IDC Independent Directors Council
Promoting Excellence in Fund Governance

ETFs and Retail Investors: FAQs

Frequently Asked Questions About ETFs and Retail Investors

Why do investors use ETFs?

Exchange-traded funds (ETFs) offer investors a number of benefits, which can include:

- diversification
- trading throughout the day, with transparent pricing
- cost-efficiency
- tax-efficiency
- exposure to particular geographic regions or industry sectors
- access to asset classes that have traditionally been more difficult for retail investors to hold, such as commodities, precious metals, and currencies
- access to investments that utilize quantitative strategies
- a means to hedge other investments in a portfolio

What factors should an investor consider when selecting an ETF?

An investor's first step in selecting any investment product—whether it's a mutual fund, an individual stock or bond, or an ETF—should be to determine the desired investment objective. As with any other type of investment, an investor should then consider various factors to determine which ETF best meets that investor's needs, including:

- risk profile of the fund
- performance
- fees and expenses
- taxes
- assets under management.

Another important factor for an ETF investor to consider is its secondary market liquidity. Typically, ETFs with high liquidity have narrower bid-ask spreads than less liquid ETFs. The "secondary market" refers to a market in which securities, such as ETF shares, are traded after they are initially issued to the authorized participant. (Authorized participants, typically large institutional investors, create and redeem ETF shares. See our FAQs on ETF Basics and Structure.) Stock exchanges, such as the New York Stock Exchange, are secondary markets.

A liquid secondary market means that there are ready and willing buyers and sellers at all times for the security. A feature of a liquid market is that a security can be sold without causing a significant movement in price and with a minimum loss of value.

One of the more common ways to gauge secondary market liquidity in a security is by looking at its average daily volume (ADV). ADV is measured as the number of shares of a security traded each day averaged over a specific period, usually one year. A security with a higher ADV will generally be more liquid and have a narrower bid-ask spread.

Investors can also look at the ADVs of the underlying securities in the ETF to assess the liquidity of the ETF. ETFs that hold liquid securities will also tend to be more liquid.

As investors examine these factors, there is a wealth of information available that can help them, including prospectuses and shareholder reports.

What kinds of risks come with ETF investing?

ETFs are subject to risks similar to those of other pooled investments, such as mutual funds. In addition to standard market risks, ETFs are also subject to the individual risks described in their prospectus. An ETF's risks may include:

- declining value of the securities held by the ETF
- adverse developments in the specific industry or sector that the ETF tracks (unless the ETF is an "inverse ETF," which seeks to produce the opposite return of an underlying benchmark—see below)
- capital loss in geographically focused funds because of unfavorable fluctuation in currency exchange rates, differences in generally accepted accounting principles, or economic or political instability
- tracking error, which is the difference between the return of the ETF and the return of its benchmark
- trading at a premium or discount, measured as the percent difference between the ETF's market price and its NAV.

An ETF's prospectus contains detailed information about the risks to which that specific ETF is subject.

Where can investors get information on ETFs?

In addition to information available on sponsor websites and the individual ETF prospectus, investors can get information about ETFs from various industry resources, including:

- ICI's Exchange-Traded Funds Resource Center
- Financial Industry Regulatory Authority (FINRA)
- NASDAQ
- NYSE
- The Securities and Exchange Commission (SEC)

Where can investors get data to compare ETFs and follow ETF prices?

ETF data and prices can be found in the same sources as are used for other investment products listed on a stock exchange, including financial and media websites, newspapers, and sponsor websites.

Where can investors get information on what assets are held by a given ETF?

ETFs must disclose information about their portfolio composition—either the composition of the creation basket or their complete portfolio holdings, depending on the ETF—every day. This information is typically disclosed on the ETF sponsor's website. For more on the creation basket, see "Frequently Asked Questions About ETF Basics and Structure."

Additionally, a complete list of each ETF's portfolio holdings can be found quarterly on the SEC's EDGAR website (on Form N-CSR and Form N-PORT). Portfolio holdings information can also be found in an ETF's annual and semiannual reports, which are typically available on an ETF sponsor's website.

What are leveraged and inverse ETFs?

Leveraged ETFs seek to provide shareholders with magnified exposure to a particular stock, bond, or commodity index. Most leveraged ETFs attempt to magnify daily index returns by a multiple of two (2x) or three (3x). For example, if a given equity index rises 1 percent during the trading day, a 2x leveraged ETF tracking that benchmark will look to use a mix of stocks and derivative contracts (swaps and futures) to deliver shareholders a 2 percent return for that day.

Inverse ETFs seek to produce the opposite return of a particular stock, bond, or commodity index. Some inverse ETFs may be leveraged to magnify performance.

Leveraged and inverse ETFs are relatively specialized tools for investors and come with unique risks. Because of the effects of compounding, leveraged and inverse funds may return significantly more or less than their benchmarks over a period longer than one day. Shareholders, therefore, need to monitor investments in these funds on a daily basis.

What are important considerations for investors working with financial advisers?

Professional financial advisers, such as full-service brokers or independent financial planners, play an important role for fund investors, including ETF shareholders. ETF investors who work with these advisers should, as with any financial product, discuss ETF holdings to ensure the advisers have a good understanding of the product, have done appropriate due diligence on the product, and have disclosed any incentive they might have to sell the product.

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