Exchange-Traded Funds

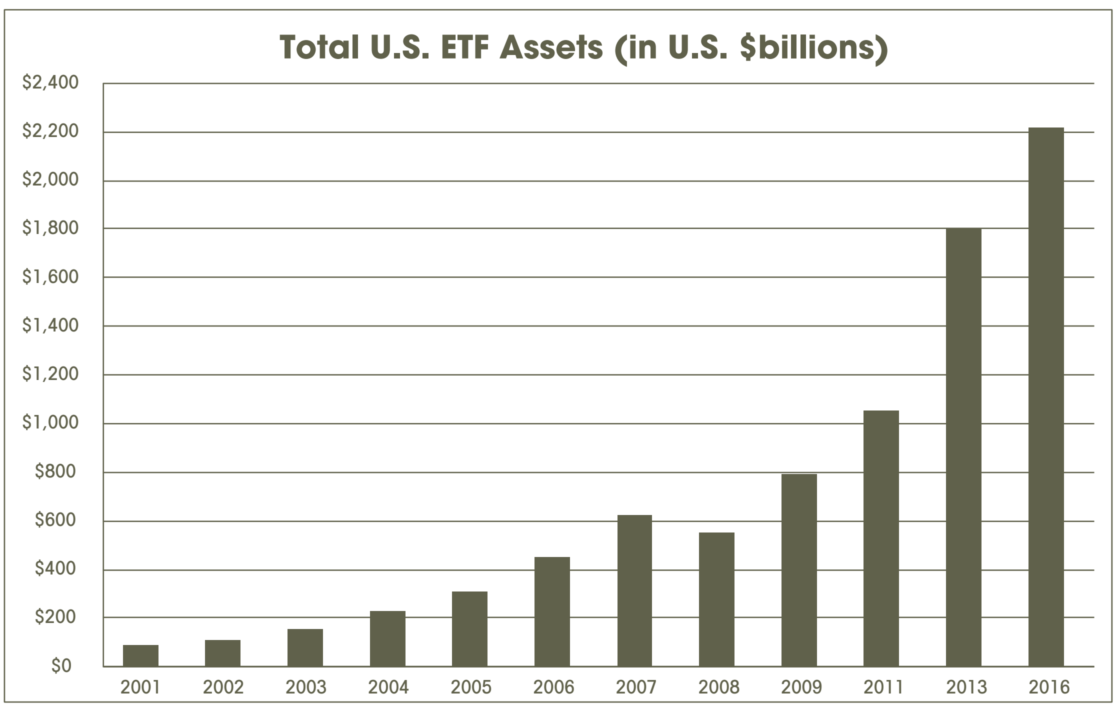
June 2016

An exchange-traded fund (ETF) is a portfolio of stocks, bonds, or other investments put together to be traded as a single security. Since ETFs were introduced in the mid-1990s, they have grown steadily in popularity and variety. ETFs offer investors many benefits including the ability to improve portfolio diversification and minimize single-issue stock risk.

Many ETFs combine the features of an open-end mutual fund with the features of a stock. Like an indexed mutual fund, an ETF gives investors partial ownership in a portfolio that tracks a specific market index or industry sector. Like stocks, ETF shares can be bought and sold on an exchange throughout the day. By contrast, mutual funds are priced only once a day, at the close of trading. Prices of ETFs fluctuate with changes in their underlying portfolios, as well as changes in the supply of and demand for the ETF shares themselves. ETFs offer investors a cost-effective opportunity to buy or sell their interests in a portfolio of stocks or bonds in a single transaction.

Partly as a result of their efficient pricing, ETFs are a popular and fast-growing fund category. The size, growth, and liquidity of ETFs all reflect investors' increasing interest in this product (see chart). ETFs are an effective way to achieve precise strategic and tactical market exposure through focused low-cost, tax-efficient index funds.

Among the most popular issuers of ETFs are Vanguard, BlackRock Institutional Trust (iShares), Invesco (PowerShares), and State Street Global Advisors. State Street Global Advisors products include the SPDR S&P 500 ETF (SPY), which tracks the S&P 500, and the SPDR Dow Jones Industrial Average ETF Trust (DIA), which tracks the Dow Jones Industrial Average.



Source: Strategas Research Partners

Individual and institutional investors both use ETFs for a variety of purposes: short-term trading, intermediate-term sector rotation, tactical asset allocation, long-term buy-and-hold strategies, and hedging. Investors typically find the following characteristics of ETFs most attractive:

- **tax-efficiency – low turnover, as with index funds**
- **trading flexibility – intraday pricing and liquidity**
- **low expense ratios – similar to those of index funds and often significantly lower than those of actively managed mutual funds**
- **a diverse array of investments**
- **participation in an entire market segment – through regional and international ETFs**
- **reduction of single-issue stock risk**

ETFs give investors access to a wide variety of sectors and indices. They are currently available in multiple benchmark categories, including

- **small-, mid-, and large-capitalization stocks**
- **growth, value, and core stocks**
- **international (by region or by country) and global investments**
- **U.S. industry sectors**
- **fixed-income securities**
- **emerging technologies investments**
- **foreign currencies**
- **commodities**
- **reverse market funds (used for hedging stock market risk)**

ETFs offer price specificity and hedging capabilities that traditional mutual funds do not. For example, intraday pricing quickly reflects sudden changes in value. Investors may place limit orders or stop orders on purchases or sales.

Exchange-traded funds are effective tools for both traditional and nontraditional investment strategies. At Longer Investments, we use ETFs

- **to increase or to decrease our exposure to a specific investment style, sector, or market capitalization**
- **to pursue sector rotation strategies**
- **to maintain investment positions when harvesting tax losses**
- **to engage in international investing**
- **to hedge risks**

At Longer, we also use ETFs to gain a foothold in undervalued industries and to mitigate the risks associated with single-issue stocks. If the underlying industry begins to show momentum, an ETF can be sold, and the proceeds can be reinvested in promising individual stocks. ETFs also provide valuable exposure to emerging industries, such as those involved in nanotechnology, water technology, and biotechnology. It is usually safer to buy a basket of stocks in an emerging-technology index than to bet on one or two stocks in a new sector.

The variety of products in the ETF market has exploded in recent years, and the pace shows no signs of slowing. Since January of 2013, 521 new funds were launched and the total number of ETFs grew to 1,884, amounting to $2.22 trillion in assets. Newly created ETFs also give traditional investors an opportunity to participate in alternative investment markets, including commodities and currencies.

The Securities and Exchange Commission is considering ways to speed up the regulatory approval process for ETFs. A faster and less cumbersome process would clear the way for even more ETF launches. Now that the ETF industry has surged to more than 2.22 trillion dollars in assets, it is clear that the product is a powerful force in the market.