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Lynn's Top Five The ABCs of ETFs

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Just like Punxsutawney Phil, stock market investors are beginning to peek their heads out and see their shadows again! So, if the winter of our discontent is finally melting away, what should we be looking for in our portfolios?

A somewhat new kid on the block is the ETF. You've probably seen that term somewhere --- you may even own ETFs already in your portfolios. What's an ETF, and when is it worth your time, consideration, and most importantly, your hard earned money?

1) What is it? ETF stands for "Exchange Traded Fund." An ETF is basically a hybrid of a mutual fund and a stock or bond: like a mutual fund in that it holds a basket of market traded assets; like a stock or bond in that it can be traded all day long, not just at market close. ETFs can invest in just about anything that is publically traded, but most often they replicate an index such as the S&P 500. They can also be specific to sectors such as gold and real estate. Additionally they can hold bonds, such as treasuries.

2) Control: That ability to lock in a known price is probably the biggest reason investors use ETFs in their portfolios over index mutual funds. You can place an order at a specific price to buy or sell, giving you much more control in the results of your investment. For example, if you need money out on a systematic or regular basis, or if you are buying into the market on a dollar cost averaging platform, you can know what you will be receiving or paying rather than waiting until the end of the day to see what happened at the market close.

3) Cost Effectiveness: For many, ETFs are also the more popular answer to the index fund because of potential cost savings. Cheaper to manage, they usually have lower internal costs than an index fund. Why are they cheaper? Because there is very little management, marketing and operating cost involved in an ETF. Mutual funds have a lot more overhead to deal with. Another cost issue can be minimums: mutual funds often have them, ETFs like stocks, are based on share purchases, not dollar amounts.

4) Tax Advantages: Like an index fund, ETFs are often sought after because of their tax benefits. Tax efficiencies exist inside ETFs because they are simply a basket of stocks or bonds. They are not actively "managed," meaning that other than the occasional rebalancing of the index they are replicating that might cause some tax ramifications, ETFs mostly only kick out the dividends on the stocks they hold (or the interest on the bonds). Any other capital gain/loss activity would come from mergers and acquisitions of any assets held within the portfolio. So you control any capital gain or loss by controlling when you sell your ETF position. When you are a mutual fund owner, the capital gains created are controlled by the

mutual fund management team (and Congress!).

5) Buyer Beware? Of course, nothing is ever without risk. ETFs are often accused of underperformance in active markets. If you are in a "stock pickers" environment, for example, you may feel that your ETF has gone up or down only as the market has, and not outperformed. Also, if you buy a sector based ETF and that sector is hit hard in a sector rotation, you may feel very bruised if you continue to hold your position. Exchange traded funds involve the risk of losing money and should be considered as part of an overall program, not a complete investment program. They may be subject to additional risks such as lack of diversification and index tracking error.

Many investment advisors like to use ETFs alongside their favorite managed funds, especially in times such as these. But be careful --- there are a lot of ETFs out there vying for your money. Not only do you need to pay attention to what's in the ETF you buy, but you also need to know the management teams that run them. Be sure they have a strong background, experience, and a top notch reputation. And understand that an ETF is simply a business line or a product to them that they might want to sell at some point.

For the right investor and the right portfolio at the right time, an ETF could be a great fit.

However, as with any potential investment, do your own due diligence before you buy!

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