

# Introduction to ETFs

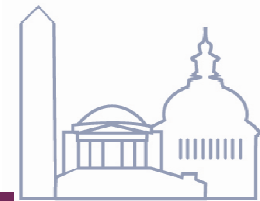
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*Exchange Traded Funds have burst on to the scene in recent years and worked their way into the investing mainstream. They are increasingly popular with investors and financial advisors. This overview is designed to help investors understand ETFs and the benefits they offer.*

Source: ETF Database

# Intro to ETFs



- **Exchange Traded Funds** (ETFs) are investment vehicles that combine the key features of a mutual fund and an individual stock.
- ETFs are a basket of assets, like a mutual fund, that can track an index, a country, commodities, etc.
- ETFs trade like stocks. They trade on an exchange throughout the day, and can be held short term or long term.
- ETFs provide portfolio diversification by providing access to a sector or asset class with one trade.
- ETFs are very transparent. The securities within the ETF are available on a daily basis, unlike many mutual funds which disclose their holdings every three months.

*Source: ETF Database*

# Exchange Traded Funds



**Key Concept: ETFs combine the range of a diversified portfolio with the simplicity of trading a single stock.**

- ETFs offer investors an undivided interest in a pool of assets and are similar to mutual funds, except that shares in an ETF can be bought and sold throughout the day.
  - Unlike most mutual funds, you don't have to wait until the end of the day.
  
- Indexed and managed ETFs
  - 1124 ETFs as of January 2011
  - These 1124 ETFs have a total asset value of approximately \$1.02 trillion.
  
- ETFs can be converted into the underlying shares of the Index

*Source: moneyandmarkets.com, The ETF Boom: 1124 and Counting!*

# Features and Advantages of ETFs

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Low cost

Liquidity

Transparency

Accessibility

Flexibility

# Features and Advantages of ETFs



- Low Cost
  - Lower expense ratios than mutual funds
  - Generally <1%
  
- Liquidity
  - Just as Fair Value of an ETF is derived from the value of the underlying securities so too is the fund's liquidity linked to the individual components that make up that specific ETF.
  - ETFs can be bought and sold throughout the day.
  
- Transparency
  - Readily prices throughout the day
  - Daily disclosure of convertible to component securities
  - Real-time trading ETF holdings

Source: ETF Database

# Features and Advantages of ETFs

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- Accessibility to:
  - Sectors
  - Single countries/Broad regions
  - Commodities (Previously only through futures)
  - Currencies (Previously only through forex trading)
  - Bonds
  
- Flexibility
  - Able to trade options on ETFs

# Exchange Traded Funds



- ETFs can track indexes such as the
  - S&P500
  - DJIA
  - Market Cap Indexes –Large Cap, Mid Cap, Small Cap, etc.
  - Sectors- for example semiconductors, consumer goods or financials
  - Keep in mind the goal of an Index ETF is to emulate an underlying index, not outperform it
- They can track countries and specific areas
  - Such as Emerging Markets- China, India, Mexico, or the BRIC markets
- The bond markets including 7-10 year Treasuries
- Commodity/Precious metals markets such as gold, silver, or oil
- Currency markets that track the euro, yen, and baskets of currencies like the G8
- One can even trade an ETF on the volatility index - the “VIX”
- Due to the expanding ETF market, this is just a representation of the ETF spectrum available.

*Source: 14 Types of ETFs (And More)*

# Active vs. Passive Managed ETFs



- Passively Managed ETFs
  - Index funds are considered passively managed because the portfolio manager of each index fund is replicating the index-- rather than trading securities based on his or her view of the potential risk/reward characteristics of various securities.
  
- Actively Managed ETFs
  - Actively Managed ETFs have a portfolio manager who is buying and selling securities based on an opinion about which securities will accomplish the fund's objectives.

*Source: 14 Types of ETFs (And More)*



# Index ETFs



- Indexes come in many varieties, some include nearly all of the stocks in the US, or other countries.
- Indexes may also be subsets of other indexes
  - Standard and Poor's breaks down the S&P1500 Composite Index into a number of different indexes such as a value index or a small cap index.
- More obscure indexes have been created to allow investors the opportunity to take advantage of markets that are more specialized.
- Investors who want to invest in commodities, foreign currencies, or socially-responsible companies can now look to ETFs.

*Source: What Are Index Funds? The Ins and Outs of Index Funds*

# Weightings



- ETFs can use different weightings such as:
  - Equal Weighting
  - Dividend Weighting
  - Earnings Weighting
  - Revenue Weighting
  - RAFI Weighting

*Source: ETF Database*

# Leveraged ETFs



The concept behind leveraged and inverse investing is hardly new. For centuries, investors have used leverage to increase their buying power and inverse strategies to profit, or to protect a portfolio during declines. The more recent availability of leveraged and inverse mutual funds and ETFs, also known as “geared” funds, has provided more ways for investors to access these strategies.

Geared investing is not for everyone! Each vehicle for geared investing is a specialized tool, useful for a variety of specialized strategies - but each also has special risks. Geared funds are generally riskier than funds without leverage or inverse exposure. Before investing, you should fully understand the risks and benefits of the investment - including the amount of attention you will need to devote to monitoring your position, which may be as frequent as daily.

*Source: ProFunds, Geared Investing*

# Performance Over Time



- The goal of a typical geared fund is to return the multiple of an index, such as 2X, for one day.
- A geared fund investor should understand that for any other time period the return from a geared fund is likely to be more or less than that multiple of the index return. This happens, in large part, because of compounding.
  - This means an investor in a 2x fund may get more or less than double the index return.
  - The difference can be significant, depending on the path the index performance takes during the period.

*Source: ProFunds, Geared Investing*

# Inverse ETFs



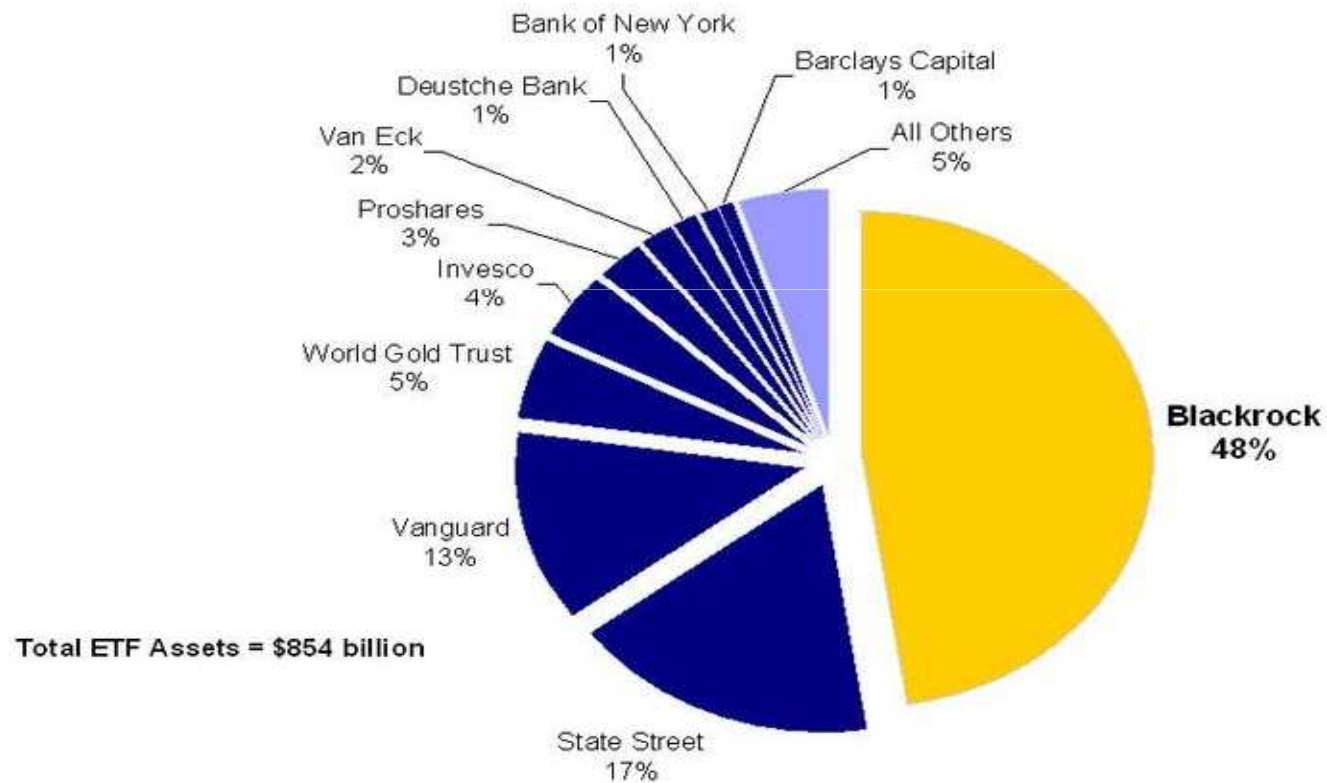
- Most investors are aware that markets move in two directions. Some want to protect against the downside - or take advantage of it.
- You can do this with inverse investing:
  - Some traditional ways investors have sought inverse exposure include short selling, put options, and futures.
- Inverse ETFs are designed to provide “short” exposure by moving in the opposite direction of the indexes or other benchmarks.
- Inverse funds and other inverse investments share many similar risks
  - Losses are limited to the amount invested.
  - Inverse funds seek the inverse, or a multiple of the inverse of their target return for one day. (A -2X inverse fund should go up about 2% on a day when its benchmark falls 1%.)

*Source: ProFunds, Geared Investing*

# Largest ETF Issuers



**ETF Managers by Percent of Total Assets**



Source: Seeking Alpha, May 2010

# Top 10 US ETF Issuers



Issuer	# ETFs	\$ Billion	Type
Black Rock iShares	186	\$364	Sector, Industry, Country, Commodity, Bond
State Street SPDRs	88	\$149	Sector plays-S&P 500, Fixed income-Junk to Treasuries
Vanguard	46	\$92	GICS sectors, REITS
PowerShares (Invesco)	106	\$33	QQQ (Nasdaq-100), Global sectors, Emerging markets, Commodities, Alternative energy
ProShares	78	\$23	Leveraged ETFs, Short ETFs
Van Eck Global	23	\$13	Niche ETFs: Broad and single country frontier and emerging markets, Currency, Sector plays on nuclear, steel, solar
Wisdom Tree	52	\$7	Dividend strategies, dividend-weighted and earnings-weighted indices
Direxion (Rafferty Capital Markets)	26	\$5	Leveraged ETFs designed to track 300% of daily moves of underlying. Used by professionals
Currencyshares (Rydex SGI)	31	\$3	Leveraged and Inverse ETFs, Currency funds
Claymore (Guggenheim Partners)	32	\$3	Global sectors: airlines, shipping, water, Solar power, Frontier markets

Source: Artemis, March 2010

# Summary



- There are advantages, disadvantages, and risks with any ETF investment.
- Advantages of ETFs include: low cost, liquidity, transparency, accessibility, and flexibility.
- Leveraged ETFs typically seek a multiple of the return of a benchmark for a single day.
  - Investment results over time can be more or less than the multiple times the benchmarked return.
- ETF fund positions should be actively monitored. Some investors may want to rebalance on a regular basis to maintain consistent exposure.
- As with any other investment, read the prospectus before investing in any fund.



# Disclosure



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