFs. An ETF's investment objective is stated in its prospectus.
- **Indices tracked.** ETFs track a huge variety of indices. Some indices are very broad market indices, such as total stock or bond market indices. Other ETFs track indices that are narrower, such as those made up of medium and small companies, only corporate

bonds or just international companies. Some EFTs track extremely narrow—and sometimes very new—indices that might not be fully transparent or about which little is known.

ETF Nuts and Bolts

Unlike mutual funds, ETFs do not sell shares to, or redeem shares from, retail investors directly. To make it possible for investors to buy and sell shares on an exchange, ETFs follow a unique format. An ETF enters into contracts with financial institutions (typically large broker-dealers) to act as Authorized Participants (APs). APs purchase and redeem shares directly with the ETF in large blocks of shares called Creation Units. APs typically sell some or all of their ETF shares on an exchange. This enables investors to buy and sell ETF shares like the shares of any publicly-traded company.

Buying and Selling ETFs

Investors purchasing or selling shares in an ETF typically pay a brokerage commission on each transaction. When you purchase or sell ETF shares, you receive the market price on the exchange at the time the order is placed. This price may fluctuate throughout the trading day. A mutual fund, on the other hand, determines its net asset value at the close of each trading day. When you purchase or redeem mutual fund shares, you receive the price based on the net asset value next computed after you submitted your order. The intraday pricing of ETFs tends to provide investors with greater trading flexibility, because you can monitor how the price is doing and do not have to wait until the end of the day to know your purchase or sale price.

As with other investments, you can make money with ETFs if you sell your shares for more than you paid. You also benefit if the securities an ETF holds pay interest or dividends. That income may either be reinvested or paid to shareholders quarterly or annually, depending on the way the ETF is structured. An ETF may also decline in value. Of course, if the value falls and you sell, you may have a loss.

Unlike mutual funds, it is possible to buy ETFs on margin and sell them short. These advanced investment strategies may be useful for some experienced investors—though for other investors, the costs and risks of such strategies might outweigh the potential benefits.

With ETFs, you typically pay a commission on each transaction, like individual stocks. For this reason, ETFs are generally not recommended for incremental investing strategies such as dollar-cost averaging: The sales charges you pay for each purchase or sale could erode your investment return. The same caution applies to mutual funds that charge front-end sales loads.

A number of ETF providers have begun to offer no-commission ETFs. While this can be advantageous to investors who plan to make numerous small trades, the no-commission sales angle shouldn't be the sole factor in determining which ETF to purchase. You will want to read the fine print with regard to no-fee trades (at least one firm charges you a fee if you buy a no-commission ETF and trade it within 30 days of purchase). And as we describe next, ETFs also have expense ratios to consider—a different type of cost to you that can add up.

ETF Expenses

In addition to any brokerage commission you may pay, ETFs have expense ratios, like mutual funds, calculated as a percentage of the assets you have invested. ETFs do not have loads or 12b-1 fees (fees that are taken out of a mutual fund's assets annually to cover the costs of marketing and distributing the fund to investors).

In general, actively managed ETFs cost more than passively managed index ETFs. Before purchasing ETF shares, carefully read all of an ETF's available information, including its prospectus. All ETFs will deliver a prospectus upon request.

ETFs and Taxes

You can own ETFs in taxable, tax-deferred or tax-free accounts. In taxable accounts, any capital gains you realize from selling fund shares are taxed in the year you realize them, though the rate that applies may be your long-term capital gains rate.

In contrast, in a tax-deferred account, any gains become part of the total assets in the account and are taxed as ordinary income when you withdraw them at some point in the future. In a tax-free account, any gains or income will not be taxed if you follow the rules for withdrawals.

While ETFs held in a taxable account will generally result in less tax liabilities than if you held a similarly invested mutual fund in the same account, there can be exceptions. Leveraged in inverse ETFs can create tax liabilities. So can certain exotic ETFs—for instance certain emerging market funds and funds that invest in precious metals, which are considered “collectables” by the IRS, taxed as ordinary income for short-term gains and 28 percent for long-term gains.

For more information about the tax treatment of a particular ETF, make sure to read the prospectus

More Information

The following resources provide additional information about ETFs:

- FINRA Investor Alert, Leveraged and Inverse ETFs: Specialized Products with Extra Risks for Buy-and-Hold Investors
- Securities and Exchange Commission (SEC) Investor Bulletin, Exchange-Traded Funds (ETFs)