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## ETFs (Exchange-Traded Funds) [Fool.com: ETF Center]

<http://www.fool.com/etf/etf.htm>

The "It" equity -- the exchange-traded mutual fund -- is no spring chicken. It's been around since the early 1990s. But ETFs are still turning heads. It's no wonder: The combination of index investing with the handiness --- and lower costs -- of individual stock ownership is irresistible. Are ETFs a good match for your portfolio? Read on...

### **0:60 Consult your investing dictionary.**

What exactly is an exchange-traded fund (ETF)? "Exchange-traded" refers to shares that trade all day long on the major stock market exchanges (just like regular stocks, although ETFs are found mainly on the American Stock Exchange). "Funds" are investing vehicles that hold dozens, hundreds, or even thousands of companies under one umbrella unified by a particular investing theme (such as companies that comprise the Dow or ones whose main business is in the biotech industry). Like any other publicly traded company, ETFs have ticker symbols (snappy ones, in fact, like Cubes, Spiders, and Diamonds). But instead of typing "MSFT" to buy Microsoft, for example, you enter "DIA" for the Dow Jones Industrial Trust, or "Diamond" ETF. Do you need diamonds in your portfolio?

### **0:54 Poke holes in your portfolio.**

Do you crave exposure to foreign indexes? Are your holdings a little heavy in large American companies? Do you think biotechnology is a boom industry, but aren't comfortable committing money to one particular company? There are ETFs to represent virtually any segment of the market - - both here and abroad -- nearly any way you slice it. There are ones tracking everything from bonds, REITs, and the utility sector to the pedestrian Fool favorite S&P 500. If that sounds a lot like the index mutual fund market's offerings, it is. For some investors, though, ETFs are a better fit for their investment dollars.

### **0:47 Get a little Zen.**

Time for some soul-searching. Don't worry -- not the touchy-feely kind. Are you a "feet first" kind of investor, or do you prefer to build your portfolio slowly? If you'd like to add an indexing element to your portfolio and are prepared to invest a lump sum, ETFs provide some flexibility you might find useful. Like regular stocks, they can be bought or sold anytime the market is open via your brokerage account. (Traditional index funds, on the other hand, can only be redeemed at the closing price of each day.)

If you plan to dollar-cost average (adding small, systematic amounts to build a portfolio), ETFs aren't ideal. They don't offer direct investment programs, so dollar-cost averaging would rack up trading costs that far outweigh any cost benefit over a traditional index fund. For you, a more efficient route would be a [no-load, low-expense index fund](#).

The mutual fund-ETF face-off isn't over quite yet, Grasshopper. Before you click "buy"...

### **0:34 Check out the competition.**

They may track the same stocks and offer easy diversification -- but subtle [differences between index funds and exchange-traded funds](#) can affect your long-term returns:

- **Taxes:** The big buzz about ETFs is their tax efficiency. The big "tax event" for ETF shareholders happens when you sell your shares, hopefully at a profit, after which you'll pay

capital gains taxes.

- **Expense ratios:** By construction, ETF investors have less exposure to capital gains taxes than mutual fund shareholders. That's because fund managers frequently buy and sell the fund's holdings -- and ask investors to pick up the tab. ETFs occasionally shift shares, too, although much less than most mutual funds. Annual expenses for ETFs range between 0.1% and 0.65% and are deducted from dividends. Index mutual funds charge anywhere from 0.1% to more than 3%.
- **Minimum investment requirement:** For investors with limited funds (say, less than \$1,000) who want to get started in the stock market, ETFs offer a cheap entrée. Through your discount brokerage account, you can buy one single measly share if you choose. In comparison, many index mutual funds have high initial balance requirements. (Those with lower requirements often charge higher fees.)
- **Ease of use:** Here's the double-edged sword of ETF investing. They are easy to buy -- you simply need a discount brokerage account (and that's [easy to get -- and cheap](#)). Consequently, they're easy to trade. And trade and trade and trade.

Don't be blinded by love based on low expense ratios and minimum investment requirements. There's still a price to pay to invest in ETFs -- mainly brokerage fees. And there's the rub...

### **0:19 Keep fees in check.**

As a stock, ETFs can be optioned, shorted, hedged, and bundled. We don't like the idea of investors trading in and out of ETFs repeatedly, or going on margin to the hilt to buy them, any more than we do any other stocks. Like traditional index funds, ETFs are best used as a long-term investment tool. The best investing strategies for most investors are the simplest ones -- filling asset allocation gaps and replacing higher-fee mutual funds.

If you want to get fancier than that, ETFs can accommodate more advanced investing tactics ([we go into in more detail here](#)). But tread lightly: Don't rack up trading commissions or capital gains taxes by actively trading.

### **0:08 Do a background check.**

And finally, as with any investment, make sure you get what you're paying for: That means [scrutinizing an ETF's holdings](#) as you would those of any mutual fund before you buy. It's not only individual investors enamored with this newfangled investing vehicle -- the industry's keen on them, too, and getting a little loosey-goosey with labels. So make sure the ETF label matches the underlying securities you want to buy before heading off into the sunset, hand in hand.

### **Got another minute?**

- [How ETFs Became the "It" Equity](#): Exchange-traded funds have attracted trillions of investing dollars. Here's how they snuck onto the scene and why the fund world is on notice.
- [Mutual Funds vs. ETFs](#): In a side-by-side taste test, which comes out ahead? It depends on who's doing the math.
- [Investing Strategies](#): They're nimble and can accommodate an array of investing techniques. But the best strategy is probably the simplest.
- [Potential Pitfalls](#): Don't be tricked into buying an ETF impostor. Here's how to avoid this and other potential trip wires.

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