ETFS 101, Part 3 – **HOW TO CHOOSE AN ETF**

We've previously discussed how Exchange-Traded Funds (ETFs) differ from traditional Open-End Mutual Funds and how intra-day trading, low expenses and tax efficiency have contributed to their explosive growth over the past ten years.

This month, we'll consider how to choose an ETF. This is an increasingly difficult task since there is now over $2 trillion in U.S. ETFs spread among about 1,500 different ETFs that are offered by nearly 50 different sponsors. ETFs investing in U.S. or foreign stocks account for 80% of ETF assets with bond-focused ETFs comprising the balance.

Investor Goals

The starting point in choosing an ETF is no different than choosing a mutual fund or an individual stock – you have to know what you are trying to accomplish with your investment.

*Are you seeking income, growth, or a combination of the two?

*Are you investing for a short period of time or is this a long-term investment?

*How much risk are you willing to accept?

*Do you have a specific return target in mind?

*Are you looking for a particular ETF strategy or trying to structure a well-balanced portfolio?

These are all big and important questions that need to be addressed when selecting ETFs, mutual funds, stocks or any investment.

Factors Impacting Your Decision

Most ETFs are passively-managed, which means they track an index. However, as we will discuss in a future article, there are a number of actively-managed ETFs. In addition, even for ETFs that track indexes, there are an incredible number of indexes to consider. And today's indexes are, in many cases, very different from some years ago, which we will also further explore in a later article.

For most investors, a suitable ETF portfolio can be constructed by focusing on ETFs that track major indexes, such as:

*U.S. Large Companies – S&P 500, Russell 1000

*U.S. Smaller Companies – S&P 600, Russell 2000

*U.S. Total Market – S&P 1500, Wilshire 5000, Russell 3000

*Foreign Developed Markets – MSCI EAFE

*Foreign Emerging Markets – MSCI Emerging Market

*U.S. Bond Market – Barclays Aggregate Bond Index

If you want your investment to reflect the results of U.S. large companies, you might choose an ETF that tracks the S&P 500 or Russell 1000 index, and there are a number of ETFs available that do this. But if you are building a portfolio and want exposure to U.S. large companies, U.S. mid-size companies, U.S. small companies, foreign developed markets, foreign emerging markets, fixed income investments, real estate investment trusts, as well as commodities – then you have a lot more work to do and will be using many different ETFs.

Providers and Costs

While there are many providers of ETFs, Blackrock, State Street, Vanguard, and Invesco currently hold perhaps 75% of all ETF assets. The largest ETFs are: SPDR S&P 500 (SPY); iShares Core S&P 500 (IVV); iShares MSCI EAFE (EFA); Vanguard Total Stock Market (VTI); Vanguard FTSE Emerging Markets (VWO); and PowerShares QQQ (QQQ).

When buying or selling an ETF, you incur brokerage transaction costs, just like buying or selling an individual stock. However, some brokerages (e.g. Schwab, Fidelity, etc.,) now offer a large number of ETFs that can be traded commission-free.

Gerald A. Townsend, CPA/PFS/ABV, CFP®, CFA®, CMT is president of Townsend Asset Management Corp., a registered investment advisory firm offering comprehensive 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.