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VIDEO

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Understanding ETFs

ICI Explains

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Exchange-traded funds, or ETFs, offer access to a variety of investments and investment strategies. Though ETFs have several similarities to mutual funds, there are some key differences between the two types of investment vehicles. Shelly Antoniewicz, senior director of industry and financial analysis, explains the basics of ETFs in this brief overview.

About Shelly

This video is narrated by Shelly Antoniewicz, senior director of industry and financial analysis at ICI, where she conducts research on the structure and trends of the US and global ETF, mutual fund, and closed-end fund industries and on the equity and bond markets in the United States and globally. She earned a BA in management science from the University of California, San Diego, and an MS and PhD in economics from the University of Wisconsin–Madison.

Transcript

Hi. I'm Shelly Antoniewicz, a senior economist at ICI, and today we're going to talk about exchange-traded funds, or ETFs. Though you may not be familiar with what an exchange-traded fund is, you probably know what a mutual fund is. So in this segment, we'll show you how ETFs are similar to mutual funds—and how they're different.

Let's start with how an ETF is similar to a mutual fund. Both ETFs and mutual funds are made up of a "pool" of assets—the pool can have stocks, bonds, and other types of assets in it. How do you get to be an investor in this pool? When you buy shares of the ETF or mutual fund, you then have a claim on the pool of assets held by the fund.

Like mutual funds, ETFs offer access to a variety of investments and investment strategies. You can buy funds that invest in domestic securities—such as domestic stocks, bonds, or both—or you can invest in international stocks and bonds. You also can buy mutual funds and ETFs that invest in different types of commodities.

Besides access, both mutual funds and ETFs have what's called an expense ratio—the fee that is paid to the fund sponsor for managing that fund. Thanks to competition and other factors, fees for both ETFs and mutual funds have been falling for years.

You may hear that ETFs are *always* cheaper than mutual funds, but that's actually not true. A lot of ETFs are index-based, meaning that they seek to track the return on a specific market index or benchmark. Because these types of funds generally are cheaper to manage, they have relatively low expense ratios. But what's often forgotten is that this is also true for mutual funds that follow an index. Index mutual funds generally have low fees, and some even have lower fees than comparable ETFs.

Let's talk about pricing. ETFs and mutual funds both post a daily net asset value, or NAV, at 4:00 p.m. (ET) What is this? At the end of every trading day, each mutual fund and ETF values all of the securities in its pool and then calculates the amount that each share of the fund is worth.

This is where ETFs and mutual funds start to differ. If you're buying a mutual fund, you buy it at one price: its upcoming 4:00 p.m. NAV. You can submit the order at any time during the trading day, but no matter when you order, the price you will pay is the net asset value that the fund posts at 4:00 p.m. ETFs are different; ETFs trade on a stock exchange, and their prices fluctuate all through the trading day. The price you pay for the ETF may be greater than, less than, or equal to the net asset value posted by the ETF at 4:00 p.m.

What makes ETF prices move around on the exchange? Two things do: first, it's the value of the pool, and second, the demand and supply of the ETF itself. Let's look at the first component—the value of the pool. Remember that ETFs are made up of a pool of stocks, bonds, or other assets that also are trading during the day. So the price of an ETF at, say, 10:00 a.m. should be a combination—or, the weighted average—of the prices of the securities in that ETF's pool at 10:00 a.m. When the prices of the underlying securities move around, the ETF's price should move as well.

The price of the ETF also is determined by supply and demand for the ETF itself at that time on the exchange. So if the demand for the ETF is really high at 10:00 a.m., that will increase the ETF's price on the exchange, potentially above the value indicated by the 10:00 a.m. prices of the securities in the ETF's pool. The reverse can happen as well, meaning that the ETF's price can fall below the value indicated by the securities in the ETF's pool.

In another video, we'll discuss what's known as the arbitrage mechanism, and how it helps to keep the ETF's price aligned with the underlying value of the ETF's pool all during the trading day, meaning that when you buy or sell an ETF, its price on the exchange is generally going to be pretty close to the value of its underlying assets.

How else is an ETF different than a mutual fund? The transaction process. Because ETFs trade on a stock exchange, if you want to buy and sell ETFs, you need a brokerage account. That's the only way you can access the stock exchange to buy and sell ETFs. Mutual funds, on the other hand, can be purchased from a broker, directly from a fund advisor, or directly from the company or some other channel.

There's one more thing to keep in mind when buying and selling ETFs: just as with stocks, you have to trade smart. Remember, the price of the ETF is also affected by the supply and demand for that ETF. So to help yourself get the best price available for the ETF you're buying or selling, you'll need to understand how the type of order you use and the time of day you trade matters. We'll cover this topic more in another video.

I hope you found this brief overview of exchange-traded funds helpful. For more information and resources, please visit ICI’s ETF Resource Center on our website at http://www.ici.org/etf.

Additional Resources

- *Investment Company Fact Book*: What Is an ETF?
- Understanding Exchange-Traded Funds: How ETFs Work
- Frequently Asked Questions About ETF Basics and Structure
