Exchange Traded Funds

ETFs

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Exchange Traded Funds Definition

Exchange Traded Funds or ETFs for short are portfolios that contain various types of financial instruments that track the returns of an underlying asset such as indices, commodities, bonds and equities.

Exchange Traded Fund shares are traded like common shares in exchanges and their prices can change throughout the day depending on the trading activities, supply and demand.

These shares are tradable with various return multipliers of the return of the underlying asset, as the Exchange Traded Fund itself doesn’t try to outperform its corresponding asset but to replicate its performance.

Unlike Mutual Fund, Exchange Traded Funds offers higher liquidity and lower fees making them more attractive for individual investors.

Exchange Traded Funds Creation and Redemption

Exchange Traded Funds are created in a similar way like other types of funds also their shares are kept near the underlying asset’s net value through a process called creation and redemption.

ETFs are created by an authorized participant that may be a market maker or other large financial institution; it’s essentially an entity with a lot of buying power.

The authorized participant acquire the financial instruments that goes in to the Exchange Traded Fund portfolio then deliver them to the ETF provider, which will exchange them with a block of equally valued ETF shares.

These blocks are called creation units and usually formed in blocks of 50,000 shares.

This process can also work in reverse. Authorized Participant can remove ETF shares from the market by purchasing enough of them to form creation units and then deliver those creation units to the ETF provider. In exchange the Authorized Participant receives the same value in the underlying financial instruments of the ETF portfolio.

The price of the financial instruments in the Exchange Traded Fund portfolio won’t quite stay in sync with the value of underlying asset, because the ETFs shares price will fluctuate during the trading day, due to simple supply and demand.

The Authorized Participant can intervene to balance these differences between ETFs shares price and the value of underlying asset.

If the ETFs shares are overvalued the Authorized Participant might buy up the financial instruments that compose the ETF and then sell ETF shares on the open market, which will help in driving the ETFs share price back toward their fair value.

On the other hand ETFs shares are undervalued the Authorized Participant can form creation units by purchasing cheap ETFs shares and redeem them for the financial instruments that compose the ETF, which can be resold.

Buying up the undervalued ETFs shares will help in driving the ETFs share price back toward their fair value.

These arbitrage processes helps to keep the ETFs shares prices in line with the value of its underlying asset, while the Authorized Participant earns a basically risk-free arbitrage profit.

Exchange Traded Funds Benefits

Exchange Traded Funds are an easy, fast and cost efficient way that allows investors to own a slice of the portfolio.

Moreover ETFs shares can be traded on margin and held either short or long.

Comparing to Mutual Funds, Exchange Traded Funds offers higher liquidity, less fees, more transparent and tax-efficient.

Some of the advantages of ETFs are summarized as follows:

1. Cost

   As the ETFs holders does not pay management fees their expense ratio are lower than the Mutual Funds

2. Liquidity

   ETFs can be sold throughout the day over the stock exchanges thus it’s easier to find a willing buyer or seller.

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3. Short Selling

   Benefiting from the practice of borrowing shares and selling them in the expectation that share prices will fall is available for industries, countries, and entire markets using ETFs.

4. Tax-efficiency

   Tax-efficiency is one of the most important advantages that made ETFs investment popular.

   ETFs are more tax-efficient than the other types of funds, as they have two main tax advantages regarding their capital gains and dividend taxes.

   Firstly even though ETFs are occasionally actively managed when rebalancing or replacing its portfolios under laying assets, these transactions are less frequent than other funds transactions thus ETFs incurs less capital gains tax.

   Moreover when an authorized participant redeems an ETF creation blocks the ETF provider does not give the authorized participant cash but the underlying assets in the ETF portfolio thus there will be no capital gains to be taxed.

   Additionally the ETF provider could give the authorized participant the most tax-efficient asset in the ETF portfolio when redeeming the ETF creation block.

   Furthermore ETF's capital gains taxes are delayed until the entire ETF is sold, not while holding some ETF share, hence investors can hold their cash now and pay taxes latter, after all cash equals more now than in the future.

   Secondly there are two kinds of dividend taxes in the US that equity ETFs incurs qualified dividends and unqualified dividends.

   ETF dividends to be taxed as qualified, the equity in the fund paying the dividend must be owned for more than 60 days during the 121-day period that begins 60 days before the ex-dividend date and it must be paid by a U.S. or qualified foreign corporation.

   Unqualified dividends which do not meet the qualifications discussed before.

   As the ETF portfolio underlying assets are held for longer periods, their dividends are recognized as qualified, thus they pay less taxes as the qualified dividend taxes are income rate depending.

On the other hand ETFs have some disadvantages like the shares are traded in the open market as opposed to being redeemed directly from the fund company, at which the share price can be higher or lower than the value of the ETFs portfolio.

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Exchange Traded Funds Types

ETFs are flexible financial instrument offering huge investment opportunities, which can benefit investors in various market situations and scenarios.

Here are the most common types of Exchange Traded Funds:

1. Long ETFs

   Are the most traded type of ETFs and as the name indicated these ETFs holds long positions on the underlying asset; however as the underlying asset price rise the ETF shares will rise by the same amount less any expenses and trading costs.

2. Inverse ETFs (Short ETFs)

   They are the opposite of the long ETFs thus if the underlying asset price decline the ETFs will gain as they are in opposite directions.

3. Gold ETFs

   Are ETFs that invest in gold stock or hold claims on actual gold bullion by custodian, or they focus on precious metals more generally.

4. Industry ETFs

   The Share of the Industry ETFs represents an entire industry segment.

5. Country ETFs

   Are Similar to Industry ETFs however they represent a cross-section of industry in a given country.

6. Leveraged ETFs

   Are traded through the use of borrowed money to magnify the ETFs portfolio return however it also magnifies the risks as well.

7. Currency and Bond ETFs

   As the name indicated these ETFs have either currencies or bonds in their portfolios.

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Most Traded and Largest Exchange Traded Funds

The following table lists the top ten largest ETFs by assets under management (AUM):

Symbol	Name	AUM
SPY	SPDR S&P 500 ETF	$189,858,150.40
IVV	iShares Core S&P 500 ETF	$78,432,160.00
VTI	Vanguard Total Stock Market ETF	$63,779,328.00
EFA	iShares MSCI EAFE ETF	$59,308,691.20
VOO	Vanguard S&P 500 ETF	$50,666,361.60
VWO	Vanguard FTSE Emerging Markets ETF	$42,758,448.00
AGG	iShares Core U.S. Aggregate Bond ETF	$41,042,675.20
GLD	SPDR Gold Shares ETF	$39,804,809.60
QQQ	PowerShares QQQ ETF	$39,337,344.00
VEA	Vanguard FTSE Developed Markets ETF	$36,086,796.80

Meanwhile the below table lists the top ten most traded ETFs by trading Volume:

Symbol	Name	Volume
SPY	SPDR S&P 500 ETF	93,964,734
GDX	VanEck Vectors Gold Miners ETF	75,737,008
EEM	iShares MSCI Emerging Markets ETF	75,165,469
XLF	Financial Select Sector SPDR Fund	53,017,176
EWJ	iShares MSCI Japan ETF	34,213,754
USO	United States Oil Fund	30,614,086
XIV	VelocityShares Daily Inverse VIX Short-Term ETN	27,856,602
VXX	iPath® S&P 500 VIX Short-Term Futures ETN	27,542,250
IWM	iShares Russell 2000 ETF	25,806,328
UVXY	ProShares Ultra VIX Short-Term Futures ETF	25,232,617

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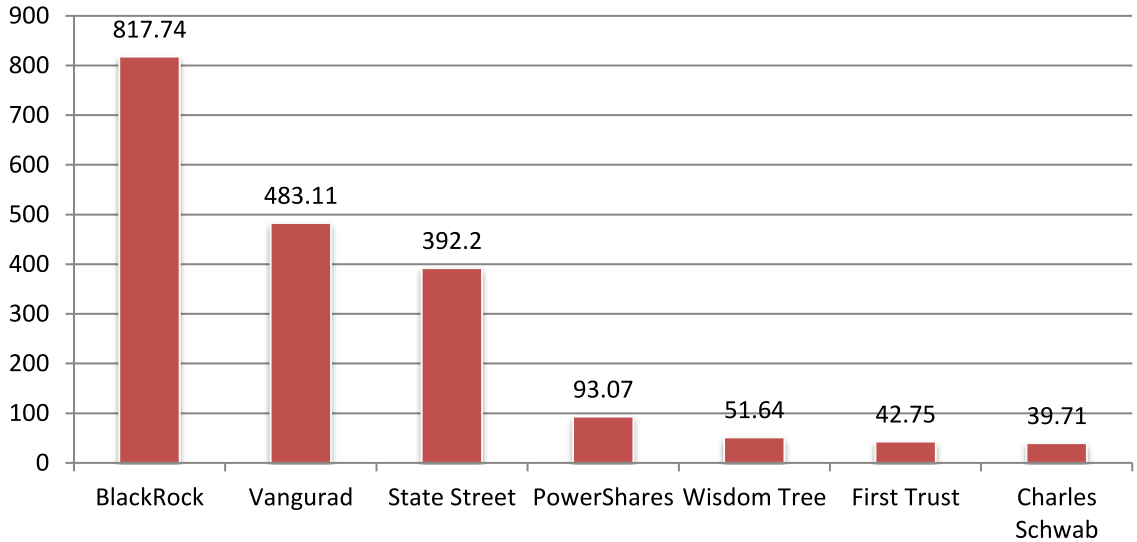
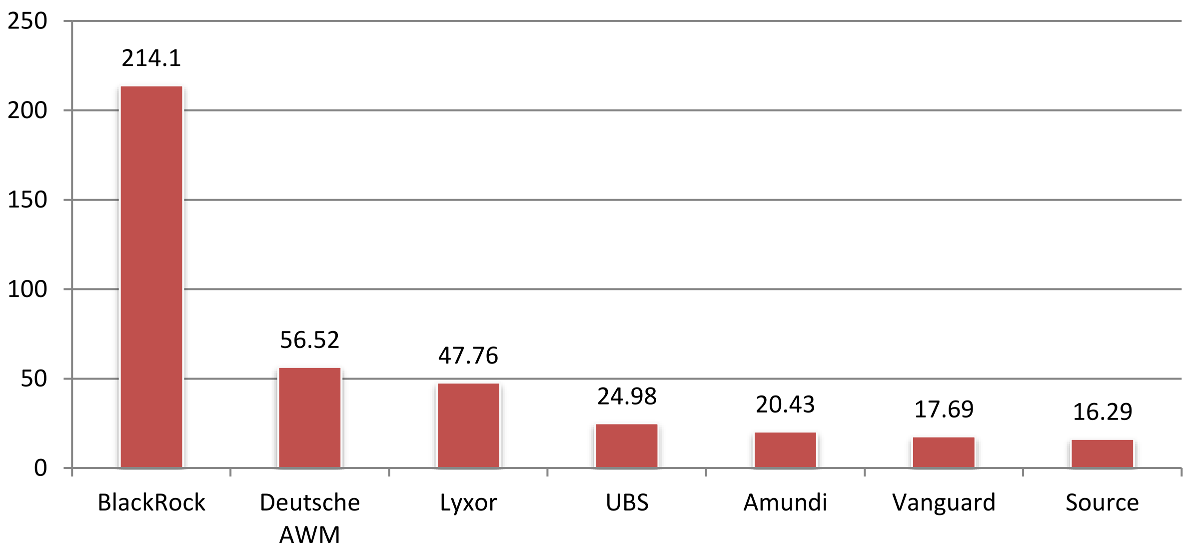
Exchange Traded Funds largest Providers

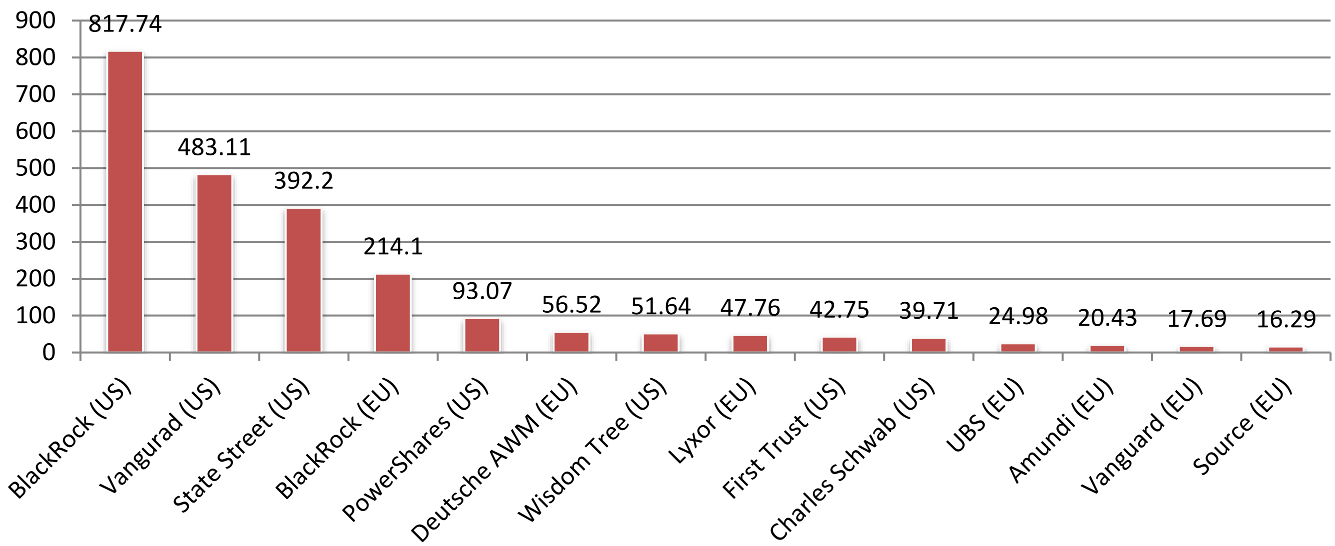
The following chart shows the largest ETFs Providers in the US market:



Moreover the below chart lists the largest ETFs Providers in the European market:



After merging the pervious data it is clear to say that the number of ETFs issued in the US market significantly supersedes the amount of ETFs issued in the European market, thus the following chart clarifies the differences in the amount of the number of ETFs issued in both regions.



The Main Differences between ETFs and Mutual Funds

Despite that ETFs and Mutual Funds have various similarities between them, they have some key differences as well.

ETFs has no management fees and they incurs less fees as they face less transaction comparing to mutual funds, moreover ETFs pays less taxes as due their tax advantages as we discussed before.

ETFs shares are traded throughout the exchange similar to any other type of shares, on the other hand Mutual Funds are only purchased or redeemed directly from the fund itself.

Additionally ETFs tracks its underlying assets performance, however Mutual Funds typically try to beat the market.

Exchange Traded Funds Reporting

Even though that ETFs have various types and structures, all ETFs must comply with the disclosure-based provisions of the Securities Act of 1933 (1933 Act) and the Securities Exchange Act of 1934 (1934 Act) and associated Securities and Exchange Commission (SEC) rules.

These acts require all issuers of securities to disclose material information via prospectuses and annual reports to help investors make informed investment decisions.

Moreover ETFs organized as investment companies must also satisfy the substantive regulations and disclosure requirements of the Investment Company Act of 1940 (1940 Act) and associated SEC rules.

The 1940 Act imposes a host of investor protections—including restrictions on affiliated transactions, limitations on leverage, the independence of boards, and the segregated custody of fund assets—making ETFs subject to the 1940 Act among the most stringently regulated investment products available in the United States.

ETFs structured as open-end investment companies and unit investment trusts (UITs) are regulated by the 1940 Act.

On the other hand ETF structures that mainly accommodate alternative investments restricted in a 1940 Act vehicle—grantor trusts, partnerships, and exchange-traded notes (ETNs)—are not regulated under the 1940 Act and may not provide its additional protections.

Conclusion

Exchange Traded Funds or ETFs for short provides great investment opportunities due their vast range of investable fields such as equities, currencies, indices, commodities and even entire industries.

Moreover these investment opportunities are expanded even more by availability of short selling and Leveraged positions, as well as their tax-efficiency and liquidity.

And as we discussed before the ETFs tax-efficiency is one of the main reasons that made ETFs a popular investment, as investors can benefit from their delayed or reduced tax payments.

The SPDR S&P 500 ETF (SPY) is the markets dominate ETF under both trading volume and the amount of assets under management.

Furthermore the cost, tax-efficiency and liquidity advantages of ETFs trading are attractive for individual and small investors, in addition to the risk free returns gained by the arbitrage process while the balancing process of the ETFs shares price and the underlying assets value.

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