First Ascent Asset Management

UNDERSTANDING EXCHANGE TRADED FUNDS (ETFS)

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What Are ETFs?

ETFs are professionally managed, diversified portfolios of stocks, bonds, or other assets that are traded on an exchange.

How Common Are ETFs?

The first ETF debuted in 1993. Today there are over 2,000 ETFs available in the US. At the end of 2019, there was over $4.4 trillion invested in ETFs.

Use of ETFs is growing at about 25% annually. Analysts at Bank of America estimate that ETFs will surpass $5 trillion in assets by the end of 2020 and $50 trillion by 2030.

Active vs. Passive

The ETF industry is dominated by index-tracking funds. At the end of 2019 there were 1,708 index-tracking ETFs and only 320 actively managed strategies. Of the $4.4 trillion invested in ETFs at the end of 2019, only about $99 billion was invested in actively managed ETFs.

Trading

ETF investors purchase and sell ETF shares through the secondary market on exchanges, much like they would purchase or sell a share of stock. ETF shares can be bought or sold at any time during the trading day.

Share prices vary throughout the day based mainly on the changing value of the ETF's underlying holdings. Two investors buying the same ETF at different times on the same day may pay different prices for their shares.

Unlike mutual fund investors who must wait for the price to be determined at the end of the day, ETF investors know within moments how much they paid when they bought shares and how much they received when they sold shares.

Transactions in ETF shares may involve the payment of a brokerage commission. However, many brokers now execute trades in ETFs without charging a commission.

All transactions in ETF shares involve a bid/ask spread. If you are selling ETF shares, you will receive the "bid" price for those shares. If you are purchasing ETF shares, you will pay the "ask" price for those shares. The difference is the bid/ask spread.

The bid/ask spread compensates the market maker who facilitates the transaction.

Low Cost

All professionally managed funds, including both mutual funds and ETFs, incur operating expenses. These costs are ultimately reflected in the internal expenses charged to investors in those funds.

ETFs have operating expenses that are generally lower than those of mutual funds. This is primarily because ETFs have fewer client servicing and recordkeeping obligations than mutual funds.

Thus, ETFs generally have lower internal expenses than mutual funds.

Transparency

There is greater transparency into the holdings of an ETF than into the holdings of a mutual fund. Most ETFs report their holdings daily. Most mutual funds, on the other hand, report their holdings on a quarterly basis.

Tax Efficiency

ETFs tend to be very tax-efficient compared to mutual funds.

Mutual funds are required to pass on their realized capital gains to their shareholders every year. So, mutual fund shareholders often pay taxes on capital gains distributions annually even though they continue to hold their shares.

Most ETFs, however, can avoid generating any capital gains throughout the year. This is because ETFs, unlike mutual funds, can—and frequently do—swap their holdings into and out of the fund on an in-kind basis rather than selling them and realizing a gain.

As a result, ETF shareholders usually only pay capital gains when they sell their shares.

Regulation

Most ETFs (98%) are structured as open-end investment companies, like mutual funds, and are subject to essentially the same regulation.

Other ETFs (2%)—primarily those investing in commodities, currencies, and futures—have different structures and are subject to different regulatory requirements.