

What is Exchange Traded Funds (ETF)?

An exchange-traded fund (ETF) is a basket of securities that trades like a stock. Unlike mutual funds, ETF prices fluctuate all day and can track or outperform an index.

Exchange-traded funds (ETFs) are SEC-registered investment vehicles that provide investors with a means of pooling capital to invest in stocks, bonds, or other assets. In return for their investment, shareholders receive a proportionate interest in the fund's holdings. The majority of ETFs are professionally managed by SEC-registered investment advisors. It combines the features of different investment options, such as mutual funds and stocks. While it is like index funds, there is a point of difference. ETFs can be bought or sold on stock exchanges like stocks.

More important details are provided in the following sections.

What is an Exchange Traded Fund (ETF)?

An exchange-traded fund (ETF) is a diversified investment vehicle that aggregates a basket of securities, such as equities or bonds. ETFs offer investors the opportunity to gain exposure to a broad range of assets with relative cost efficiency and enhanced liquidity compared to traditional funds.

However, it is imperative to evaluate ETFs on an individual basis, considering factors such as management fees, transaction costs, ease of trading, alignment with existing investment strategies, and the underlying quality of the securities held within the ETF.

Types of ETFs

Discussed below are the various types of Exchange Traded Funds:

1. Equity ETF

Equity ETFs are described as passive investment options combining the features of stocks and equity mutual funds. Investors can trade these funds on stock exchanges, namely the NSE (National Stock Exchange) or BSE (Bombay Stock Exchange). They can purchase or sell these funds at market prices on a real-time basis.

While the minimum investment quantum is one unit, there is no specification regarding the minimum investment amount. Equity ETFs are cost-effective and provide transparency regarding their holdings.

2. Bond ETF

Through bond ETFs, investors receive exposure to various fixed-income instruments such as Government bonds (with different maturities) and debentures. These ETFs combine the features of stock investments with the benefit of debt investments and the simplicity of mutual funds. People can trade bond ETFs on the open cash market.

3. Commodity ETF

Gold and silver ETFs are the only commodity ETFs available in India right now. These are passively managed funds tracking an underlying market index. The NAV (Net Asset Value) of commodity ETFs is subject to change throughout the day. The movement in prices depends on the demand and supply of the commodity in the markets.

4. Sectorial/ thematic ETF

A sectorial or thematic ETF tracks the performance of a particular sector or theme. A sectorial Exchange Traded Fund invests in a specific industry, such as banking, pharmaceuticals, and real estate. A thematic ETF focuses on an idea that encompasses multiple sectors like consumption or ESG (Environmental, Social, and Governance).

5. International ETFs

International Exchange Traded Funds replicate the index of a foreign country or that of the global market. These ETFs provide the opportunity to invest directly in foreign companies. They are similar to international mutual funds. Investors could use such ETFs to diversify the political and geographical risks associated with their portfolios. The price determination depends on the region-specific timelines and takes place at the end of the day.

6. Index ETFs

Index ETFs are designed to replicate the performance of a specific market index, such as the Nifty 50, Sensex. Investors who believe in the overall performance of the market can invest in these ETFs without the need to select individual stocks. Index ETFs offer broad diversification and are often considered a passive investment strategy.

7. Fixed Income ETFs

For investors seeking exposure to the bond market, fixed income ETFs provide a convenient and diversified option. These ETFs track various bond indices, including government bonds, corporate bonds, and even international bonds. They offer a way to invest in fixed-income securities without the need for extensive research and portfolio management.

8. Leveraged ETFs

Leveraged ETFs employ leverage to amplify the returns of the underlying index. This means that these ETFs can generate significantly higher returns than the index during periods of market growth. However, it's important to note that leverage can also magnify losses during market declines. Leveraged ETFs are suitable for experienced investors who understand the risks associated with leverage.

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What things to consider before investing in ETFs

Given their hybrid nature, ETFs offer a unique blend of the benefits of stocks and mutual funds. To effectively utilize ETFs, investors must possess a solid

understanding of both asset classes. ETFs provide flexibility in investment planning and offer diversification opportunities across various security types. However, thorough research is essential to maximize the potential of ETF investments.

1. Analysing underlying assets

ETF performance is directly linked to the underlying assets they track. Investors should conduct a thorough analysis of these assets, considering factors such as risk, return, volatility, investment horizon, alignment with financial goals, and desired portfolio allocation. This DIY approach is particularly suitable for confident investors seeking convenient exposure to specific asset classes.

2. Evaluating bid-ask spreads

In stock exchanges, buyers and sellers engage in bidding and asking for securities. The difference between the bid and ask prices, known as the bid-ask spread, indicates the ETF's liquidity. A narrow spread signifies high liquidity, implying ample trading activity and ease of buying and selling ETF units. Conversely, a wide spread suggests lower liquidity.

3. NAV vs iNAV

While ETFs derive their pricing from bid-ask spreads, they share a similarity with mutual funds in terms of net asset value (NAV). Mutual funds calculate their NAV at the end of each trading day, reflecting the value of underlying assets. ETFs, on the other hand, use an Indicative Net Asset Value (iNAV) calculated using a similar formula. Investors can compare the ETF's asking price to its iNAV to ensure fair pricing and monitor the iNAV to gauge ETF performance.

4. Considering costs

ETFs generally have lower expense ratios than actively managed mutual funds due to their passive management approach. However, investors should factor in additional costs such as trading fees and demat account maintenance charges. If a demat account is not already in place, the costs associated with opening and operating one, as well as the quality of broker services, should be considered.

5. Understanding tax implications

To make informed investment decisions, investors should be aware of the tax treatment of ETFs. ETFs are categorized into equity and non-equity (debt, commodity, and international) types for tax purposes, impacting their tax implications.

How do Exchange Traded Funds work?

ETF builds a fund by investing in a collection of assets based on a benchmark index. Traders can purchase units of an ETF funds in the same way they purchase stocks of a firm. ETF trading takes place on a stock exchange throughout the day.

ETFs function like a basket of investments traded on a stock exchange. The provider creates the ETF by pooling underlying assets like stocks or bonds, then offers shares in this basket to investors. While investors own a portion of the ETF, they don't directly own the underlying assets. ETFs that track a stock index can distribute dividends to shareholders, similar to how the companies within the index pay dividends.

How to buy and sell ETFs?

Given below are steps to purchase units of an ETF:

Step 1: Open a Demat and trading account with an online brokerage firm. Before that, conduct thorough research and decide on the fund to invest in.

Step 2: A variety of options will be available depending on the AMC (Asset Management Company). Insert the correct symbol and number of shares to purchase.

Step 3: Depending on the preferred ETF transaction, place an order and click on 'submit'. After the completion of the deal, the investor will receive an order update.

Investors can sell ETFs throughout the day. It enables them to benefit from intraday price changes. This is in stark contrast to mutual funds, where investors can make a purchase or redemption only at the end of a trading day.

Conclusion

Exchange Traded Funds are a useful investment option for investors who wish for exposure to a particular asset class, industry, region, or currency. People don't have to worry much about conducting thorough research on specific sectors or industries. Furthermore, due to low operational expenses, these assets are well-suited for long-term investments.

While the popularity of ETFs is growing rapidly, it would be wise if investors evaluated which funds would be best suited for them after formulating their investment goals and assessing their risk appetite.



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