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Types of Exchange-Traded Funds

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ETFs: growing in diversity

Though individual investors have not been investing in exchange-traded funds as long as they have mutual funds, there is already a long menu of possibilities from which to choose.

The following is a sample of broad categories of exchange-traded funds, though as the industry grows, new types of ETFs will doubtless emerge. For example, most ETFs are passively managed to reflect a particular index; however, a few actively managed ETFs also have begun to appear.

Caution: *Before investing in an exchange-traded fund, carefully consider its investment objectives, risks, fees, and expenses, which can be found in the prospectus available from the fund. Read it carefully before investing.*

Broadly focused ETFs

Many of the earliest and most widely adopted ETFs track a broad index of securities, such as the S&P 500 or the NASDAQ. Most broad-based ETFs track a stock index, though that may not always be the case as the number of ETFs grows. Though there are differences in how the two operate, a broad-based ETF is somewhat similar to an index mutual fund in that it is typically not actively managed. However, even passively managed ETFs may rely on an index that exhibits some aspects of active management--for example, one that selects and weights the securities in the index based on fundamental data.

Narrowly focused ETFs

A narrowly focused ETF also tracks an index, but one that concentrates on a particular sector or the market or subset of an asset class. Investors who are interested in a particular field but are unfamiliar with or reluctant to invest in individual companies in that industry sometimes choose a narrowly focused ETF as an alternative to buying individual stocks. Many ETFs introduced in recent years have been narrowly focused. Some examples of narrowly focused ETFs include:

- Funds focused on a particular country, region, or group of countries (i.e., ETFs that invest in the so-called BRIC countries: Brazil, Russia, India, and China).
- ETFs that invest only in a specific industry, which may be quite targeted.
- Funds that invest in a particular alternative asset class. For example, ETFs have become a popular way to invest without having to buy and hold physical assets such as gold or commodities.
- Funds that concentrate on companies at a particular stage of their life cycle, such as spinoffs or IPOs.

Strategy-based ETFs

Though a strategy-based ETF may track an index, the index itself may reflect a particular investing strategy. For example, an ETF might include investments designed to profit from specific currency fluctuations, such as a weaker dollar. Or it might use leverage to attempt to magnify the movements of a particular index. A leveraged ETF might be designed to go up or down by twice as much as the S&P 500 stock index. An inverse ETF's goal would be to deliver the opposite results from those of the index, going down when the index rose, and vice versa. A leveraged inverse ETF might attempt to not only move in the opposite direction from its benchmark index, but by two or even three times as much.

Strategy-based ETFs often use complex financial instruments such as derivatives to try to achieve their intended results. Those investments involve their own risks, which should be considered carefully before investing. Because they can be extremely volatile, leveraged and inverse ETFs in particular are not suitable for all investors.

Caution: *Leveraged and inverse ETFs are designed to achieve their results on a daily basis. However, their performance can differ significantly from the daily results of the index a given ETF tracks. In some cases, those differences can be dramatic; leveraged ETFs (non-inverse) have even been known to move in the opposite direction from their benchmark. And even small differences can be magnified over time by the effects of compounding. As a result, such investments are typically not well suited for individual investors who plan to hold them for more than a day. Leveraged and inverse ETFs may be more costly and less tax-efficient than traditional ETFs.*

Tip: *Check on an ETF's track record. As ETFs have become more popular, more and more have been introduced, many with innovative strategies that may or may not have been proven over time. Check on how an ETF's record has held up not only in back-testing of its strategy but in the real world.*

To schedule an appointment with Faye Sykes, click [here](#) .

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