Client Education Library

# Learn About Exchange-Traded Funds

Vanguard®

1 Introduction

2 What is an ETF?

6 How do ETFs work?

12 How do ETFs compare with other investments?

Exchange-traded funds, or ETFs, are attracting more and more attention from investors. In fact, as of March 28, 2008, investors had poured more than $559 billion into ETFs.[1]

In this education guide, you'll get answers to common questions about ETFs. You'll also learn how ETFs and conventional mutual funds compare, and you'll gain a better understanding of why your financial advisor may be using ETFs in your investment portfolio.

[1] Source: Investment Company Institute.

# What is an ETF?

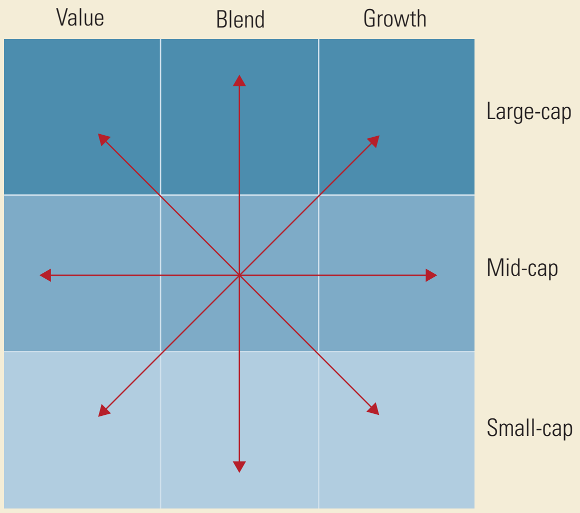
Simply put, virtually all ETFs are index-based mutual funds that trade like individual securities stocks on major exchanges. They offer the advantages of traditional index funds with the trading flexibility of individual stocks.

## ETFs offer a wide variety of investment choices

There are more than 600 equity ETFs, with virtually every segment of the domestic and global equity markets represented.

| Global equity markets | Sectors |
|---|---|
| **MSCI EAFE** | Energy |
| Europe | Materials |
| Pacific | Industrials |
| **MSCI ACWI (ex USA)** | Consumer discretionary |
| Europe | Consumer staples |
| Pacific | Health care |
| Emerging markets | Financials |
| Canada | Information technology |
| **Country-specific ETFs** | Telecommunication services |
| | Utilities |
| | **Other specialty ETFs** |
| | Real estate |
| | Commodities |

Equity ETFs range from those that invest in the widest swaths of the markets to those that invest in specific industries.



The ETF market continues to expand and now includes more than 50 bond ETFs. Also available are a growing number of hybrid ETFs, which are similar to traditional actively managed mutual funds, offering a range of management styles and asset classes.

## ETFs offer the advantages of mutual funds

Like mutual funds, most ETFs are registered investment companies that offer investors a proportionate share in a professionally managed portfolio of securities, such as stocks or bonds. Virtually all ETFs are indexed portfolios, meaning they seek to closely track the performance of specific market indexes. ETF investors enjoy the traditional advantages of indexing:

- Very low costs.
- The opportunity to track a market.
- Relative diversification within a market segment.
- Potential for tax-efficiency.
- Consistent management strategy.

Remember that diversification does not ensure a profit or protect against a loss in a declining market. Also, investors cannot invest directly in an index.

## Equity ETFs offer the trading flexibility of stocks

Equity ETFs are traded on a stock exchange and can be bought and sold through a brokerage account anytime during exchange hours, at up-to-the-minute prices. Traditional mutual funds, on the other hand, take orders during Wall Street's trading hours, but the transactions are actually completed when the markets close.

With ETFs, investors can use stock-trading techniques such as limit orders, margin buying, and short-selling.

Of course, like stocks, ETFs are subject to traditional stock market risks and rewards. The value of ETF shares will rise and fall as stock markets fluctuate, causing an ETF to gain or lose value over short or long periods of time.

# How do ETFs work?

Despite their similarities, mutual funds and ETFs work quite differently. First, and perhaps foremost, is the way ETFs are bought and sold. Investors must trade ETF shares through a brokerage firm. Shares can be bought and sold at the current market price anytime the stock exchange is open.

### How mutual funds work

Conventional equity mutual fund shares are purchased or redeemed directly with the fund or through a broker, and the price is the shares' net asset value (NAV) determined at the market close.

In a mutual fund, most transactions are conducted in cash. With rare exceptions, investors purchasing fund shares pay cash to the fund, while those redeeming shares receive cash from the fund, possibly requiring the fund manager to buy or sell securities in the portfolio.

When the fund trades securities, it incurs transaction costs such as brokerage commissions, and in some cases, it realizes capital gains on which shareholders will owe taxes.

## A comparison of equity ETFs and index equity mutual funds

| | Exchange-traded funds | Index mutual funds |
|---|---|---|
| Buying and selling shares | Through a brokerage firm | Directly from the fund company or through a broker |
| Share price | Market prices fluctuate throughout the trading day | NAVs are determined after financial markets close |
| Frequency of share pricing | Throughout the day while financial markets are open | Once per day after financial markets close |
| Average annual expense ratio | 0.48%[2] | 0.91%[3] |
| Transaction costs | Commission and bid-ask spread on each direct purchase and sale | None for no-load funds when purchased from or redeemed directly with the fund |
| Automatic dividend reinvestment | Availability depends on the broker, who may charge for the service | Generally available at no charge |
| Client services | Provided by the broker | Provided by the fund sponsor or a broker |
| Average cost statement | Availability depends on the broker | Generally available from the fund sponsor |

[2] For all ETFs. Source: Lipper Inc., as of 12/31/2007.

[3] For all index equity funds. Source: Lipper Inc., as of 12/31/2007.

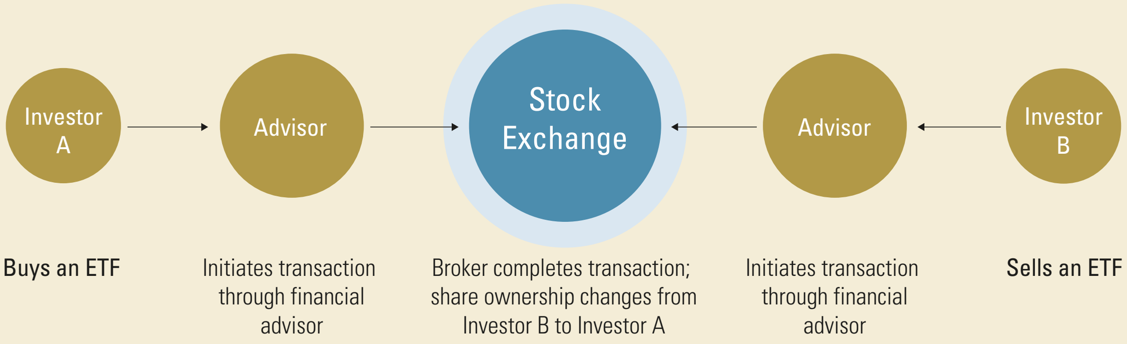
## The ETF difference

Unlike mutual funds, ETFs do not generally experience cash flows into or out of the fund. Only certain sophisticated institutional investors (brokerage houses, for example) are authorized to purchase or redeem shares directly, and they do so almost exclusively with securities.

When these institutional investors purchase shares of an ETF, they give the ETF specific quantities of securities that are part of the index the ETF tracks. Similarly, when these institutions redeem their ETF shares, the ETF provides them with securities, not cash. These cashless transactions benefit the ETF in two ways: The ETF does not incur transaction costs or realize capital gains.

Institutional investors sell their ETF shares to individual investors on the open market, who may then sell their shares to other investors for cash. These market trades, however, have no effect on the ETF itself; no cash flows into or out of the ETF that would require it to purchase or sell portfolio securities, pay brokerage commissions, or realize capital gains. As a result, the ETF is largely able to hold down its operating costs and limit the distribution of taxable gains to shareholders.

## How ETFs are traded


Investor A
Advisor
Stock Exchange
Advisor
Investor B
Buys an ETF
Initiates transaction through financial advisor
Broker completes transaction; share ownership changes from Investor B to Investor A
Initiates transaction through financial advisor
Sells an ETF

## ETFs offer added trading options

Because equity ETFs trade like stocks any time during regular exchange hours, your financial advisor has the ability to execute specific portfolio strategies to help you achieve your investment objectives.

Here are a couple of the ways that equity ETFs can offer more flexibility than conventional mutual funds:

**Limit or stop orders.** A stop order is an order to buy or sell a stock once it reaches a certain share price, known as the stop price, whereas a limit order is an order to buy or sell a security at a specified share price. Stop orders may be triggered by temporary market movements or may be executed at prices several points higher or lower than the stop price because of market orders placed ahead of them. A limit order may not be executed immediately or only partially, or at all. Stop and limit orders can help protect you from trading a security at a lower or higher price than you want.

**Short-selling.** This investment technique involves essentially borrowing a security and then selling it with the intent to buy it back at a lower price. Short-sellers hope to make money when the market goes down. With short sales, you risk paying more for a security than you received from its sale and there is no limit to the amount of money you can lose.

In some cases, your financial advisor can sell ETF shares that you have borrowed short to hedge the risk of other investments you hold. Your financial advisor can also shift assets out of and back into an ETF on a short-term basis to realize capital losses to better manage your tax liability. Your financial advisor can help determine if these strategies are appropriate for your individual situation.

### ETFs are potentially tax-efficient

ETFs can be tax-efficient investment vehicles when you follow a buy-and-hold strategy.

Nearly all ETFs enjoy the low portfolio turnover inherent with indexing, so they typically pass on a small amount of capital gains to investors. However, certain types of ETFs, such as those that invest in small-capitalization stocks or in specific market sectors, may experience higher turnover and be less tax-efficient than broader-market ETFs.

### ETFs can be very inexpensive

As with any investment, operating costs vary among ETFs. Generally though, ETFs cost much less to operate than conventional mutual funds. Because ETF investors place transactions through brokerage firms, the ETFs do not incur the administrative costs that mutual funds do for such things as correspondence, customer service, and account recordkeeping.

Even though ETFs have very low operating expenses, they do incur transaction costs. Whenever your financial advisor buys or sells ETF shares in your portfolio, you will incur brokerage commissions.

ETF market prices are also affected by bid-ask spreads. This is the difference between what the dealer pays for a security he or she buys from an investor and the somewhat higher price at which the dealer sells the same security. Like any other investment costs, these expenses are borne by the individual investor and can affect investment returns.

Prices for small-cap ETF products often fluctuate more than those of large-cap ETF products. Sector ETF products are subject to sector risks and nondiversification risks, which may result in performance fluctuations that are more extreme than fluctuations in the overall stock market. In addition, sector ETF products that sample their target indexes to comply with tax diversification rules may experience a greater degree of tracking error than other ETF products. Bond ETFs are subject to interest rate, credit, and inflation risk.

Each person should consult an independent tax advisor about his or her individual situation.

# How do ETFs compare with other investments?

| | ETFs | Typical index mutual funds | Portfolio of stocks |
|---|---|---|---|
| Diversification | ■ | ■ | □ |
| Cost-effectiveness | ■ | ■ | □ |
| Tax-efficiency | ■ | ■ | ■ |
| Trading flexibility | ■ | ◪ | ■ |
| Transparency | ■ | ◪ | ■ |

■ High level

◪ Medium level

□ Low level

> Trust your financial advisor to answer any questions you may have about ETFs and to explain how they can be used to help you achieve your financial goals.

Vanguard®

Vanguard Financial
Advisor Services™

P.O. Box 2900
Valley Forge, PA 19482-2900

Financial advisors: visit advisors.vanguard.com
or call 800-997-2798.

**For more information about ETFs, contact your financial advisor to obtain a product description and prospectus. Investment objectives, risks, charges, expenses, and other important information are contained in these documents; read and consider them carefully before investing.**

All investments are subject to risk.

ETF shares are not redeemable with an Applicant Fund other than in Creation Unit aggregations. Instead, investors must buy or sell ETF shares in the secondary market with the assistance of a stockbroker. In doing so, the investor will incur brokerage commissions and may pay more than net asset value when buying and receive less than net asset value when selling.

Investment Products: Not FDIC Insured • No Bank Guarantee • May Lose Value

© 2008 The Vanguard Group, Inc.
All rights reserved.
Vanguard Marketing Corporation, Distributor.