

What is an Exchange Traded Fund (ETF)?



Exchange Traded Funds combine features and potential benefits of both common stocks and mutual funds. The combination of these and other features has attracted growth within the investment in recent years.

An Exchange Traded Fund (ETF) is an investment vehicle that holds a basket of securities and tracks an index or group of assets yet trades on an exchange, such as the New York Stock Exchange, like a common stock. ETFs are similar to a mutual fund in that each ETF share represents a partial ownership in a portfolio. Thus, ETFs combine features and potential benefits of both common stocks and mutual funds. The combination of these and other features has attracted growth within the investment in recent years.

The majority of ETFs are created to track a particular index, market capitalization, or sector of the economy. Among the largest and most popular are ETFs tracking broad indexes such as the S&P 500, Dow Jones Industrial Average, and the MSCI EAFE. Exchange Traded Funds also have the ability to track specific segments of the economy. Such ETFs hold stocks of companies focusing in particular sectors such as energy, technology, or consumer goods. Furthermore, ETFs are also able to create more specialized portfolios including those of particular countries, commodities, currencies or fixed income instruments.

WHO SHOULD CONSIDER ETFs?

- **Long-term, buy-and-hold investors who seek to replicate a specific market return:** This type of strategy does not incur frequent trading costs, and the investor would still benefit from the low expense ratios many ETFs offer.
- **Large dollar lump-sum investors:** A single large investment spreads the trading commission across the entire investment, reducing the impact of trading costs to the client.
- **Investors looking for the trading flexibility of stocks:** As mentioned earlier, many investors prefer utilizing ETFs because of the transparency and trading flexibility. Pricing occurs through the day as opposed to mutual funds where pricing occurs at the close of the market.

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WHAT ARE THE BENEFITS OF ETFS?

Availability:

Due to the growth of the investment vehicle, ETFs now cover virtually all segments of the U.S. stock market as well as a sizeable share of the U.S. bond market. A growing number of International ETFs have also emerged, giving investors an easy way to gain exposure beyond U.S. investments.

Diversification:

ETFs hold a grouping of investments giving an investor more diversification than holding one stock. However, diversification does not assure a profit or protect against loss.

Flexible Trading:

The stock-like trading features of ETFs provide more benefits beyond continuous pricing availability. Investors have the ability to place specialized trading methods on ETFs. Trading methods, such as limit or stop orders, may provide greater control over the pricing and timing of ETF transactions.

ETFs also have no minimum investments nor do they require a minimum holding period. Investors in ETFs are free to purchase as few as one share and have the ability to sell their shares without penalty as they choose.

Low Expenses:

A majority of ETFs are passively managed, meaning managers usually only trade shares to mirror underlying benchmarks. Due to this fact, many ETFs have lower annual expenses when compared with actively managed funds.

Tax Efficiency:

ETFs may be more tax efficient than some traditional mutual funds. A mutual fund manager may trade stocks to satisfy investor redemptions or to pursue the fund's objectives. This selling of shares may create taxable gains for the fund's shareholders. Since ETFs are bought and sold between investors, and managers of index-based ETFs will generally only make trades to match changes in their index, ETFs may provide greater tax efficiency. However, capital gain distributions may still be incurred.

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TYPES OF EXCHANGE TRADED FUNDS:

The following are examples of several of the largest ETFs in terms of trading volume and assets under management:

- Standard & Poor's Depository Receipts (SPY), issued by State Street Global Advisors' Spiders series, tracks the S&P 500. This index contains 500 of the largest companies based in the U.S. State Street Global Advisors' SPDRs also track specific sectors within the U.S. economy.
- Diamonds (DIA) follows the 30 large-cap companies that create the Dow Jones Industrial Average.
- iShares, one of the largest providers in terms of assets, has issued numerous ETFs tracking broad and specific U.S. or International indexes. Among their most popular include those of Emerging International equity markets as followed by the MSCI EAFE index.
- PowerShares (QQQ) track the 100 largest businesses of the technology-driven Nasdaq Composite Index.

INVESTMENT STRATEGIES:

One of the most widely used ETF strategies today is the **portfolio completion strategy**. This approach utilizes ETFs to gain exposure to an area of the domestic or global economy not currently held within a portfolio. The additional ETF can help fulfill the asset allocation plan set forth by you and your Financial Consultant with the purchase of a single holding.

A second popular strategy making use of ETFs is referred to as **Core and Satellite management**. In this approach, the core investments are generally comprised of broad based assets that seek to return performance in line with a stated benchmark, while the satellite aspect of the portfolio seeks active management outperformance against a specific benchmark.

Investing in Exchange Traded Funds involves risk and other potential drawbacks. Please consider these factors before investing:

Exchange Traded Funds are subject to trading risks and will fluctuate in response to the activities of the individual companies and general economic and market conditions domestically and abroad. When redeemed, you may gain or loss money. ETFs may trade for less than their net asset value. Each ETF has a unique profile risk which should be considered carefully when making investment decisions.

The trading flexibility of ETFs may encourage frequent trading, which could lead to the possibility of mistiming the market.

Brokerage commissions are incurred. For this reason, ETFs may be better suited for a buy-and-hold investor or individuals who are buying a large number of shares at one time. Investors utilizing a systematic investment program may incur higher transaction charges.

There is a possibility of capital gains distributions. At times, some ETFs have distributed taxable capital gains. Usually this occurs when a manager needed to buy or sell stocks to match their underlying benchmarks.

You should carefully consider the potential benefits and risks of different ETFs. Please request and read carefully the ETF's prospectus before sending or investing money. Check with your Hilliard Lyons Financial Consultant to make sure that you have the most up-to-date information.

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