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I sometimes hear people talk about ETF investing as something special, different, maybe even sophisticated. Allow me to attempt to demystify.

ETF stands for Exchange Traded Fund. They are pooled investments that trade on an exchange which means you can buy and sell them throughout the day. This is unlike traditional, open-end, mutual funds which are bought and redeemed daily and only directly from the mutual fund company itself.

There are over 2,000 different ETFs available and almost all follow an index. So, think of them as index funds trading throughout the day. The indexes they follow can be like the familiar S&P 500 or Dow Jones Industrials, or something more esoteric like social media companies or pet-care companies.

Be careful, though, as some ETFs do not trade very often. If so, I think it may be better to stay away as you may get a less favorable price during a sudden large selloff.

Next, keep commissions in mind. If you save to invest frequently, maybe per paycheck, buying ETFs with relatively small amounts could potentially make the commissions add up to a significant ‘toll’. Then, maybe consider open-end index mutual funds which may not charge a load (‘load’ is mutual fund lingo for commission).

A potential benefit of ETFs is that they may be more tax efficient than mutual funds. If you own mutual funds you might be used to receiving a form 1099 early in the year listing your capital gains even if you never sold any mutual fund shares. This happens because mutual fund companies may sell investments in the fund and realize gains. The fund is required to distribute these capital gains to you, the shareholder.

Studies show that the potential avoidance of capital gains distributions may equal a full percentage point of your total return. That’s significant as your long-term return may be less than ten percent annually.

In the end, I believe most ETFs are pretty straight forward. Like any other investment, use them if you believe they fit with your overall portfolio plan.

Good luck.

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Exchange-Traded Funds are subject to risks similar to those of stocks. Investment returns may fluctuate and are subject to market volatility, so that an investor’s shares, when redeemed, or sold, may be worth more or less than their original cost. Exchange Traded funds may yield investment results that, before expenses, generally correspond to the price and yield of a particular index. There is no assurance that the price and yield performance of the index can be fully matched. S&P 500 Index: The S&P 500 Index consists of 500 stocks chosen for market size, liquidity, and industry group representation. It is a market value weighted index with each stock's weight in the Index proportionate to its market value. Dow Jones Industrial Average: The Dow Jones Industrial Average is a price-weighted index of 30 "blue-chip" industrial U.S. stocks.
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