Research & Guidance for the
INDIVIDUAL INVESTOR

November 2010

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Find ETFs to help meet your investment goals.

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ETFs: Different From Mutual Funds

Source: McGraw-Hill Financial Communications

ETFs often present lower costs, tax advantages and a high degree of transparency.

Summary Points

- Exchange Traded Funds (ETFs) are baskets of securities that typically reflect the composition of an index.
- Like individual securities, ETFs are traded in real time at prices that change throughout the trading day depending on investor demand.

- ETFs generally have lower expense ratios and may be less likely to generate capital gains compared with mutual funds.

You've probably heard of Exchange Traded Funds (ETFs), but you may not have a clear idea of how they work, how they differ from mutual funds or how they might fit in your investment portfolio. Here's your chance to take a closer look at ETFs and examine the characteristics they share with mutual funds as well as those that set them apart.

If you decide ETFs may be a good choice for you, TD Ameritrade invites you to visit the new **ETF Market Center** where you'll find more than 100 commission-free ETFs.[1]

Mutual Funds That Trade Like Stocks

Although ETFs and mutual funds both register with the SEC as investment companies, they are structured and operate quite differently.

Mutual funds pool investor's money to purchase a portfolio of securities. Each investor owns shares, which represent a portion of the holdings of the fund. Shareholders buy and sell shares based on the funds net asset value (NAV), which is calculated daily and fluctuates as fund holdings and shares outstanding change. Some mutual fund shares can be purchased from fund companies directly, while others are sold through brokers, banks, financial planners or insurance agents. If you purchase mutual fund shares through a third party, there is a good chance you will pay a sales commission, or load. Increasingly, funds can be purchased through no-transaction-fee fund supermarkets that let you buy funds from many different companies.

When describing ETFs, it may help to think of them as mutual funds that trade like single stocks. ETF shares are created when an institutional investor or "authorized participant" deposits a specified block of securities with the fund. This "basket" of stocks reflects the composition of an index, such as the S&P 500 or the Nasdaq 100. Individual investors can buy and sell ETF shares only after they are listed on an exchange such as the American Stock Exchange (AMEX) or the New York Stock Exchange (NYSE). Unlike mutual funds that must be purchased or sold at their end-of-day NAV, ETFs can be bought and sold in real time at prices that change throughout the day. Although ETFs still calculate an end-of-day NAV, intraday prices are based on investor demand. ETFs can thus be used for certain hedging strategies typically associated with stocks, such as buying on margin and selling short.

Comparing Costs

One of the key selling points of Exchange Traded Funds is cost. ETF expense ratios are generally lower than no-load index mutual funds and are significantly lower than actively managed mutual funds.[2] For instance, the average expense ratio is 0.57% for ETFs, 0.94% for index funds and 1.17% for actively managed funds.[3]

These cost savings can be significant, especially for long-term investors. Although ETF investors will pay a brokerage commission on a per-trade basis to buy or sell shares, the savings from lower expenses can help offset these transaction costs.

Tax Consequences

One major tax advantage that sets ETFs apart from mutual funds is that ETF shareholders are not affected by the trading activity of fellow investors. For instance, mutual fund managers may be forced to sell portfolio holdings to meet the redemption demands of certain fund investors, resulting in an unexpected capital gain or loss to all shareholders. With ETFs, since trading takes place on an exchange between investors, the fund doesn't need to sell stock to meet redemptions, thereby avoiding unforeseen tax events. In addition, the generally low portfolio turnover rate of ETFs contributes to their lower operating costs.

It should be noted that mutual funds and ETFs are required to make annual capital gains distributions to investors, which may be caused by index rebalancing. But as noted above, for ETF investors, capital gains distributions are never caused by redemptions in the fund.

Fund Transparency

In the wake of recent scandals affecting the financial services industry, investors are increasingly demanding more transparency with regard to fees, portfolio holdings and other operational features. By design, ETFs and index mutual funds deliver greater transparency than actively managed mutual funds because their composition and performance are tied directly to the indexes they mimic. Individuals can easily gauge the performance of their investment by referring to the index it follows. By comparison, the holdings in actively managed funds are subject to change and are less easy to monitor.

A Balancing Act

Perhaps the biggest concern for investors with regard to ETFs is derived from one of their greatest attractions. ETFs are so easily bought and sold through a broker or by accessing an online trading account that investors could be tempted to trade too frequently and eliminate any tax or cost advantages due to transaction costs. Therefore, as with any other investment, ETFs should be considered carefully and used only as part of a tailored investment strategy.

At-a-Glance Comparison

Attribute	Exchange Traded Fund	Mutual Fund
Trading	Buy or sell on an exchange at "real time" prices throughout the day.	Buy or sell once a day at the closing net asset value.
Buy on margin/Sell short	Yes.	No.
Purchase/Sale	Buy through online trading account or through broker.	Buy direct from fund company, through a third party (broker, bank, financial advisor) or fund supermarket.
	Expense ratio is generally lower than index or actively managed mutual funds;	May be subject to front-end or back-end sales loads and annual

Expenses	managed mutual funds, brokerage commissions are charged on a per-transaction basis.	management expenses, including 12b-1 fees; however, some funds may not charge a sales load.
Tax consequences	Same as for individual stocks.	Same as for individual stocks; may force unwanted capital gains distribution due to trading activity of other fund shareholders. ■

[1]To trade commission-free ETFs, you must be enrolled in the program. Eligible ETFs purchased commission-free must be held for at least 30 days. If you sell an ETF within 30 days of its being purchased commission-free, a short-term trading fee will apply.

[2]An expense ratio represents the percentage of fund assets paid for operating expenses and management fees, including 12b-1 fees, administrative fees and all other asset-based costs incurred by the fund except brokerage and trading costs.

[3]Source: Morningstar, December 2009. Expense ratios are calculated from actual expenses paid if available; otherwise, they are calculated from the stated expense ratio in the fund's prospectus.

Before investing in an ETF, be sure to carefully consider the fund's objectives, risks, charges and expenses. For a prospectus containing this and other important information, please visit www.tdameritrade.com or call a TD Ameritrade representative at 800-669-3900. Please read the prospectus carefully before investing.

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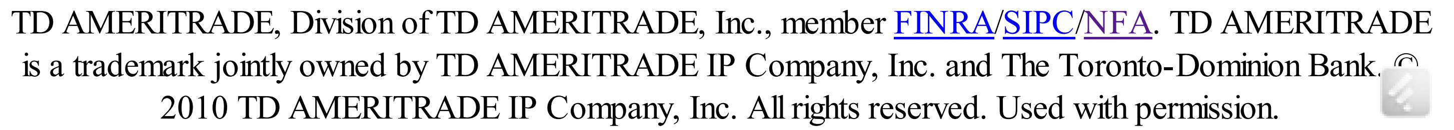
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