

More on ETFs

Exchange-Traded Funds Defined

Like mutual funds, exchange-traded funds (“ETFs”) offer investors a convenient way of owning a portfolio of securities, except that ETF shares are traded on stock exchanges. An ETF combines the valuation feature of a mutual fund, which can be bought or sold at the end of each trading day for its net asset value (the market value of the securities portfolio), with the tradability feature of a closed-end fund, which trades throughout the trading day at prices that may be more or less than its net asset value. (Closed-end funds are not considered to be “ETFs”, even though they are funds and are traded on an exchange.) Nearly all ETFs are index funds (only a few are actively managed), and their fees are typically quite low.

Although in common parlance the term ETF is used to connote all exchange-traded products (ETPs), technically ETPs include four different legal structures:

- *Exchange Traded Fund (ETF)*: an open-ended Registered Investment Company (RIC) or Unit Investment trust (UIT) that is registered under the Investment Company Act of 1940.
- *Exchange Traded Vehicle (ETV)*: an open-ended trust or partnership unit that is registered under the Securities Act of 1933. Many commodity and currency funds are ETVs.
- *Exchange Traded Note (ETN)*: A senior unsecured debt obligation of a public company issuer, designed to track the total return of an underlying index or other benchmark, minus investor fees. They are redeemable to the issuer.
- *Certificate*: A security with the characteristics of a complex debt instrument. They are issued by a public company issuer (usually banks) and have settlement terms on a given date that are known at the time of issue. They cannot be redeemed to the issuer.

At SelectAlts, when we use the term “ETF,” we are including all of these exchange-traded investment instruments.

Alternative ETFs

In the last few years a number of “alternative ETFs” began trading in the U.S. These ETFs use hedge fund-like investment strategies and instruments such as:

- Commodities
- Currencies
- Long/short equities
- High yield debt
- Emerging market debt and equity
- Real estate debt and equity

- Merger arbitrage
- Publicly traded venture capital
- Equity market volatility futures
- Inflation-indexed debt

These investments may have a relatively low correlation to U.S. stocks and bonds, offering the prospect of lowering portfolio risk through diversification when they are included in an investor's portfolio.

Characteristics of ETFs

Compared to investing in alternatives either through a fund of funds or a collection of hedge funds, SelectAlts ETF portfolios are designed to be more attractive by providing the following benefits:

- *Lower cost:* Nearly all ETFs are index funds. They tend to have much lower fees than actively managed funds, and they do not have performance or incentive fees.
- *Style purity:* Because they are index funds, ETFs must follow their published underlying indexes and the related strategies as described in their prospectuses.
- *Greater liquidity:* ETFs trade every day on U.S. stock exchanges which facilitates tactical and opportunistic shifting among alternative strategies.
- *Unambiguous pricing:* Because they trade every day, fair entry and exit pricing, and fair marking-to-market, are inherent.
- *Absolute transparency:* ETFs are required to post their holdings daily.
- *Increased diversification:* ETFs are portfolios with a common underlying investment strategy or theme, lowering security-specific risk, as no single holding will typically be more than 10% of the fund.
- *Greater investor protections:* As registered public securities, ETFs are subject to a high degree of regulation to protect the public from fraud and abuse.