ETFS 101, Part 2 – **KEY FEATURES**

Last month, we introduced Exchange-Traded Funds (ETFs) and contrasted them with traditional open-end mutual funds, closed-end funds, and unit-investment trusts. This month, we'll review the key features making ETFs an increasingly popular investment option for investors.

First, it is important to remember that all mutual funds, including ETFs, are a way for investors to easily diversify their portfolios, obtain professional management, and implement both simple and sophisticated investment strategies. But, it is the special characteristics ETFs provide that have resulted in them now holding 10% of all mutual fund assets.

(1) Intra-Day Trading

You can buy or sell ETFs throughout the trading day. If it is 10 in the morning and you place an order to buy an ETF, you pay the price that it is trading for at that moment. With a traditional open-end fund, even though you place your order to buy at 10 a.m., the price you pay is determined by the 4 p.m. closing price of the fund's shares. Now, for many investors, this probably makes little difference. But, in a volatile market or when trading particular types of funds or with a short-term trading strategy, it could make a big difference.

(2) Shorting and Options

When you "short" a stock, you are betting the price will drop. You cannot short traditional funds, but you can short ETFs, allowing you to bet on a price decline for the broad market or a particular segment of the market. In addition, just as you can buy and sell options on individual stocks, you can also buy and sell options on ETFs.

(3) Low Cost

ETFs provide investors a very low cost way to invest. First of all, almost all ETFs are passively-managed, tracking a specific index. An index-tracking fund, whether it is structured as a traditional fund or an ETF, will invariably be a lower cost alternative than an actively-managed fund, simply because it is passive and has no live person at the helm. But, not all ETFs are low cost. ETFs tracking very narrow indexes or engaging in active management can have costs similar to traditional funds.

(4) Small Discounts/Premiums

Not only do ETFs trade throughout the day, but the underlying assets held by ETFs (stocks and bonds), also trade throughout the day. How do I know that the price I pay for the shares of a particular ETF fairly reflects the current value of the underlying assets at the very moment I buy the shares of the ETF? It is certainly possible for the price of an ETF to have a discount or premium when compared with the actual stocks or bond it owns, but usually any divergence is relatively immaterial, at least for the ETFs that have significant assets and a large trading volume. What keeps the price of the ETF in line? Throughout the day, traders quickly pounce on any difference between the ETF price and the price of the actual holdings of the ETF, arbitraging away any differences.

(5) Tax Efficiency

ETFs provide two forms of tax efficiency. Since most ETFs are passive, index-tracking funds, they do not have the portfolio turnover that an actively-managed one would have. But, the structure of ETFs provide another level of tax efficiency. Suppose there is a traditional open-end fund with $100 of assets that originally cost $60. If an investor wanted to withdraw from the fund, the fund might have to sell the asset, generating a $40 taxable profit that is taxed to every investor in the fund, not just for the one investor wanting to withdraw. However, with the ETF, only the withdrawing investor would be subject to tax in this scenario, not every investor.

Gerald A Townsend, CPA/PFS/ABV, CFP®, CFA®, CMT is president of Townsend Asset Management Corp., a registered investment advisory firm offering wealth management expertise to its clients. Email Gerald@AssetMgr.com for more information. And for the latest news and updates, follow Townsend's growing platforms on Linked In, Facebook and Twitter.