ETFS 101, Part 1- **AN INTRODUCTION**

Exchange-Traded Funds, or "ETFs," sprung to life in 1993, with the introduction of the SPDR Trust by a subsidiary of the American Stock Exchange. SPDR was the acronym for the Standard & Poor's Depository Receipt, and was referred to as "Spider." The SPDR had an investment objective of tracking the S&P 500 Index, thereby permitting its portfolio to be changed whenever the composition of the index changed. Over the next three years, three more ETFs followed, matched to the S&P Midcap 400 Index, Dow Jones Industrial Average, and the NASDAQ 100 Index.

From these humble beginnings, ETFs have soared in popularity, with assets in them increasing from $151 billion in 2003 to nearly $2.0 trillion today.

Over the course of 2015, I will be discussing the reasons why investors have embraced ETFs, look under the hood and explain their structure, review their pros and cons, examine the various types of ETFs and look at how to structure an investment portfolio that utilizes ETFs.

While we will be focusing this year on ETFs, let's first take a broad look at all "registered investment companies."

Registered Investment Companies

U.S. registered investment companies play an important role in our economy and markets, holding over $17 trillion in assets as of last year, supplying investment capital to bond and stock markets. While investors can buy stocks of individual companies and bonds of both companies and governments, the pooling of assets, convenience, diversification, professional management and record-keeping provided by registered investment companies make them an attractive investment method for nearly 98 million U.S. investors.

There are actually four different types of registered investment companies:

(1) Mutual Funds

Pooling of money for investment purposes has long existed, but the modern "mutual fund" arrived in 1924. As of last year, 88% of the assets in investment companies were held in mutual funds. Two criteria distinguish mutual funds from other types of investment companies. First, they don't have a fixed number of shares, but create more shares as investors put money into a fund. For this reason, mutual funds are also referred to as "open-end funds." Second, they are priced just once per day, after the market closes. This end of day pricing is important for investors. You may place an order to buy or sell a particular mutual fund at 10 AM, but the actual price you pay or receive is determined only at the end of the day.

(2) Closed-End Funds

Closed-end funds hold less than 2% of investment company assets. They have a fixed number of shares outstanding. They can be bought and sold throughout the day, but often at significant discounts or premiums to the underlying value of their assets.

(3) Unit Investment Trusts

UITs hold less than 1% of investment company assets. They have a fixed number of assets that do not change over the life of the UIT. For example, a UIT might be formed to own 20 different NC municipal bonds. The UIT sponsor simply receives the income from those bonds and remits it to the shareholders.

(4) Exchange-Traded Funds

ETFs now hold nearly 10% of investment company assets. Similar to mutual funds, they are "open-ended" and more shares are created as people invest in them. Similar to closed-end funds, they can traded throughout the day, at current, not end of day, prices. However, in contrast to closed-end funds, ETFs attempt to maintain a price that closely tracks the value of their underlying holdings, hopefully making any discount or premium immaterial.

In Part 2, we will examine the features that make ETFs so attractive for investors.

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