Understanding ETFs

The first ETF, launched by State Street as SPY to track the movements of the S&P 500 stock index, came to life on January 23, 1993. 26 short years later, there are now approximately 2,000 ETFs in the United States alone, representing close to $4 trillion in assets*. That growth is remarkable when we consider the extent to which many investors still do not fully understand them. With that in mind, we attempt to educate here on this growing investment.

What is an ETF?

An ETF, or Exchange-Traded Fund, is a fund that owns baskets of securities (stocks, bonds, etc.) just like a mutual fund does.

How do I invest in an ETF?

Most investors are familiar with mutual funds. When one buys (or sells) a mutual fund, no matter what time of day the order is entered, it is always executed at that day's closing price. In contrast, an ETF trades on an exchange (hence the name) just like a stock. If an investor buys SPY at 10:15 a.m., ownership is taken at that time. Relatedly, that investor could turn around and sell SPY at 10:19 a.m. if so desired. This is not the case with mutual funds, which have rules about how long they must be held before they may be sold.

Aren't ETFs just the same as owning the whole market?

This is one of the most common misconceptions. An understandable one because SPY was the first and is the largest ETF. However, with 2,000 ETFs just in the US, they come in all shapes and sizes to fit just about any investment need. There are those that invest in stocks and those that invest in bonds. Some invest in high dividend yield stocks; some invest in cannabis companies. There is even an Obesity ETF (no joke: the ticker symbol is SLIM). There are now a growing number of ESG (think social and environmental responsibility) ETFs. The point is that ETFs were once equated with "the market" for good reason, but no longer.

How do ETFs invest my money?

In our opinion, this is the crux of the lack of knowledge around ETFs. For most of investors' lives they have been comfortable with mutual funds being managed by someone with a pedigree and a name. These managers appear in the financial media regularly, so investors come to know them. Peter Lynch, who used to manage Fidelity's Magellan fund, and Bill Gross, who used to manage PIMCO's Total Return Bond Fund, are just a couple well-known names. This raises the important issue of active versus passive, which is a much longer topic than we'll consider here. Suffice it to say that passive generally means an investment that strives to track an index of stocks or bonds, while active refers to an investment with a portfolio manager at the helm trying to beat "the market". With that as a base, MOST ETFs track an index and are therefore passive investments. This does not mean there isn't a portfolio manager – it simply means the portfolio manager's job is to track the index as closely as possible. In the case of SPY,

the manager is tasked with owning the 500 stocks in the same weights as they are represented in the S&P 500 index. Active ETFs are starting to see some growth, but the bulk of existing assets are in index-tracking ETFs.

Why would I want to own a passive investment?

This gets into a philosophical discussion that will be the topic of another paper. In short, because the portfolio manager in a passive investment is simply buying the securities of an index, there is no need to do research on those stocks. The main responsibility is strong trade execution to match the index as closely as possible. Because there is no need to conduct research, all those research costs (teams of portfolio managers, analysts, junior analysts, company visits, research subscriptions, and so on) disappear. Furthermore, there are generally synergies that can be leveraged by not having to do all that research, meaning the portfolio manager can oversee a group of ETFs, as opposed to a small handful of funds. While there are other reasons, this is the primary reason index ETFs have fees so much lower than traditional active mutual funds.

What are the tax consequences of an ETF?

While mutual funds must pass along capital gains to investors as securities are bought and sold inside the funds, ETFs generally do not. This is because of the structure of ETFs that allows them to dispense securities "in-kind" rather than having to actually sell. This gets technical, but when an index-tracking ETF sells securities, the ETF company can deliver an entire basket of the underlying securities to someone called an Authorized Participant, who then delivers back to the ETF company shares of the ETF. As a result, the securities weren't sold – they were transferred in kind, so no capital gain event occurred. There are some securities that cannot be transferred in kind, but most large, liquid stock and bond ETFs tend not to distribute capital gains.

Conclusion

Exchange-Traded Funds, or ETFs, are similar to mutual funds in that they offer investors who don't want the risk of owning an individual security (or a small group of them) a way to diversify. That is about where the similarity stops. Here is a summary of the differences:

- Mutual funds have daily liquidity, meaning they can be transacted once per day. ETFs have continuous liquidity, meaning they can be bought and sold anytime on an exchange.
- Most ETFs track an index and are therefore relatively low cost. Most mutual funds are run by an active manger and have higher costs. This is a trend issue, not a structure one. ETFs can be run by an active manager and be more expensive and mutual funds can track indexes and be cheaper.
- ETFs are transparent investments. If an investor wants to know what is in an ETF, all holdings are publicly available daily. Mutual funds, on the other hand, do not have to disclose holdings daily and, when they do disclose, it tends to be with a lag, so the holdings may not be in the fund anymore.

- ETFs tend to be tax efficient. While they must distribute dividends as income, they tend not to distribute capital gains. Mutual funds also must distribute dividends as income **and** have to pass along any short- and long-term capital gains to the fund owners.

Because there are so many types of ETFs out there, it is important to know what you are buying. Since ETFs trade on an exchange, there is always a bid (the price at which you can sell) and an ask (the price at which you can buy). For a large, liquid ETF, the difference between the bid and the ask tends to be very small. However, for a more esoteric ETF (i.e. the aforementioned SLIM) the difference can be much larger. This can affect returns, depending on how long the investor holds.

We hope that has been a useful exercise. ETFs are growing and can be beneficial in many ways, but also require a lot of education. To learn more, visit www.metricfin.com or email us at info@metricfin.com.

*Source: ETFGI

The S&P 500 is a Standard & Poor's index that tracks 500 large- and mid-cap companies in the United States. All companies in the index are weighted by their market capitalization (or stock price x number of shares outstanding).

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