Using Exchange Traded Funds

The distinct attributes and potential benefits of ETFs can be appealing to both institutional and individual investors. Typically structured like mutual funds, but listed and traded on an exchange like stocks, ETFs are flexible trading and investment vehicles that you can use to help satisfy a number of critical investment needs.

Savvy investors are discovering what institutional investors have known for some time: asset allocation, not security selection, helps drive long-term investment results. However, advanced asset allocation strategies have traditionally been difficult for many individual investors to implement, given the costs and asset size required to achieve proper levels of diversification.

ETFs are making that job a lot easier, though. ETFs offer investors a sophisticated tool to efficiently gain exposure to broad market segments, encompassing a wide range of asset classes, equity market capitalizations, styles and sectors. This enables investors to build customized investment portfolios consistent with their financial needs, risk tolerance and investment horizon. It's important to remember that diversification and asset allocation do not ensure a profit or guarantee against loss.

Completion Strategies  An investor can use ETFs to fill asset allocation voids in a portfolio. Voids can arise due to non-representation of certain sectors, industries or market capitalization ranges. The broad array of ETFs available provides an efficient mechanism to complete a diversified asset allocation plan. For example, if an investor was benchmarked to the S&P 500® Index, but through stock selection remained underweight to Financials, by purchasing a Financial Sector ETF the investor could reduce the underweight relative to the benchmark.

Active Sector Rotation  An investor can buy or short sector ETFs in an attempt to benefit from the divergent performance of different segments of the economy.

Core-Satellite Strategy  Style-, sector-, commodity-based or other ETFs that track “satellite” asset classes can be used as a cost-effective and efficient complement to a “core” investment in a separately managed account, mutual fund or broad benchmark ETF. Conversely, broad-based ETFs can be used as the core of an investment strategy and combined with other style-and sector-specific ETFs or mutual funds.
**Tax Management**

Tax loss harvesting is the practice of selling investments that have lost value to offset a portfolio’s current capital gains. If capital losses exceed the gains (or if there are not capital gains), the net loss can be used to offset up to $3,000 of the current year’s ordinary income (even though ordinary income may be taxed at a higher rate than capital gains). If the annual loss is more than $3,000, the excess can be carried over to offset gains and ordinary income in future years.

Importantly, the Internal Revenue Service’s Wash-Sale Rule prohibits taxpayers from claiming a loss on the sale of an investment if the same or “substantially identical” investment is purchased either 30 days before or after the sale date. Therefore, to maintain exposure when taking a loss, a “tax swap” — a similar but not identical security — can serve as a placeholder to maintain your exposure to the asset class for 30 days. After 30 days, you can choose whether to switch back to your original holding.²

**Sample Uses**

**Book Losses From a Concentrated Stock Position** Sector ETFs may enable an investor to maintain exposure to a particular market segment after selling a losing position. For example, an investor with an underwater position in a biotech firm could sell the stock at a loss and then purchase an ETF with a high correlation to the sold position. By doing so, the investor maintains her exposure to, or conviction in, the sector while increasing the diversification of her portfolio.

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**Risk Management**

ETFs are an attractive hedging vehicle because they can be sold short. The broad array of ETFs available today creates risk management approaches for individuals and smaller institutions that only large institutional investors could access previously. Also, the smaller denominations in which ETFs trade relative to most derivative contracts can provide an accurate risk exposure match for portfolios of any size. Furthermore, in the US, ETFs can be shorted on a downtick, providing greater trading flexibility.

The increasing use of incentive stock options has also created a growing segment of affluent investors with unique risk management needs. By using sector ETFs,³ these investors can hedge their concentrated exposure to the companies they own or work for and effectively diversify their risk exposure across the broader equity market.

**Sample Uses**

**Long/Short Market Neutral Strategies** An investor is long the S&P 500 Index and feels the Technology Sector will underperform. If the investor considers short selling a Technology Sector ETF, the dollar amount of the long position can be balanced with the short position to minimize the Technology Sector exposure inherent in the S&P 500 Index.

**Concentrated Portfolios** An investor has a concentrated holding in a stock expected to decline in price, but cannot sell the holding because of potential market impact, undesirable tax consequences or other restrictions on the position. Shorting ETFs in related sectors or industries can provide a temporary hedge that can be constructed at a competitive cost and liquidity.
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**Figure 1**

**Shorting with ETFs**

<table>
<thead>
<tr>
<th>Step</th>
<th>Action</th>
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<tbody>
<tr>
<td>1</td>
<td>BORROW</td>
</tr>
<tr>
<td>2</td>
<td>SELL</td>
</tr>
<tr>
<td>3</td>
<td>REPURCHASE</td>
</tr>
<tr>
<td>4</td>
<td>RETURN</td>
</tr>
<tr>
<td>5</td>
<td>POTENTIAL FOR PROFIT</td>
</tr>
</tbody>
</table>

The use of short selling entails a high degree of risk, may increase potential losses and is not suitable for all investors. Please assess your financial circumstances and risk tolerance prior to short selling. An investor makes money only when a shorted security falls in value. Short selling is done on margin, and so you must pay interest and are subject to the rules of margin trading. The shorter must pay the lender any dividends or rights declared during the course of the loan. The two reasons for shorting are to speculate and to hedge. There are restrictions as to what stocks can be shorted, and when a short can be carried out (uptick rule).

The information contained above is for illustrative purposes only.

Diversification does not ensure a profit or guarantee against loss.

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### Transition Management

When investors change asset managers, they are often concerned with how to preserve equity exposure during the transition. One way to achieve this goal is to liquidate the portfolio and reinvest the assets in an ETF with a high correlation to the benchmark of the active manager. Once established, the new manager can then sell the ETF shares to fund the purchase of the new portfolio’s holdings.

### Sample Uses

An investor is no longer satisfied and decides to terminate the current investment manager of his active small-cap growth portfolio. Until he identifies a new active manager, he temporarily chooses to place his assets in a small-cap growth ETF. This will maintain proper asset allocation exposure and can limit cash drag until a new manager can be identified. Once he selects a new manager, his ETF portfolio can be sold and the proceeds can be used to fund the new active manager.

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**Figure 2**

<table>
<thead>
<tr>
<th>Action</th>
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<tbody>
<tr>
<td>SELL</td>
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<tr>
<td>HOLD</td>
</tr>
<tr>
<td>BUY</td>
</tr>
</tbody>
</table>

The information contained above is for illustrative purposes only.
1. Frequent trading of ETFs could significantly increase commissions and other costs such that they may offset any savings from low fees or costs.

2. Information represented in this material does not constitute tax advice. Investors should consult their tax advisors before making any financial decisions.

3. Because of their narrow focus, sector funds tend to be more volatile than funds that diversify across many sectors and companies.

4. Liquidating a portfolio and reinvesting the assets could incur additional costs such as fees, expenses and possible tax consequences. Additionally, the investment return and principal value of your investment could fluctuate in value, so that when shares are sold or redeemed they may be worth more or less than when they were purchased.