Debunking Myths & Common Misconceptions of ETFs

Even as ETFs have grown in popularity, there is still a great deal of misunderstanding about how they are structured and regulated, how they trade, and how their performance compares to other kinds of investments.

Since State Street launched the SPDR® S&P 500® ETF (SPY) in 1993, exchange traded funds (ETFs) have grown to become an increasingly popular investment vehicle for both individual and institutional investors. Today there are more than 2,000 US-domiciled ETFs available and $4.04 trillion in assets.¹

ETFs offer an easy, cost-efficient way for investors to incorporate various asset classes, investment styles, sectors, industries and even commodities into their portfolios. Because most ETFs are passively managed, they generally have low management fees and operating expenses. Like individual stocks, ETFs give investors the flexibility to buy and sell shares throughout the day at the market price. It's important to keep in mind that frequent ETF trading, which typically occurs through a broker, can significantly increase brokerage commissions, potentially washing away any savings from low fees or costs.

But even as ETFs have grown in popularity, there is still a great deal of misunderstanding over how they are structured and regulated, how they trade and how their performance compares to other kinds of investments. Increased disclosure, greater transparency and improved investor education are vital to helping investors decide which financial products are most appropriate for their investment needs, including ETFs. This article is designed to provide the facts behind some common ETF myths that persist today.

Myth: ETFs are the Same as Individual Stocks

Reality A stock is a type of security that signifies ownership in a corporation and represents a claim on part of the corporation's assets and earnings. A stock can be bought and sold on the major stock exchanges throughout the day at the market price. A stock’s price will generally reflect the market’s supply and demand for its shares.

An ETF is a commingled investment vehicle comprised of a collection or ‘basket’ of securities that tracks, and is intended to represent, the performance of a broad or specific segment of the market, such as US equities, small cap stocks or emerging markets. Most ETFs offer the combined benefits of index mutual funds and individual securities. Like index mutual funds, ETFs allow investors to track the return of hundreds of domestic and international indexes. Like individual stocks, ETFs give investors the flexibility to buy and sell shares at market prices on the major stock exchanges throughout the day.
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Myth: Individual Stocks, Bonds and Mutual Funds Generally Outperform ETFs

Reality Any short-term or long-term analysis of the markets will demonstrate that no particular investment category or type can consistently outperform another. Performance of any security, whether it’s a stock, bond, mutual fund or ETF is determined by any number of factors, including the economy, monetary policy, market conditions or issues affecting a particular security’s asset class or industrial sector. For individual stocks, fundamentals such as earnings, valuations and financial stability may also affect share prices. For bonds, factors such as interest rates, inflation and credit ratings may influence their yields.

The advantage of commingled vehicles such as mutual funds and ETFs is that they offer the potential benefits of diversification, which may help to reduce the overall risk of a portfolio, as the decline in the price of any one security may be offset by the rise in price of another.

Myth: ETFs are Riskier Investments than Mutual Funds

Reality There’s no significant investment research that proves that all ETFs carry significantly higher risk than mutual funds. Because most ETFs are designed to replicate the performance of an associated index, their overall risk level should not be significantly higher or lower than that of the index itself. Investors should evaluate their level of comfort with the unique risk and volatility characteristics of a given index, industrial sector or asset class of interest before investing in an associated ETF.

Further, the risk and volatility level of any commingled investment vehicle, whether it is an ETF or a mutual fund, is determined by a number of factors, including:

- The performance characteristics of the fund’s underlying holdings
- The inherent volatility and risk of the markets or sectors in which the vehicle invests
- The investment style the fund uses
- In the case of actively managed funds, the manager’s bets on individual securities or sectors

Myth: All ETFs Replicate Their Underlying Indexes

Reality Most, but not all, ETFs are designed to provide investment results that generally track the performance of an underlying benchmark index (such as the S&P 500) by holding a portfolio of securities that mirror this performance.

The majority of ETFs around the world use one of three techniques to achieve this goal: full replication, optimization-based tracking and synthetic replication. However, not all ETFs are replication-based. Within the past few years a growing number of actively managed ETFs have been launched that leverage the expertise of portfolio managers to execute security selection and trading decisions. Let’s examine each of these approaches in greater depth.
• **Full Replication**  In this approach, an ETF holds all of the securities in the same weightings as its associated index. Over time, the manager adjusts the portfolio to reflect changes in the index (such as the replacement of one security with another) and manages cash flow from dividends or income generation. This strategy tends to provide very close tracking with the underlying index.

• **Optimization-Based**  Designed to control trading costs and promote liquidity, this strategy uses a sampling process to create a representative or optimized portfolio of securities that closely matches the characteristics of the underlying index. While this approach may be more cost-efficient, it tends to carry a higher potential for tracking error than ETFs that use the full replication method.

• **Synthetic Replication**  A recent introduction to the marketplace, synthetic ETFs attempt to replicate index returns by purchasing derivatives such as swap agreements with one or more counterparties, such as a bank. Typically, the counterparty will agree to deliver the performance of the associated index (minus a small spread), including capital gains and dividends, in exchange for the value of the performance generated by a pool of physical securities held by the ETF (these securities are not necessarily the same as those comprising the ETF’s index). This allows the ETF to mirror the performance of an index without having to own the actual securities, which can be advantageous when it is difficult or expensive to trade in certain markets or sectors. Synthetic ETFs are riskier than other kinds of ETFs because a counterparty could default on its obligations. However, financial regulators in most countries limit the amount of assets that can be invested in derivatives and require these ETFs to provide adequate liquidity to protect investors against default-related losses.

• **Actively Managed**  This relatively new category of ETFs allows managers to apply their own expertise in overseeing portfolio construction and trading decisions, similar to actively managed mutual funds. While the ETF will have a benchmark index, its managers will generally attempt to outperform that index’s returns rather than simply match it. The main difference between actively managed ETFs and mutual funds is that actively managed ETFs are priced and traded intraday, while actively managed mutual funds can only be purchased or sold at their net asset value after the market closes. Generally, actively managed ETFs have higher expenses than replication-based ETFs.

In general, while there are benefits and risks to each approach, understanding the product structure is vital to helping investors decide which financial products are most appropriate for their investment needs.

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**Myth: ETFs May Have Lower Expenses, but They Cost More to Own Because You Have to Pay a Brokerage Commission When You Trade Them**

**Reality**  It is true that investors pay commissions when they buy or sell shares of an ETF, as they do when they trade individual stocks. It is also true that frequent trading of ETFs could significantly increase commissions and other costs. However, the same thing can be said for trading individual stocks.
While investors don’t pay brokerage commissions when purchasing and redeeming mutual fund shares, certain share classes do carry either up-front sales loads or back-end redemption charges that compensate brokers for selling these funds. In addition, many funds charge ongoing 12b–1 fees, which are used to compensate brokers, 401(k) record-keepers, transfer agents and other entities for marketing and servicing costs. Indeed, depending on the amount invested, the commissions an investor may pay for trading shares of a particular ETF may actually be less than the sales charges and management fees they would be charged by investing the same amount in a mutual fund with a similar strategy.

Mutual funds may incur additional costs that may not be readily apparent to investors. For example, some mutual funds can raise their investment management fees if their managers outperform their benchmarks. And mutual funds with high turnover rates may declare higher capital gains distributions, which can increase an investor’s tax burden, whereas most passively managed ETFs have lower turnover rates, which generally result in lower capital gains.

It’s important for investors to consider both immediate and future costs — commissions, sales charges, management fees and tax implications — when evaluating the suitability of any kind of investment.

**Myth: ETFs Are Only for Day Traders and Short-Term Investors**

**Reality** ETFs are effective investment tools for all types of investors, from short-term traders to those investing for long-term financial goals such as retirement or their children’s education. Their unique structure as commingled investment vehicles that can be bought and sold as market prices gives ETFs the flexibility to be used to execute a variety of investment strategies, without the added expenses of active management.

**Myth: Actively Managed ETFs Deliver Superior Performance Over Passive ETFs**

**Reality** If the last decade has proven anything about investing, it’s that the only thing you can predict about the market is that it will be unpredictable. Any given asset class, investment style or active or passive vehicle may outperform any other during a given timeframe. Yet, as all mutual fund and ETF investors are told time and time again, past performance is not guarantee of future results.

The price of active management is higher costs. Portfolio manager compensation and higher trading costs generally result in higher expense ratios for investors.

The most important consideration when evaluating any investment option is whether it is a suitable choice, given your own investment goals, timeframe and risk tolerance. In addition, actively managed funds tend to have higher turnover rates, which can result in higher capital gains.
ETFs have grown to become an extremely popular choice for investors seeking a cost effective option for executing both short and long-term investment strategies. Understanding their unique characteristics is an important step toward determining whether ETFs can be an appropriate choice for your portfolio and the role they may play in helping you achieve your own investment objectives.

**Talk to Your Financial Advisor** If exchange traded funds interest you, speak to your advisor to determine if you could benefit from incorporating ETFs into your investment plans. Your advisor can help you analyze your current investments, risk tolerance, tax situation and time horizon and then recommend strategies to help you achieve your goals.

### Endnotes

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**Capital Gains Distributions**
A payment to shareholders prompted by a fund manager’s sale of underlying stocks or securities in a mutual fund, or derived from dividend and interest earned by the fund’s holdings, minus the fund’s operating expenses.

**Index**
An indicator or measure of something—typically securities prices. An index is typically an imaginary portfolio of securities (stocks, bonds or even futures contracts) that represent a specific market, such as: say the US equities market by way of the MSCI USA Total Return Index.

**Index Mutual Fund**
A type of mutual fund or exchange traded fund with a portfolio designed to track a market index.

**Intraday Trading**
Trading of a product that occurs during the regular business hours of an exchange.

**Swap**
A derivative contract involving the exchange of financial instruments of almost any kind by two parties, usually businesses and financial institutions and not retail investors. The most common kind of swap is an interest rate swap, and swaps don’t trade on exchanges.

**Turnover Rate**
The percentage of an investment’s holdings that have changed in a given year.

**Volatility**
The tendency of a market index or security to jump around in price. Volatility is typically expressed as the annualized standard deviation of returns. In modern portfolio theory, securities with higher volatility are generally seen as riskier due to higher potential losses.

**Important Risk Information**
ETFs trade like stocks, are subject to investment risk, fluctuate in market value and may trade at prices above or below the ETFs’ net asset value. Brokerage commissions and ETF expenses will reduce returns.

Frequent trading of ETFs could significantly increase commissions and other costs such that they may offset any savings from low fees or costs. Generally, among asset classes, stocks are more volatile than bonds or short-term instruments. Government bonds and corporate bonds generally have more moderate short-term price fluctuations than stocks, but provide lower potential long-term returns. Diversification does not ensure a profit or guarantee against loss.

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ID17137-2206630.3.1.AM.RTL SPD001971 0819 Exp. Date: 08/31/2020

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