What Are Exchange-traded Funds and How Do They Work?

An exchange-traded fund (ETF) is a basket of securities created to track as closely as possible a particular market index, such as the Standard & Poor's 500 Index or the Dow Jones Industrial Average. They're similar to mutual funds in that they represent investments in the same types of securities, but they generally have lower fees and can be bought and sold with more pricing immediacy than mutual funds. They also have some clear tax advantages.

Since their launch in the early 1990s on the American Stock Exchange, there are now hundreds of ETFs available for investors to buy. As the market has struggled its way back since 2000, investors have embraced ETFs as a more efficient alternative to a mutual fund invested in the same securities. A financial planner can tell you whether ETFs are right for your portfolio, but here are some details to know beforehand:

How are ETFs created? An ETF is created by large institutional investors who buy stocks aligning with the shares in a particular index, and then they exchange those shares – in baskets as large as 50,000 shares – for shares in the ETF. The redemption process works the same way in reverse -- the institutional investors exchange shares of the ETF for baskets of the underlying stocks.

Are all ETFs based on indexes? Yes. Indexes, like the S&P 500 or the Hang Seng Index (the primary stock index of the Hong Kong Stock Exchange), are a listing of stocks reflecting the activity of a particular investment sector on a stock exchange. One of the first popular ETFs had an unusual nickname – Spiders – a play on its actual name, SPDR, short for Standard and Poor's Depositary Receipts. Newer ETFs track less well-known indexes, even indexes of bonds, and some ETFs are tracking very dynamic indexes that almost act like actively managed funds.

How are ETFs traded? Unlike mutual funds, which have their prices set at the end of the trading day, ETFs are priced and traded every moment of the trading day. That's generally more meaningful to institutional investors who buy and sell constantly than long-term investors who buy and hold. Furthermore, unlike mutual funds, ETFs can be bought on margin or sold short.

Why might ETFs be more tax-efficient? Generally, ETFs generate fewer capital gains due to the unique creation and redemption process as well as the usually lower turnover of securities that comprise their underlying portfolios. Financial planners note that investors can better control the timing of the tax treatment of ETFs relative to mutual funds. Most importantly -- by holding an ETF for at least one year and a day, capital gains will be treated as long-term capital gains, which are currently taxed at a federal rate of 15 percent (5 percent for low tax bracket investors).

Are there other advantages? Unlike traditional mutual funds, which must disclose their holdings quarterly, ETF holdings are fully transparent, and investors know what holdings are in the ETF at any given time. Each ETF also has a NAV tracking symbol for even more precise analysis. This helps keep ETFs trading within pennies of their intraday NAV.

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What about fees? Shares of index-based ETFs may have even lower annual expenses than similar index mutual funds, which, in turn, tend to be lower than those of actively managed mutual funds. ETFs must, however, be bought and sold through brokers, and those trades do involve transaction costs. ETFs may prove to be more expensive than mutual funds to investors who add money each month to their portfolio.

What's the downside? Unlike regular mutual funds, ETFs do not necessarily trade at the net asset values of their underlying holdings. Instead, the market price of an ETF is determined by supply and demand for the ETF shares alone. Usually, the ETF value closely mirrors the value of the underlying shares, but there's always a chance for ETFs to trade at prices above or below the value of their underlying portfolios. Also, since so many new ETFs are hitting the market, investors should be aware of the maturity of the particular ETF they are considering.

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