Important Facts on Exchange-Traded Funds

An Overview of ETFs' Structure and Risks

By Baird's Private Wealth Management Research

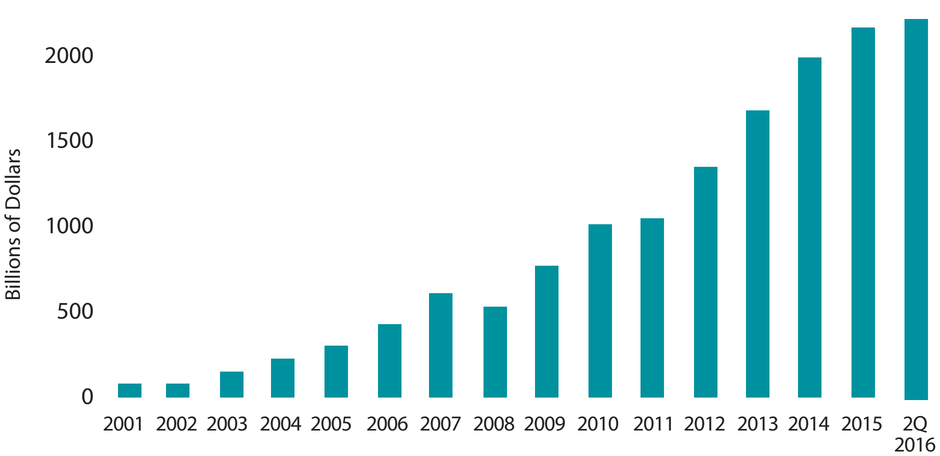
Introduction

An exchange-traded fund is an investment company whose shares are traded intraday on a stock exchange at market-determined prices. ETFs are typically open-ended, index-based funds, but active ETFs are gaining in popularity. ETFs provide exposure to a diverse set of financial instruments, financial benchmarks or investment strategies across a wide range of asset classes.

GRAPH 1:

Total Net Assets in ETFs

Billions of Dollars, Year End 2001 – 2Q 2016



Source: Investment Company Institute Fact Book 2015 and ETFGI.com

ETFs have been in existence for more than 20 years. Through the 1990s, these investments gained moderate traction, though they were mostly confined to tracking broad market indices. In the 2000s, the exchange-traded fund industry witnessed a proliferation of both the number of available ETFs and ETF providers. According to ETFGI, ETF assets under management have grown from $83 billion in 2001 to $2.256 trillion in the United States through the second quarter of 2016 (see Graph 1). Furthermore, through June of 2016, more than 1,900 exchange-traded products are listed on U.S. exchanges.

Both institutional investors, as well as retail investors, have driven the increased demand for ETFs . Institutional investors have used the ETF vehicle as a convenient way to invest in – or hedge against – market movements. An increased awareness of the vehicle's investment benefits by retail investors and their financial advisers also has driven demand. According to the Investment Company Institute, ETFs accounted for approximately 12% of total assets managed by U.S. investment companies as of the start of 2016.

How ETFs Can Benefit Investors

Liquidity. ETFs are traded intraday on a stock exchange without minimums, allowing investors to trade a basket of securities in the same way they would an individual stock. Shares of an ETF can be purchased through on-screen liquidity or, if an order is greater than the available shares, through the creation of new shares by an authorized participant. Additionally, because ETFs trade on the exchange, investors have the ability to place limit orders, buy on margin or short sell ETFs as they could individual stocks.

Transparency. ETF sponsors publish the fund's holdings on a daily basis. This not only allows authorized participants to transact in the market, but it also allows investors to have complete knowledge of the underlying holdings. Knowledge of the underlying portfolio helps with portfolio positioning, as well as risk management.

Cost. ETFs tend to have relatively lower expense ratios vs. other types of investment vehicles for a few reasons. First, most ETFs do not have to cover the expense of teams of highly paid portfolio managers and analysts because they are passively managed to track an index. Those that are actively managed tend to have higher relative fees. Second, trading costs occur outside of the fund: Through primary and secondary liquidity, costs to buy and sell are expenses to the purchaser or seller, not the fund itself. Also, ETF expense ratios exclude fees that would be required to trade the securities within a managed account.

Tax Efficiency. Because they use in-kind transactions, which do not have the same tax consequences as cash purchases or sales, ETFs have an advantage in limiting capital gains distributed at the fund level. Additionally, ETFs traditionally have lower-turnover portfolios, which can be more tax-efficient from a capital gains distribution standpoint.

Note, though, that investors in ETFs will have to pay taxes on gains realized in the fund or on dividends. The tax efficiency comes from limiting unrealized capital gains distributions to the fund holders by using in-kind transactions and lower turnover. ETFs that use cash redemptions or have higher turnover would have a greater likelihood of distributing unrealized capital gains. Be sure to consult a tax advisor if you have questions regarding ETF taxation.

The Key to the ETF Structure: The Creation/Redemption Mechanism

A unique feature of ETFs is the ability to offer both *primary* liquidity, with issuance through the fund (similar to mutual funds), and *secondary* liquidity, as shares can be bought or sold through exchanges (similar to individual stocks or closed-end funds). The primary liquidity for ETFs occurs through the creation/redemption mechanism. (See Figure 1.)

Unlike mutual funds, ETFs can use authorized participants to act as an intermediary between the fund and the capital markets. APs contract with the fund and arbitrage out premiums or discounts that occur between the fund and the underlying net asset value. Because the ETF discloses the underlying holdings on a daily basis, the AP can track the NAV of the fund throughout the day. **The AP has the ability to create shares if an increase in demand causes the fund to trade at a premium, or, likewise, to redeem shares if excess supply causes the fund to trade at a discount.** While ETFs trade on an exchange like closed-end funds, the creation/redemption mechanism in ETFs can limit premiums or discounts to NAV that occur in the closed-end fund structure.

The creation/redemption process primarily uses **in-kind transactions**. This means that the fund itself is not transacting in cash, but uses the AP as a conduit to purchase or sell shares. The AP's participation allows the costs of creating or redeeming shares to be borne by the transacting shareholders instead of the fund as a whole.

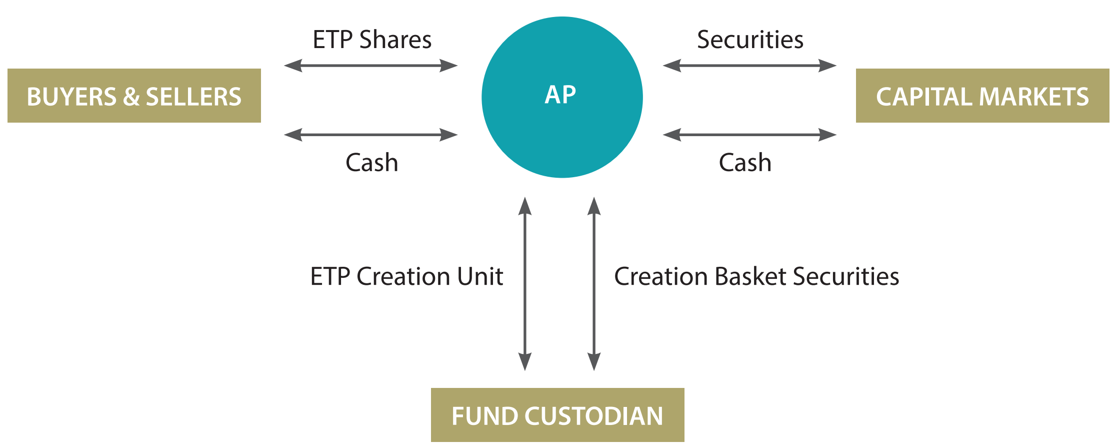
Understanding Investment Risks

As the industry has expanded, ETFs are no longer simply instruments that track the performance of a broad stock

MORE ABOUT THE AUTHORIZED PARTICIPANT:

- Institutional investors
- Also known as market makers
- Contract with the exchange-traded product issuer
- Motivated by the ability to make a spread
- Creation/redemption units in 25,000- or 50,000-share increments

FIGURE 1:



index. Most ETFs are structured as open-end investment companies or unit investment trusts. Exchange-traded products (ETPs) are a more sophisticated option for those looking to invest in commodities, currencies, futures or other investment products. The structures, including unsecured debt, grantor trusts, partnerships and commodity pools, add risks in taxation and regulations.

In 2008, the SEC agreed to allow fully transparent, actively managed ETFs – so long that they meet certain requirements. These ETFs have to disclose holdings and weightings publicly but are able to deviate holdings from an underlying index, providing an additional investment vehicle to portfolio managers and their investors. As ETFs' structure and holdings increase in complexity, so does the knowledge required to invest in the securities.

The set of the investment considerations must also evolve. ETPs have increased the investment set for retail investors, allowing access to commodity futures, physical commodities, currencies, MLPs, international stock and bond markets, and less liquid areas of the bond market. These investments may have liquidity and/or tax constraints, which may limit investment benefits. They also have investment-specific risks for the asset class. Investors should consider the risks of the ETP structure, as well as the risks in the underlying holdings, when evaluating an investment.

While investors would expect ETFs to trade near NAV, there are instances when they may trade at a premium or discount, which present an added level of risk. Most often, premiums or discounts occur because of a lack of liquidity in the underlying investments (which are used to determine NAV) when the ETF is trading. This may occur for international stocks, when the local stock market is closed.

Conclusion

ETFs have gained in popularity over the past 20 years due to their liquidity, transparency, low cost and tax efficiency, which differentiates them from mutual funds. As the popularity of ETFs has increased, so have the investment set of products and their complexity. If you are interested in implementing ETFs into your portfolio, talk to your local Baird Financial Advisor or visit rwbaird.com.

Investors should consider the investment objectives, risks, charges and expenses of the fund carefully before investing. This and other information can be found in the prospectus or summary prospectus. A prospectus or summary prospectus may be obtained from your financial advisor or the fund website and should be read carefully before investing.

Past performance is not indicative of future results and diversification does not ensure a profit or protect against loss. All investments carry some level of risk, including loss of principal. An investment cannot be made directly in an index. Investments in international securities include exposure to risks including currency fluctuations, foreign taxes and regulations, and the potential for illiquid markets and political stability. This is not intended to provide legal or tax advice. Please consult your legal or tax professional for specific information.