

9 Questions Every ETF Investor Should Ask Before Investing

1. What is an ETF?

An exchange-traded fund (ETF) is a pooled investment vehicle with shares that can be bought or sold throughout the day on a stock exchange at a market-determined price.

Pooled investment vehicle

Like a mutual fund, an ETF pools the assets of multiple investors and invests those assets according to its investment objective. Each share of an ETF represents an undivided interest in the underlying assets of the fund. This feature distinguishes ETFs from exchange-traded notes (ETNs), which do not own underlying assets, but rather represent a credit obligation of the issuer, which is typically a bank.

Most ETFs invest primarily in securities, and are regulated, like mutual funds, by the Monetary Authority of Singapore (MAS) under the Securities and Futures Act (SFA), Chapter 289 of Singapore. This regulatory framework imposes a number of significant investor protections. Some ETFs invest primarily in commodities or commodity derivatives; these ETFs have a different corporate and regulatory structure, with different tax consequences.

Bought or sold throughout the day at market-determined price

Unlike mutual funds, shares of which may only be purchased or sold at the fund's net asset value (NAV), which is calculated at the end of the trading day, ETFs may be bought or sold throughout the day on a stock exchange at a market-determined price.

ETFs are designed to trade at a price that approximates the market value of their underlying assets. To facilitate this, most ETFs publish detailed information about their portfolio holdings on a daily basis. Doing so enables investors to identify when a share of its ETF is over-valued or under-valued relative to its underlying assets and to transact accordingly. Additionally, certain large broker-dealers, known as "authorized participants," create and redeem shares directly with the ETF in large blocks, typically 50,000 to 100,000 shares, helping to keep the trading price of the ETF shares in line with the market value of their underlying assets.

2. What Kinds of ETFs are Available?

ETFs follow a wide range of strategies, including equities, fixed income securities, and blended strategies. Within these broad categories are a number of sub-categories, including geographic restrictions, capitalization ranges, industry sectors, and credit quality, to name a few. ETFs may be broadly diversified or narrowly focused. Some ETFs seek exposure to commodities. Many of these ETFs have a different corporate and regulatory structure, with different tax consequences.

1. What is an ETF?
2. What kinds of ETFs are available?
3. How do ETFs differ from other investment products like mutual funds, closed-end funds, and ETNs?
4. What should I know before investing in an ETF?
5. How do investors use ETFs?
6. What are the costs associated with investing in ETFs?
7. How do investors buy and sell ETFs?
8. How can an ETF be evaluated?
9. I read the following things about ETFs. Are they accurate?

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The vast majority of ETFs are index-based, i.e., they are designed to track the performance of a designated index. Some index-based ETFs are “geared” — that is, they seek to track the multiple or inverse (or multiple inverse) of an index. Other ETFs are actively managed, i.e., their investment adviser selects investments to meet a particular investment objective or policy, which is typically to outperform a selected benchmark.

3. How do ETFs Differ from Other Investment Products Like Mutual Funds, Closed-End Funds, and ETNs?

ETFs are often described as a hybrid between a mutual fund and a closed-end fund. Here is how they compare to these funds, as well as ETNs:

Mutual funds

Like mutual funds, ETFs hold a portfolio of assets, and each share represents an undivided interest in that pool of assets. Also like mutual funds, new shares of ETFs can be created or redeemed at any time. The vast majority of ETFs are regulated by the MAS under the SFA, in essentially the same way as mutual funds.

Unlike mutual funds (shares of which may only be purchased or sold at the fund’s net asset value [NAV], which is calculated at the end of the trading day), ETFs can be bought or sold throughout the day on a stock exchange at market-determined prices. To enable secondary market prices to approximate the market value of the ETF’s underlying assets, certain large broker-dealers, known as “authorized participants,” are permitted to create and redeem shares daily directly with the ETF, in large blocks, typically 50,000 to 100,000 shares. ETFs are also required to provide information about the composition of their portfolios daily, compared to required quarterly portfolio disclosures by mutual funds.

The levels and types of costs of ETFs, as well as tax implications, may be different than those of mutual funds.

Closed-end funds

Like closed-end funds, which are also pooled asset vehicles regulated by MAS under the SFA, ETFs are primarily traded on the secondary market, i.e., a stock exchange. While ETFs permit certain large broker-dealers, known as “authorized participants,” to create and redeem shares daily, closed-end funds do not. Rather, closed-end fund shares are typically issued only at initial — and sometimes secondary — public offerings, and redeemed when the fund liquidates; some closed-end funds also issue or redeem shares at specified “intervals.” As a result, while ETF shares typically trade on the secondary market at a price close to the market value of their underlying assets, the price of closed-end fund shares fluctuates, and is frequently different from the market value of their underlying assets.

Exchange-traded notes (ETNs)

ETNs are exchange-traded securities designed to provide investors with a return that corresponds to an index. Unlike ETFs, however, ETNs are unsecured debt instruments — they do not represent an interest in an underlying pool of assets, but rather a promise to pay a specific return (typically corresponding to the index or benchmark, minus a fee).

There are two primary implications of this difference. First, an ETN investor assumes a credit risk. If the issuer of the ETN goes bankrupt, the investor is in the same position as all other unsecured creditors of the issuer, and may lose some or all of his investment. By contrast, ETF assets are kept separate from the assets of their sponsors. If an ETF sponsor goes bankrupt, the fund will either continue to be managed by a different adviser, or will be liquidated, in which case the investor will receive cash representing the value of his share of the underlying assets.

Second, because it is simply a promise to pay a specified return, the return of an ETN will precisely correspond to its benchmark, less any management fee (barring the default of the issuer). By contrast, an ETF provides its investors with a share of the return of the pool of assets it maintains, which may or may not perfectly track its target index (i.e., may have a tracking difference).

4. What Should I know Before Investing in an ETF?

As with any financial product, an investor should carefully consider the objectives, risks, and costs associated with an investment in an ETF. This and other information is available in an ETF’s prospectus and its product highlight sheet, and on its website. You may also wish to consult a professional financial advisor. Following are some things to consider:

Investment objective

ETFs follow a wide range of investment strategies and objectives. In addition to the stated objective of an ETF, you should consider how the ETF sponsor is attempting to achieve that objective.

Index-based ETFs For an index-based ETF, you should understand the index the ETF seeks to track. While a number of ETFs may cover the same market segment, they may do so in different ways. For example, an index might have a few or a few thousand securities, and it may weight them equally, by market capitalization, by dividends, or by other mechanisms. You should also assess how the ETF tracks the index. It may invest in every security in the index, or it may invest in a representative sample of securities in the index. Some ETFs may also employ derivative instruments. The chosen approach may affect how well the ETF tracks the index (tracking difference), and may pose other risks.

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Actively managed ETFs Actively managed ETFs are managed to meet a particular investment objective or policy, which is typically to outperform a selected benchmark. As with an index-based ETF, an investor should understand the strategies the sponsor employs to achieve the fund's objective.

Risks

Like all pooled investment vehicles, ETFs are subject to risk. These risks are explained in the ETF's prospectus and its product highlight sheet. The principal risks are typically those associated with the ETF's investment objective, i.e., adverse developments in the securities or market segments in which the ETF invests, or related developments such as interest rate or currency fluctuations.

One risk of index-based strategies is tracking difference (the difference between the return of the ETF and the return of the index it tracks). Another risk for all ETFs is premium/discount volatility (i.e., changes in the difference between the market price of ETF shares and the market value of the underlying assets).

Costs

You should consider all of the costs associated with investing in an ETF. Any fees charged by the ETF sponsor, such as advisory and administrative fees, will be detailed in the fund's prospectus and its product highlight sheet. You may also pay fees such as brokerage commissions to trade ETFs, and/or account fees associated with receiving financial advice. Finally, there are some indirect costs that should be considered when investing in an ETF, including the bid/ask spread (i.e., the difference between the highest price a buyer is willing to pay for an ETF share (bid), and the lowest price a seller will accept to sell an ETF share (ask)), and any premium/discount volatility (i.e., the difference between the market price of ETF shares and the market value of the underlying assets).

An investor should also consider the metrics available to evaluate ETFs.

5. How do Investors Use ETFs?

Investors use ETFs in a wide variety of ways.

For example, individual investors may use ETFs to build a diversified investment portfolio for the long term, or use one or more ETFs to gain exposure to a certain asset class, for the long term or temporarily (e.g., to express a view on an impending market development).

Institutional investors and other traders may use ETFs in the same way. They may also use ETFs for shorter-term purposes, such as to obtain short-term exposure to an asset class or to hedge other investments in a portfolio. For example, because ETF shares can be sold easily for cash, an institutional investor such as a mutual fund or pension fund may invest in an ETF as a way to gain interim exposure to a particular market while gradually investing directly in that market.

ETFs are designed to permit this short term trading without impacting long-term investors. Because most ETF transactions take place on a stock exchange, they do not affect the fund and its shareholders directly. That is, those trades do not represent money going into or out of the fund itself, so the fund does not need to react, such as by buying securities to invest new money or selling them to meet redemptions. These transactions incur costs, which affect all shareholders. Further, even when authorized participants trade directly with the ETF to create or redeem shares, they frequently do so on an in-kind basis. In these transactions, the APs typically absorb the costs associated with transactions in the ETF's underlying securities, rather than the ETF itself. The in-kind redemption process may also limit capital gains distributions.

6. What are the Costs Associated with Investing in an ETF?

There are several costs associated with investing in an ETF. These include

Fund operating expenses

Like mutual funds, ETFs charge fees to cover operating expenses, such as advisory services, administration, and recordkeeping, among other things. These fees are detailed in the fund's prospectus and its product highlight sheet, expressed as a percentage of fund assets paid annually. This percentage is commonly called an "expense ratio." ETFs typically have lower total expense ratios than retail share classes of comparable mutual funds. However, investors must also consider the following costs associated with buying and selling ETFs that are not captured by the expense ratio, and that may not apply to mutual funds.

Brokerage commissions

Because ETFs are exchange-traded, investors must buy and sell ETFs through a broker, who is typically compensated for this service. Some brokers charge a flat fee for each transaction, while others may assess a fee based on the total assets in the investor's account.

Bid/ask spread

When buying or selling ETF shares on the secondary market, there is typically a difference between the highest price a buyer is willing to pay for an ETF share (the "bid"), and the lowest price a seller will accept to sell an ETF share (the "ask"). As a result, an investor will typically buy ETF shares for slightly over "market" price and sell for slightly less. Bid/ask spreads are typically lower for larger ETFs and those that are heavily traded and/or highly liquid.

Premium/discount volatility

Although ETF shares are designed to trade on the secondary market at a price that approximates the market value of their underlying assets, at times their market price may be higher (a "premium" to) or lower than (a "discount" to) the estimated market value of their underlying assets. Premiums and

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discounts are not direct costs to an investor, but changes in premiums and discounts (i.e., volatility) may affect the value of the investor's ETF shares, e.g., if an investor buys shares at a premium and sells at a discount.

7. How do Investors Buy and Sell ETFs?

Most investors buy and sell ETFs on the secondary market — such as a stock exchange — at a market-determined price. This means that they enter their trades through a brokerage account, and typically pay a brokerage commission, just like trading a stock.

When placing a trade order through a brokerage account, there are two basic options: market orders and limit orders. The selection will impact how (and possibly whether) an investor's order is executed.

Market order

A market order is an order to buy or sell a security at the best available price. Generally, this type of order will be executed immediately. Although placing a market order ensures that a trade will be executed, the price at which the order will be executed is not guaranteed to be an optimal price. It is important for investors to remember that the last-traded price is not necessarily the price at which a market order will be executed. In fast-moving markets, the price at which a market order will execute often deviates from the last-traded price or “real time” quote.

Limit order

A limit order is an order to buy or sell a security at a specific price or better. A buy limit order can only be executed at the limit price or lower, and a sell limit order can only be executed at the limit price or higher. A limit order is not guaranteed to execute. A limit order can only be filled if the security's market price reaches the limit price. While limit orders do not guarantee execution, they help ensure that an investor does not pay more (or receive less) than a pre-determined price for a security.

Certain large broker-dealers, known as “authorized participants,” create and redeem shares directly with the ETF in large blocks, typically 50,000 to 100,000 shares.

8. How Can an ETF be Evaluated?

There are a number of metrics that can be used to evaluate an ETF. Because investors use ETFs in a variety of ways, the relative importance of each of these metrics may vary by investor.

Performance

While past performance is not an indication of how an ETF may perform in the future, an investor may wish to evaluate an ETF's performance against its stated objective

or benchmark. For an index-based ETF, this is measured by the ETF's tracking difference. When evaluating an actively managed ETF, an investor might look at how the ETF has performed compared to its stated benchmark. An investor in an actively-managed fund might also wish to consider whether the ETF's portfolio managers have changed, i.e., whether the ETF's past performance is attributable to the current managers.

Tracking difference

Tracking difference is the extent to which the ETF's return deviates from the return of its benchmark index. Tracking difference can be influenced by a number of factors, such as how an ETF seeks to track the index (i.e., whether it invests in every security in the index or in a representative sample of securities in the index), the ETF's operating expenses, and how the manager handles index rebalancing and corporate actions. Tracking difference is sometimes called “tracking error,” but tracking error more precisely refers to the standard deviation of the differences between the performance of the fund and its benchmark.

Cost

There are a number of costs associated with investing in an ETF, including fees charged by the ETF sponsor, brokerage commissions, and/or account fees associated with receiving financial advice. An investor may also wish to consider indirect costs, including those stemming from the bid/ask spread and any premium/discount volatility.

Premiums/discounts

Although ETF shares are designed to trade on the secondary market at a price that approximates the market value of their underlying assets, at times their market price may be higher (a “premium” to) or lower than (a “discount” to) the estimated market value of their underlying assets.

Liquidity

Liquidity refers to how easily shares can be bought or sold without moving the market for those shares. Securities with high trading volumes are generally considered more liquid. ETF liquidity should be considered with respect to both the ETF shares and the underlying securities the ETF holds. Highly liquid ETFs and ETFs that have highly liquid underlying securities (even if the ETF shares do not have high trading volumes) typically have narrower bid/ask spreads than ETFs that trade less or hold less liquid securities.

Bid/ask spread

When buying or selling ETF shares on the secondary market, there is typically a difference between the highest price a buyer is willing to pay for an ETF share (the “bid”), and the lowest price a seller will accept to sell an ETF share (the “ask”). As a result, an investor will typically buy ETF shares for slightly over “market” price and sell for slightly less. Bid/ask spreads are typically lower for larger ETFs and those that are highly liquid.

9. I read the Following About ETFs. Are they Accurate?

ETFs are less expensive than mutual funds

Like mutual funds, ETFs charge fees to cover operating expenses, such as advisory services, administration, and recordkeeping, among other things. These fees are set out in the fund's prospectus and its product highlight sheet, expressed as a percentage of fund assets paid annually. This percentage is commonly called an "expense ratio." ETFs typically have lower total expense ratios than retail share classes of comparable mutual funds.

However, an investor should also consider other costs associated with ETFs, which may not apply to mutual funds, such as brokerage commissions. There are also indirect costs, including those stemming from the bid/ask spread and any premium/discount volatility.

Some ETFs are not suitable for buy-and-hold investors

ETFs are available in a wide range of strategies. Some ETFs are complex, may be more appropriate for sophisticated investment approaches, and may not be suitable for buy-and-hold investors — for example, those that use leveraged, inverse, volatility, and spread strategies. As with any financial product, an investor should understand the objectives and risks associated with an ETF before investing. Investors are encouraged to read the ETF's prospectus and its product highlight sheet for additional information on the fund's objectives and risks. Professional financial advisors can also help educate investors about the appropriate use of ETFs and other financial products.

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Passively managed funds invest by sampling the index, holding a range of securities that, in the aggregate, approximates the full Index in terms of key risk factors and other characteristics. This may cause the fund to experience tracking errors relative to performance of the index.

Actively managed funds do not seek to replicate the performance of a specified index. The Strategy/fund is actively managed and may underperform its benchmarks. An investment in the strategy/Fund is not appropriate for all investors and is not intended to be a complete investment program. Investing in the strategy/Fund involves risks, including the risk that investors may receive little or no return on the investment or that investors may lose part or even all of the investment. Diversification does not ensure a profit or guarantee against loss. There can be no assurance that a liquid market will be maintained for ETF shares. Frequent trading of ETF's could significantly increase commissions and other costs such that they may offset any savings from low fees or costs.

ETFs trade like stocks, are subject to investment risk, fluctuate in market value and may trade at prices above or below the ETFs net asset value. Brokerage commissions and ETF expenses will reduce returns.

Asset Allocation may be used in an effort to manage risk and enhance returns. It does not, however, guarantee a profit or protect against loss.

In general, ETFs can be expected to move up or down in value with the value of the applicable index. Although ETFs may be bought and sold on the exchange through any brokerage account, ETFs are not individually redeemable from the fund. Investors may acquire ETFs and tender them for redemption through the fund in creation unit aggregations only, please see the prospectus for more details.

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