

## **Making ETFs Work For You**

By Dan Greenshields, CFA

The last two years in the global financial markets can make any investor wince; the huge swings have left many investors shaking. As we know, too many new and experienced investors put all their chips into one or two different stocks, crossed their fingers, and hoped for the best. This combined with one of the worst market downturns in decades decimated a significant percentage of their retirement savings and investment accounts of everyday Americans.

The recent market rollercoaster has bolstered the case for finding investments that are lower-cost and diverse. Enter Exchange-Traded Funds (ETFs). Even if you do not have a portfolio as big as Warren Buffet's, you can have a similar strategy by placing added emphasis on ETFs in your portfolio. Those who have a diversified ETF investment strategy may benefit from reduced risk and volatility.

### **What is an ETF?**

ETFs are essentially a basket of stocks lumped into one investment that trades on exchanges around the world. The sub segment of the industry began in 1993 with State Street issuing the Spider, an Index fund linked to the S&P 500. There are now over 300 indexed ETF funds in the U.S. focused to everything from Gold, Real Estate and Treasury Bonds to Bio-Tech. Most ETFs have the same diversification benefits as mutual funds but, with lower management costs driven by their indexing approach.

### **How Do ETFs Work?**

An ETF is a security registered with the SEC for trading on U.S. exchanges like the NYSE. ETF prospectuses describe in detail what and how the investment strategy will be executed. However, ETFs have several key features which distinguish them from their mutual fund and closed end fund cousins. Indexed ETFs are not actively managed. The manager is just balancing the portfolio and participating in the underlying index, commodity or industry where the ETF is invested. ETFs trade on an exchange and the price fluctuates throughout the trading day unlike mutual funds whose value is based on one calculated price ("NAV" = net asset value) at the end of the day.

### **Making ETFs Work for You**

ETFs have become popular among investors because of their convenience, mitigation of risk, liquidity and affordability.

- **Convenience** – Most ETFs are designed to track one industry or region of the globe such as "real estate", "China Region", "technology", or "health & biotech". Once you've identified an industry you're interested in, an ETF is a convenient way to view and track that industry's performance over time.
- **Mitigate risk** – An ETF is comprised of a collection of individual securities. As a result, securities in an ETF that perform poorly may be balanced-out by ones that perform well. This can work to an investor's advantage by balancing out some risk. Though you will still have the general market risk of the industry or category of assets the index is tracking.
- **Liquidity** – **Unlike mutual funds**, ETFs trade throughout the day—like a stock. This can make them more convenient to buy or sell than other investment vehicles that are only processed at the end of the day.
- **Affordable** – Since ETFs are composed of a collection of individual securities, they can be an affordable way to buy many securities at once without having to pay a large amount in commissions. For example, trading the S&P 500 ETF is an affordable way to buy shares in all 500 companies represented in the S&P 500 index without having to pay a high cost for each individual stock.

### **Selecting an appropriate ETF?**

To help select the appropriate ETF(s) for your needs, consider taking these following few steps:

1. Identify the industry or region of the globe that you want to invest in.
2. Find a list of ETFs that match your interest and investment style.
3. Obtain a copy of the fund's prospectus, which typically can be found online.
4. Review the prospectus carefully before investing.
5. Lastly, consider the ETFs' investment objectives, risks, charges and expenses prior to making your decision.

Buying an ETF allows you all the benefits of diversification and liquidity without the cost or hassle of following dozens of individual stocks. By quickly and inexpensively buying into an asset class with one transaction, ETFs can be a part of any prudent investor's portfolio.

*Dan Greenshields, CFA is President and CEO of ShareBuilder Corporation*