Anatomy of an ETF

At the most basic level, exchange traded funds are just what their name implies: baskets of securities that are traded, like individual stocks, on an exchange. Funds can track any number of indexes from the large-cap S&P 500, small-cap Russell 2000, or even commodities.

ETFs often look similar to an index mutual fund, but there are some important differences.

The process of buying and selling ETFs works differently than with mutual funds. ETFs trade like individual stocks. You can purchase them in real time at any point during the day, unlike mutual funds, which settle only at the day's close. This means you can use trading features like stop losses on an ETF that you can't use on an open-end mutual fund. There are no redemption fees on ETFs, unlike on many of their mutual fund cousins, but investors typically do pay a transaction fee to their broker every time they buy or sell shares (though some brokers do offer free transactions on certain ETFs).

The fact that you must trade ETFs with other market participants means that an ETF will have two prices: A net asset value, which is set daily based on the ending value of its portfolio and accrued expenses—just like a traditional fund—and a share price, which is determined by the ETF's supply/demand profile in the market, just like a stock.

To a large extent, the supply and demand for ETF shares is driven by the underlying values of their portfolios, but other factors can and do affect their market prices. As a result, the potential exists for ETFs to trade at prices above or below the value of their underlying portfolios. However, a special process that allows large investors to take advantage of this price differential should, in theory, help prevent sustained discounts or premiums from opening up.

Many different fund companies have ETFs on the market currently, under brand names like SPDRs, sector SPDRs, MidCap SPDRs, iShares, Powershares, Vanguard, Flexshares, and more. Most of them are passively managed, tracking a wide variety of broad to narrow market indexes.

Funds that drill down into specific sectors, industries, regions, countries, and asset classes make up a great percentage of the ETF universe, offering relatively inexpensive access to investments such as currencies, precious metals, or emergent industries that heretofore have been the sole province of larger institutional and wealthy investors. More recently, fund companies have also launched actively managed ETFs. These funds are not tethered to a benchmark, but continue to sport the familiar features of ETFs, including intraday trading.
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