What is an ETF

Exchange traded funds (ETF) are unit trust funds that are listed & traded on a stock exchange. They are open-ended, index tracking funds which invest in a basket of securities (eg. stocks, bonds, commodities, etc.) to mirror the performance of the index that it tracks.

Think of them as a cross between an index fund and a stock. Like index funds, they are passively managed and low-cost funds that invest in all the constituents of the index that it tracks providing diversification.

But like stocks, they are bought through a brokerage account and are traded on an exchange anytime during trading hours. Thus, it combines the characteristics of both instruments providing investors with each of their distinct benefits.

> What are the Advantages of Investing in ETFs

The following are the distinct advantages of investing in ETFs:-

- **Low-cost** – Passive solutions like index funds or ETFs will have lower fees since there is no need for detailed analysis and selective stock-picking, as it merely tracks the index. Thus, ETFs will incur lower management fees and transaction costs.
- **Tradability** – As ETFs are listed on an exchange similar to how stocks are, they can be bought or sold anytime during regular trading hours. As such, ETFs can be traded intraday mand allow investors to take profit from shorter-term market movements.
- **Diversification** – ETFs offer investors a simple method of constructing a diversified portfolio in a cost-efficient manner. By investing in an ETF, investors can gain broad exposure across various markets & sectors, as opposed to holding all the stocks in the particular index.

> What are the Risks?

An investor should also consider the following risks when investing in ETFs:-

- **Performance** – Because of their cost-effective manner, ETFs will have limitations on their performance where at best the returns will equal the market's average returns, minus the expenses or fees incurred (however low). Since they are no active managers as well, there are no real attempts to try and outperform the benchmark index.
- **Lack of Discretion** – Also, because ETFs only tracks the performance of an index, an investor will have less control over his investments. For example, an investor may decide to hold securities in different weightages from the index or perhaps even select securities that are not in the index at all. A portfolio constructed entirely of ETFs, will not allow investors that degree of flexibility.
- **Concentration Risk** – There is also a potential disadvantage for ETFs to be unduly concentrated in certain sectors, especially during periods of excessive market exuberance which could lead to inflated valuations.

> Who Should Invest in ETFs?

Like all investments, ETFs do not come without risk nor do they guarantee returns. Similar to stocks or unit trusts, ETFs are subject to the same type of market dynamics and factors that could influence its returns and performance.

As the objective of an ETF is to track the performance of an index, its returns will only be as good the performance of the constituents that make up the index. As such, its performance will fluctuate accordingly to markets peaks and troughs.

However, due to its passive strategy - ETFs may be more suited towards investors who are in for the long-haul, and employ a buy-and-hold strategy. Passive investments are generally held over the long-term before they exhibit material results, and may be suited for investors with a similar longer-term investment timeframe.

Likewise, investors who are looking to gain broad exposure in their portfolios could also consider ETFs as a cost-efficient approach to diversify their investments through a single instrument.

> Comparison between ETFs, Stocks and Unit Trusts

	ETF	Stock	Unit Trust (including index funds)
Trade via	Broker	Broker	Agents
Initial Fee	Brokerage fees apply consisting of clearing fees and stamp duties where applicable	Brokerage fees apply consisting of clearing fees and stamp duties where applicable	Upfront sales commission between 3% to 5%
Annual Management Fee	Less than 1% of the fund's NAV	None	Between 0.75% to 5% per annum of the fund's NAV.
Diversification	Yes	None	Yes
Pricing	Intraday Investors can execute trades throughout the day during normal market hours	Intraday Investors can execute trades throughout the day during normal market hours	Once a day, at close of business All purchases or redemptions are entered based on a single price at the end of the trading day