



# NORTH CAROLINA DEPARTMENT OF THE SECRETARY OF STATE

## Securities Division

ARE YOU AN INFORMED INVESTOR?

# EXCHANGE TRADED FUNDS

Exchange Traded Funds (ETFs) have grown increasingly popular among retail investors seeking safe, stable alternatives to mutual funds.

## What are ETFs?

ETFs are baskets of investments such as stocks, bonds, commodities, currencies, options, swaps, futures contracts and other derivative instruments that are created to mimic the performance of an underlying index or sector.

ETFs are often compared to mutual funds because they pool investors' assets and use professional fund managers to invest the money according to a specific strategy detailed in the fund's prospectus. Unlike a mutual fund, which is bought or sold directly from the fund issuer at the fund's net asset value (NAV), which is set at the end of each trading day, an ETF is bought and sold on an exchange like any other listed stock at a price continuously determined on the exchange.

Initially, ETFs were purchased primarily by sophisticated investors, such as hedge fund managers, who used the products to "hedge" against a particular risk. Today, retail investors with investment objectives of safety and stability are purchasing ETFs as an alternative to mutual funds and other investments.

## Common Traditional ETFs

- **Index** – Seeks to mirror the performance of a specific investment index, such as the S&P 500 or the Dow Jones Industrial Average.
- **Commodity** – Seeks to mirror the performance of a specific commodity or commodity group, such as gold or oil.
- **Bond** – Seeks to mirror the performance of a specific bond index or product, such as U.S. Treasury or municipal bonds.
- **Currency** – Seeks to mirror the performance of a specific currency or basket of U.S. or international currencies, such as the Euro or Yen.
- **Industry** – Seeks to mirror the performance of a specific industry segment, such as healthcare or manufacturing.

Before investing in an ETF, ask yourself these questions:

- Do I understand this investment?
- Is this investment right for me?

Just like other investment opportunities, you should contact the N.C. Department of the Secretary of State's Securities Division to determine if the ETF and the person recommending the investment are properly registered in North Carolina.

ETFs should be registered with the U.S. Securities and Exchange Commission (SEC). You should ask for and read the ETF's prospectus before investing.

**N.C. Department  
of the Secretary of State  
Securities Division**  
[www.sosnc.com](http://www.sosnc.com)  
(800) 688-4507

# For more investor education resources, visit the website of the North American Securities Administrators Association at [www.nasaa.org](http://www.nasaa.org).

## Non-traditional or Synthetic ETFs

- **Leveraged** – Uses financial derivatives and debt to multiply the returns of an underlying index, commodity, currency or basket of assets.
- **Inverse** – Uses various derivatives to profit from the decline in the value of an underlying index, commodity, currency or basket of assets; used typically to hedge exposure to downward markets.

## What are the risks associated with ETFs?

- **Liquidation** – The number of ETFs that are shut down or liquidated is on the rise, up 500 percent in each of the last three years over 2007 levels (which equates to one ETF each week). These liquidations often include the charging of termination fees and can result in lost opportunity costs if the providers convince investors to stay in the fund through the liquidation process to save on commission costs. Commission savings are often not worth the additional risk of staying in a liquidating fund.
- **Tax consequences** – While traditional ETFs may provide greater tax efficiency through fewer capital gains distributions, non-traditional ETFs may be less tax efficient due to daily resets that promote more frequent trading, which can result in significant short-term capital gains that may not be offset by a loss.
- **Redemption** – For most retail investors, the only option for redeeming shares of an ETF is to sell them through a broker on the secondary market. By comparison, mutual funds may be sold back to the fund's issuer for the fund's cash equivalency.

- **Fees** – Traditional ETFs charge a management fee that is deducted directly from the assets of the fund. The fee, called an expense ratio, management fee or investor fee, typically ranges from 0.1 percent to 1 percent. Because ETFs trade like stocks, brokerage commissions and transaction costs typically apply to ETF purchases and sales on a per transaction basis. Leveraged and inverse ETFs must be traded more frequently because of their volatility, therefore incurring substantial brokerage fees and commissions.

## Are ETFs suitable for you?

Not all ETFs are the same. Some may be appropriate for long-term holders, but others may require daily monitoring. You need to know your investment objectives and risk tolerance level as well as your investment timeline.

Synthetic products like leveraged or inverse ETFs are not appropriate for “buy and hold” investors because an ETF may reset each day, and its performance may quickly deviate from the underlying index, currency, commodity or basket of assets it is attempting to mirror. In other words, it is possible that your ETF could suffer significant loss even if the long-term performance of the index or sector shows a gain.

You should consult a tax adviser and registered investment professional to determine the potential tax consequences and to better understand the risks and benefits of an ETF to your portfolio. Investors unfamiliar with the features and applications of exotic ETFs may be introducing into their investment portfolios an investment that can increase losses more rapidly than anticipated.

**To learn more or for help with these or other products, contact:**

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