Debunking Myths & Common Misconceptions of ETFs

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Even as ETFs have grown in popularity, there is a still a great deal of misunderstanding over how they are structured and regulated, how they trade, and how their performance compares to other kinds of investments.

For nearly over the twenty years since State Street launched the first Exchange Traded Fund (ETF)[1] in 1993, ETFs have grown to become an extremely popular investment vehicle for both individual and institutional investors. Today there are more than 5,500 options available and US$2.6 trillion in assets globally.[2]

ETFs offer an easy, cost-efficient way for investors to incorporate various asset classes, investment styles, industry sectors and even commodities to their portfolios. Because most ETFs are passively managed, they generally have low management fees and operating expenses. Like individual stocks, ETFs give investors the flexibility to buy and sell at market price on the major stock exchanges throughout the day. It's important to keep in mind that frequent ETF trading, which typically occurs through a broker, can significantly increase brokerage commissions potentially washing away any savings from low fees or costs.

But even as ETFs have grown in popularity, there is a still a great deal of misunderstanding over how they are structured and regulated, how they trade, and how their performance compares to other kinds of investments. Increased disclosure, greater transparency and improved investor education are vital to helping investors decide which financial products are most appropriate for their investment needs, including ETFs. This article is designed to provide the facts behind some common ETF myths that persist today.

Myth ETFs Are the Same as Individual Shares

Reality A stock is a type of security that signifies ownership in a corporation and represents a claim on part of the corporation's assets and earnings. A stock can be bought and sold on major stock exchanges throughout the day at the market price. A stock's price will generally reflect the market's supply and demand for its shares.

An ETF is generally a commingled investment vehicle comprised of a collection or 'basket' of assets that tracks, and is intended to represent, the performance of a broad or specific segment of the market, such as equities, small-cap stocks, emerging markets or a specific commodity class such as gold. Most ETFs offer the combined benefits of index mutual funds and individual securities. Like index mutual funds, ETFs allow investors to track the returns of hundreds of domestic and international indices. Like individual stocks, ETFs give investors the flexibility to buy and sell shares at market prices on the major stock exchanges throughout the day.

Myth All ETFs Replicate Their Underlying Indexes

Reality Most, but not all, ETFs are designed to provide investment results that track the price and yield performance of an underlying benchmark index by holding a portfolio of securities that mirror this performance. The majority of ETFs around the world generally use one of three techniques to achieve this goal: full replication; optimization-based tracking; and synthetic replication. However, not all ETFs are

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replication-based; within the past few years a growing number of actively managed ETFs have been launched that leverage the expertise of portfolio managers to execute security selection and trading decisions.

Let's examine each of these approaches in greater depth.

Full Replication

In this approach, an ETF holds all the securities in the same weightings as its associated index. Over time, the manager adjusts the portfolio to reflect changes in the index (such as the replacement of one security with another) and manages cash flow from dividends or income generation. This strategy tends to provide very close tracking with the underlying index.

Optimisation-Based

Designed to control trading costs and promote liquidity, this strategy uses a sampling process to create a representative or optimized portfolio of securities that closely matches the characteristics of the underlying index. While this approach may be more cost-efficient, it tends to carry a higher potential for tracking error than ETFs that use the full-replication method.

Synthetic Replication

A recent introduction to the marketplace, these funds (also known as 'synthetic' funds) attempt to replicate index returns by purchasing derivatives such as swap agreements with one of more counterparties, such as a bank. Typically, the counterparty will agree to deliver the performance of the associated index (minus a small spread), including capital gains and dividends, in exchange for the value of the performance generated by a pool of physical securities held by the ETF (these securities are not necessarily the same as those comprising the ETF's index). This allows the ETF to mirror the performance of an index without having to own the actual securities, which can be advantageous when it is difficult or expensive to trade in certain markets or sectors. Synthetic ETFs are riskier than other kinds of ETFs because a counterparty could default on its obligations. However, financial regulators in most countries limit the amount of assets that can be invested in derivatives and require these ETFs to provide adequate liquidity to protect investors against default-related losses.

Actively Managed

This relatively new category of ETFs allows managers to apply their own expertise in overseeing portfolio construction and trading decisions, similar to actively managed mutual funds. While the ETF will have a benchmark index, its managers will generally attempt to outperform that index's returns rather than simply match it. The main difference between actively managed ETFs and mutual funds is that actively managed ETFs are priced and traded intraday, while mutual funds can only be purchased or sold at their net asset value after the market closes. Generally, actively managed ETFs have higher expenses than replication-based ETFs.

Myth Individual Stocks, Bonds and Managed Funds Generally Outperform ETFs

Reality Any short-term or long-term analysis of the markets will demonstrate that no particular investment category or type can consistently outperform another. Performance of any security, whether it's a stock, bond, mutual fund or ETF, is determined by any number of factors, including the economy, monetary policy, market conditions, or issues affecting a particular security's asset class or industry sector. For individual stocks, fundamentals such as earnings, valuations and financial stability will also affect share prices. For bonds, factors such as short-term interest rates, inflation and credit ratings will influence their yields.

The advantage of commingled vehicles such as mutual funds and ETFs is that they offer the benefits of diversification, which may help to reduce the overall risk of a portfolio, as the decline in the price of any one security may be offset by the rise in price of another.

Myth ETFs Are Riskier Investments Than Managed Funds

Reality There is no significant investment research that proves that ETFs carry significantly higher risk than mutual funds. Because most ETFs are designed to replicate the performance of an associated index, their overall risk level should not be significantly higher or lower than that of the index itself. Investors should evaluate their level of comfort with the unique risk and volatility characteristics of a given index, industry sector or asset class of interest before investing in an associated ETF. Further, the risk and volatility level of any commingled investment vehicle, whether it is an ETF or a mutual fund, is determined by a number of factors, including:

- The performance characteristics of the fund's underlying holdings;
- The inherent volatility and risk of the markets or sectors in which the vehicles invests;
- The investment style the fund uses;
- In the case of actively managed funds, the manager's ability to pick individual securities or sectors.

Myth ETFs May Have Lower Expenses, but They Cost More to Own Because You Have to Pay a Brokerage Commission When You Trade Them

Reality It is true that investors pay commissions when they buy or sell shares of an ETF, as they do when they trade individual stocks. It is also true that frequent trading of ETFs could significantly increase commissions and other costs. However, the same thing can be said for trading individual stocks.

And while investors don't pay brokerage commissions when purchasing and redeeming mutual fund shares, certain share classes do carry either up-front sales loads or back-end redemption charges that compensate brokers for selling these funds. In addition, many funds charge ongoing fees to compensate brokers, record keepers, transfer agents and other entities for marketing and servicing costs. Indeed, depending on the amount invested, the commissions an investor may pay for trading shares of a particular ETF may actually be less than the sales charges and management fees they would be charged by investing the same amount in a mutual fund with a similar strategy.

Mutual funds may incur additional costs that may not be readily apparent to investors. For example, some mutual funds can raise their investment management fees if their managers outperform their benchmarks. And mutual funds with high turnover rates may declare higher capital gains distributions, which can increase an investor's tax burden depending on where the funds are domiciled, whereas most passively managed ETFs have lower turnover rates, which generally result in lower taxes where applicable.

It's important for investors to consider both immediate and future costs — commissions, sales charges, management fees, and tax implications — when evaluating the suitability of any kind of investment.

Myth ETFs Carry Unreasonable Bid/Ask Spreads

Reality The bid is the price at which a buyer is willing to purchase ETF shares, and the ask is the price at which a seller is willing to sell ETF shares. The difference between the bid and the ask is the spread, which indicates the overall cost of trading in any security (plus any applicable brokerage commission costs). Like anything sold in a public marketplace, the bid/ask spread for any exchange traded security, whether it's a stock or ETF, is governed largely by supply and demand, the availability of information about the securities and investors' reactions to geopolitical or market and economic events.

Larger and highly liquid ETFs tend to have tighter spreads than ETFs that invest in less liquid asset classes or are thinly traded. As trading volume in an ETF rises, competition reduces spreads and allows investors to buy and sell shares in a more cost-efficient manner. ETFs that trade in international securities often have wider spreads because many overseas markets are closed when these ETFs are trading, making it difficult for Hong Kong investors to access updated information on the securities in which the ETF invests.

Generally, bid/ask spreads are of less concern to long-term investors. However, those who are concerned about spreads may wish to use stop or limit orders when purchasing or selling shares of ETFs or any other security, particularly in periods of high market volatility.

Myth ETFs Are Only for Day Traders and Short-Term Investors

Reality ETFs are effective investment tools for all types of investors, from short-term traders to those investing for long-term financial goals such as retirement or their children's education. Their unique structure as commingled investment vehicles that can be bought and sold at market prices gives ETFs the flexibility to be used to execute a variety of investment strategies, without the added expenses of active management.

Myth ETFs Encourage Excessive Trading

Reality The broad universe of asset classes, investment styles and industry sectors represented by ETFs have made them attractive vehicles for executing strategies designed to capitalize on pricing efficiencies in a given market. However, investors were engaging in short-term trading long before ETFs were introduced to the market. While ETFs have become a tool that investors use to execute decisions, the average trading volume of ETFs represents only a fraction of all securities transactions on any given day in the market.

Myth Actively Managed Funds Seeks to Deliver Better Performance Over Passive ETFs

Reality If the last decade has proven anything about investing, it's that the only thing you can predict about the market is that it will be unpredictable. Any given asset class, investment style, active or passive vehicle may outperform any other during a given time frame. Yet, as all mutual fund and ETF investors are told time and time again, past performance is no guarantee of future results.

In any case, performance alone should not be the sole criteria for determining whether an actively managed or passively managed fund is an appropriate choice for you. Other factors should also be considered, such as:

Manager Discretion

While most passive ETFs limit investments to securities representing its associated index, an actively managed fund may have a wider degree of latitude to invest across asset classes, investment styles and sectors. This allows the fund to focus on delivering higher total returns, rather than mirroring index performance.

Alpha Generation

Through effective portfolio management and trading decisions, an active fund manager may be able to outperform a benchmark in rising markets or mitigate losses in a declining market more effectively than passively managed funds. Of course, it's also possible that an active manager's decisions may result in higher volatility or greater losses.

Costs

The price of active management is higher costs than its passive counterpart. Portfolio manager compensation and higher trading costs generally result in higher expense ratios for investors.

And, of course, the most important consideration when evaluating any investment option is whether it is a suitable choice, given your own investment goals, timeframe and risk tolerance.

Conclusion

Over the past 20 years, ETFs have grown to become an extremely popular choice for investors seeking a cost-effective option for executing both short and long term investment strategies. Understanding their unique characteristics is an important step toward determining whether ETFs can be an appropriate choice for your portfolio and the role they may play in helping you achieve your own investment objectives.

Talk to Your Financial Adviser or Broker

If exchange traded funds interest you, speak to your advisor or broker to determine if you could benefit from incorporating ETFs into your investment plans.

Your advisor can help you analyze your current investments, risk tolerance, tax situation and time horizon, and then recommend strategies to help you achieve your goals.

[1] The ETFs mentioned herein are offered in limited jurisdicitions only and may not be available for certain investors.

[2] S&P, MSCI, Barclays, Factset, as of 9/30/2015.

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