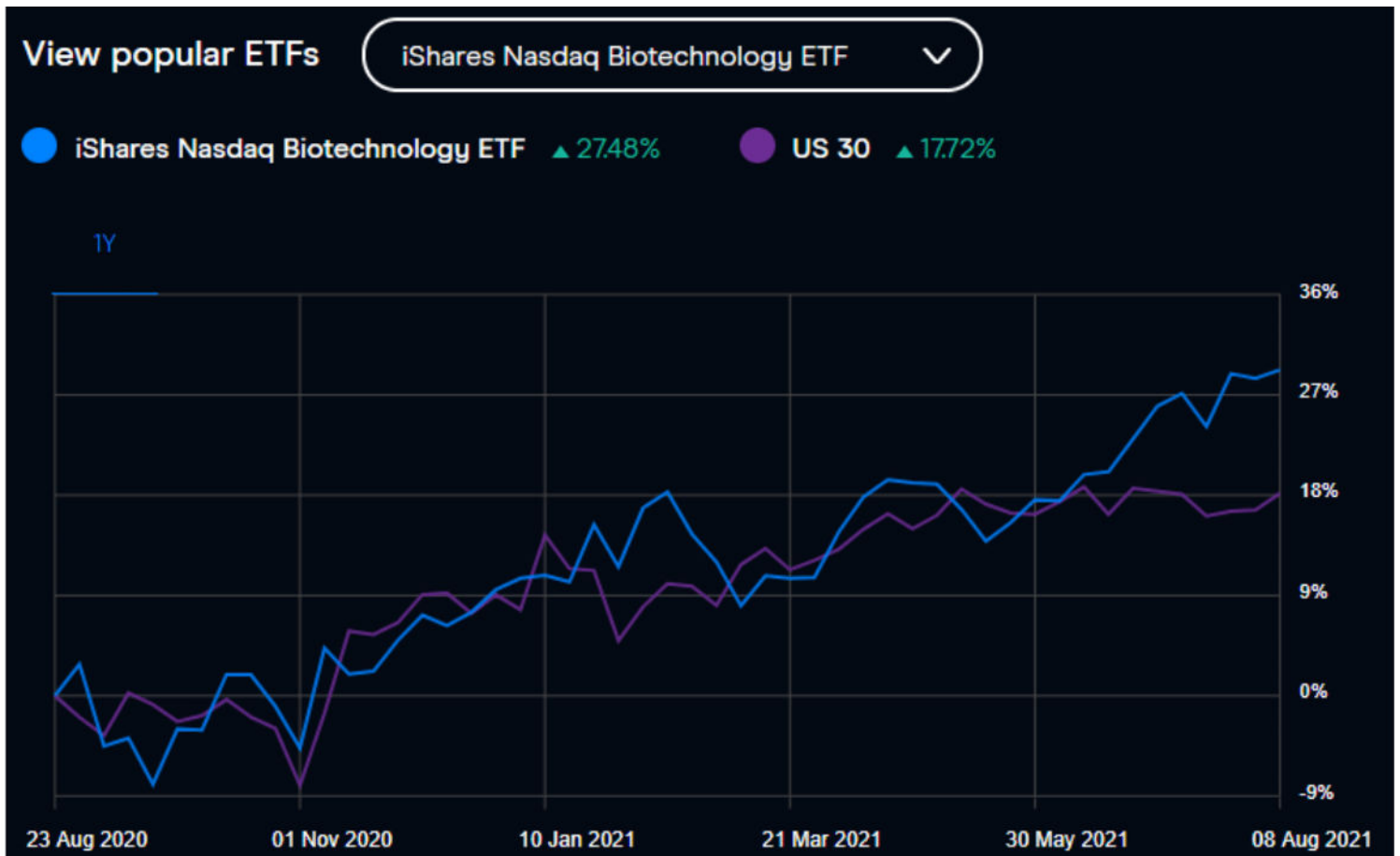





Stock Markets Guides

Author: Nishit Kumar

Exchange Traded Funds (ETF's) Explained



As a [beginner investor](#), you could choose to invest in a variety of instruments. Investors who do not have a high degree of knowledge about the market choose to invest their money into mutual funds.



In a mutual fund, you as an investor will either put your money into an index across the board, or your money will be invested at the discretion of an experienced fund manager.

On the other hand, those investors or traders who have a high degree of technical knowledge about the market choose to invest in stocks.

An alternative to these instruments is an ETF or an Exchange Traded Fund. It combines the best aspects of both stocks and mutual funds, making it the perfect investment vehicle for anyone who is just getting started in the market.

In this article, you will find out what ETFs are, how they differ from other instruments and learn about the various kinds of ETFs available in the market.

What are Exchange Traded Funds (ETF's)?

An ETF or an Exchange Traded Fund is a type of security that tracks an index, sector, commodity, or another financial instrument. It is usually used to track a collection of diverse securities, and it can be bought and sold on the market like any other share.

Specialized ETFs that track specific investment strategies are also available in the market.




The price of an ETF at which it trades is a product of all the instruments inside the ETF. For example, if the price of a particular component of an ETF goes up, then the ETF's price on the market also rises proportionately.

It's called exchange-traded because it can be traded on the stock exchange throughout the trading day, just like ordinary securities. ETFs are primarily of two types: actively managed ETFs and passively managed ETFs.

Actively managed ETFs are under the supervision of an experienced portfolio manager, and they can choose how they wish to invest your money.

On the other hand, passive managed ETFs invest in a particular index on the [stock market](#) and trade on the securities available on that index at any given point in time.



ETFs are preferred by investors over single stocks since they allow you to diversify, which decreases your overall risk factor and increases the likelihood of you making a profit.

For example, even if a particular asset in your ETF goes down, you could still book a profit overall because of the exceptional upwards movement of the other assets.

In addition to this, an ETF can also hold several different asset categories, such as a combination of bonds, commodities, and stocks, which further increases the diversification level of your portfolio as a whole.

Depending on your preferences, they could either be across industries and asset classes, focussed on one geographical region, or specific to a particular industry.

Exchange Traded Funds Definition

The simplest definition of an ETF is an investment fund that holds assets such as stocks, currencies, or bonds. An investor might prefer investing in an ETF for various reasons, some of which have been discussed below.

Generation of Income

Since ETFs can be traded on the market at any point during the trading hours, they can be used to [generate income](#) in much the same way as a stock.

Most stock ETFs pay out dividends equal to the sum of all the individual stocks in the portfolio. They do this by acquiring the



company's shares, holding the quarterly dividends that are paid out, and then distributing them to investors on a pro-rata basis.

ETFs are a popular choice with investors looking for a diversified portfolio that can still provide them with dividends.

There is another way ETF investors can earn money, and this is through the appreciation of the ETF's price. If the price of the underlying securities increases over time, this will translate to an increase in the ETF's price. This ETF can then be sold in the market, thereby booking the profits and generating income for the investor.

Speculation

As with stocks, another way of making profits off of ETFs is through speculation.

If you think that stock prices in general across the market are going to fall due to an inflation announcement by the Fed or any other event that could affect the market at large, you could choose to go long or short an ETF, and then close your position when the event occurs.

This is a way that investors prefer to use when they believe that an event will impact an entire sector or asset class at large, as they can easily open up sector-wide positions through an ETF.

ETF vs Index Fund

There are several similarities between ETFs and Index Funds, which is why several investors can get confused as to which one is the right fit for them.

One of these similarities is that both ETFs and Index Funds allow investors to diversify their portfolios, thereby reducing risk overall.

Another similarity is that since most ETFs are passively managed, they have a low expense ratio, just like index funds.


Vanguard Index Funds - Vanguard Value ETF chart ⓘ



This is because no human manager is making the decisions on where the capital should be allocated, and therefore the fee charged by the fund tends to be lower.

In addition to this, ETFs and Index Funds both have outperformed actively managed funds over long periods of time because indexes have historically shown positive returns when considered in the long run.

At the same time, ETFs and Index Funds have several key differences; the biggest is how they are bought and sold in the market.



An index fund only considers the price of the securities at the end of any trading day, whereas an ETF incorporates the live price of each underlying asset.

This does not make much of a difference to [long-term investors](#); however, it is a key differentiating factor for intraday traders who wish to have the option of getting out of their trades whenever they want.

Another key difference is the minimum investment required. Index funds usually have higher minimum investments that you need to make instead of ETFs, where you can even transact in fractional amounts on some platforms.


Exchange Traded Funds vs Mutual Funds

Mutual funds and ETFs also have a lot in common, particularly because they offer diversification prospects and allow investors to invest in a basket of securities.

However, one of the key differences is that, similar to index funds; mutual fund prices are also only tallied up at the end of the trading day. In contrast, ETF prices are a live reflection of the prices of the underlying securities.

In addition to this, mutual funds are usually actively managed, which means higher expense ratios. An expense ratio is a fee you pay to the fund manager for effectively allocating your money. For example, a 4% expense ratio means that you will pay \$40 for every \$1,000 you invest in a particular fund.

While mutual funds have high expense ratios, ETFs are known for their expense ratios sometimes being as low as 0.03%.



There are also tax advantages to investing in ETFs as compared to mutual funds. To understand this better, an example can be considered.

Suppose you invested in a mutual fund with only one stock in it, at \$10.

The prices go up after a while, and you can redeem the fund for \$11. In this case, the \$1 is your capital gain, and you will be taxed on this. Therefore, you generally end up having to pay capital gains on the sale, which are then distributed to all the investors by the fund at the end of the year.

On the other hand, suppose you had invested in the same stock but through an ETF.

When you ask for a redemption of an ETF, then the fund does not sell off the \$11 stock but instead offers you “in-kind redemptions”, which limits the possibility of you paying capital gains taxes.

Best Exchange Traded Funds

If you wish to start investing in ETFs, then there are several considerations to make and a lot of factors that you need to consider.

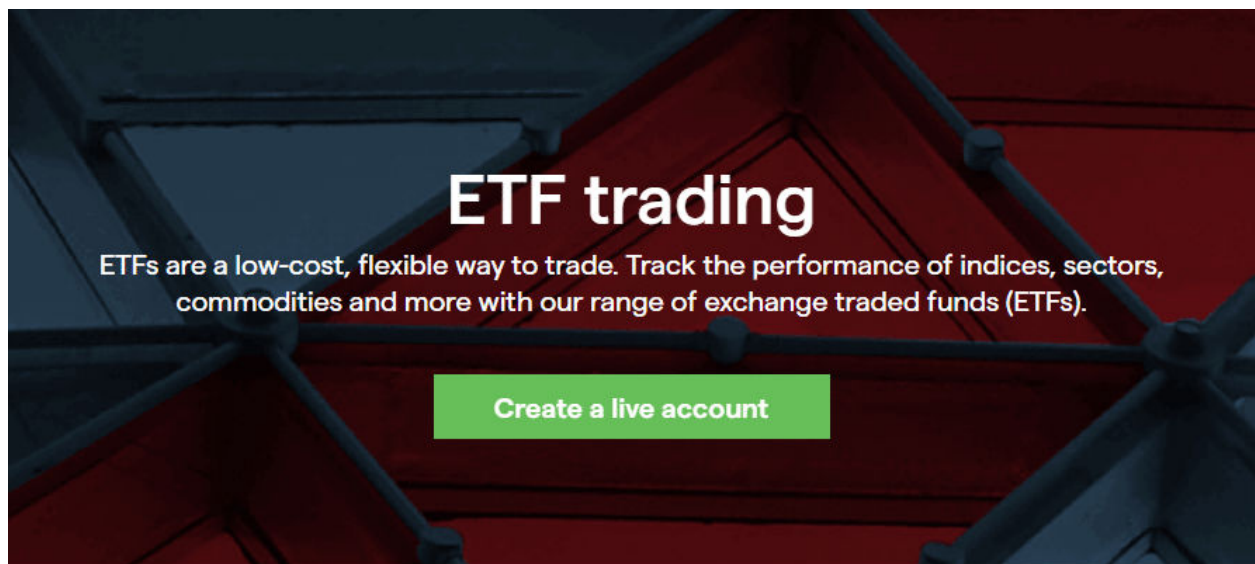
Similar to how you would make any other investment, due research is important when deciding to invest in an ETF.

The various steps you should follow to optimally grow your capital and make the right decision when selecting ETFs have been discussed below.

Find a Broker or Platform

Your first step should be to look at a broker or [investing platform](#) that meets your requirements.

While there are several brokers available online that you can make an account with instantly, you should make sure to find the broker that best suits your needs.



A list of the things that you need to consider at this step are:

- What is the minimum balance that this broker requires you to maintain?
- What are the different ETFs and instrument pairs that this broker offers? Do they allow you to trade shares, bonds, commodities, currencies, as well as derivatives?
- What is the minimum number of trades you need to make each month? Some brokers levy charges on you if you do not meet a minimum threshold of trades, so you need to know this information ahead of time.
- What are the commissions that the brokerage charges? Most online brokers these days have zero commissions, so you

should make sure that you find the right one with the lowest charges.

- What is the spread on different trading instruments? The spread is the difference between the bid price and the ask price, which is also part of how the broker makes money. Some brokers have a higher spread than others, and you need to find the one with the lowest spread to ensure that your trades are executed at the lowest possible charges.

Research and Identify the Right ETFs for You

Once you have identified the right broker, the next step is for you to begin researching ETFs themselves and identifying the ones that suit your investment parameters the best.

At this stage, there are several things that you will have to consider, and these have been listed below:

- The first thing that you need to think about is your risk profile: how much risk are you willing to take? This will significantly impact the type of investment decisions you make; therefore, you need to consider this as the first step.
- What is your investment timeline? Are you planning to trade intraday, i.e., buy and sell stocks and ETFs on the same day? Are you planning to swing trade, i.e., hold the stocks for a couple of days or weeks to take advantage of an upwards swing? Or are you planning to hold the ETFs over the long term? Either way, your investment horizon will also dictate what securities you can invest in and which ones you can't.
- What sectors and asset classes do you wish to be involved in? Some people choose to trade only a specific sector, and some choose to trade the entire market, while some diversify even further to include currencies and bonds in their ETFs. Your risk

profile and investment timeline will also influence what sectors and asset classes you can invest in.

- Do you wish to invest in an active or passive ETF? While most ETFs are passive, there are a few active ETFs designed by asset management firms. While they have higher expense ratios, they are more likely to give higher returns in the short term because they are invested at the discretion of an experienced fund manager.
- What is your objective for investing in ETFs? Are you investing to get dividends and have a source of passive income? Is this a source of speculation, or are you investing for the long term to make money when the ETF value appreciates? The reason for your investment will also enable you to select ETFs that cater to your needs.

Develop a Trading and Investment Strategy

The next step is to develop a [trading strategy](#) that you can use to profit while trading on ETFs.

One of the popular strategies that beginners use is dollar-cost averaging, which is the strategy of buying a set dollar amount of the same asset at regular intervals despite the fluctuations in the asset's price. It enables you to inculcate discipline into your investing behavior while also averaging out the cost of your holdings and increasing your overall profits in the long run.

Some of the other commonly used strategies include asset allocation strategies, swing trading strategies, and sector rotation.

Gold Exchange Traded Funds

A gold ETF is an exchange traded fund that aims to track the domestic price of gold. These are passive ETFs that follow the price of gold and enable an investor to speculate on their prices without actually buying gold.

There are several costs involved with the purchase of physical gold as an asset. These costs involve transportation costs, storage costs, as well as maintenance costs.

To avoid these, investors can now trade on gold ETFs. They represent units of physical gold, in that 1 unit of a gold ETF is equal to owning 1gm of gold. They are a way to combine the simplicity of investing in gold with the convenience of stock investments.


When you decide to redeem a gold ETF, you will get a payout equivalent to the proportionate price of gold at that particular time.

Oil Exchange Traded Funds

An oil ETF is similar to and yet different from a gold ETF in several ways. The main similarity between the two is that they are both commodity ETFs. Investing in them allows investors to avoid all the costs associated with the transportation and storage of these assets.

However, unlike a gold ETF, owning one unit of an oil ETF does not entitle you to one barrel of oil.

On the other hand, an oil ETF is a collection of stocks belonging to companies involved in the oil, energy, and natural gas space. Most companies featured on oil ETFs could be involved with one or more



processes in the oil supply chain, such as discovery, production, distribution, or retail businesses.

Similar to other ETFs, an oil ETF could focus on companies in a specific geographic region or across the world.

Lastly

Exchange Traded Funds offer many opportunities and investment avenues to investors, as they are the middle ground between mutual funds and stocks.

Along with the opportunity to effortlessly diversify your portfolio, an ETF also offers live prices on the various underlying assets, making them a better investment than either mutual funds or individual stocks.

ETFs can be of several types and span asset classes, countries, industries, and commodities; therefore, your research is important whenever you want to invest in an ETF.

The first step for you is to research your broker, research ETFs, and develop your trading strategy that meets your parameters. Finally, all that is left for you to do is observe how your strategy performs and continually tweak it for the highest returns.



Stock Markets Guides