Foundations of ETFs

ETF Academy

What's an ETF?

An ETF is like a mutual fund in that it invests in a basket of securities, but it trades like a stock on an exchange.

Mutual fund similarities

- Hold multiple underlying securities to meet a specific investment objective
- Have an expense ratio
- Have an official end of day NAV
- Open-ended '40 Act Investment Companies

ETF

Stock similarities

- Trade intraday on stock exchanges
- Have opening and closing auctions
- Can be bought/sold with different order types including market, limit and stop loss

Who's who?

ETF ecosystem

Individual Investor
Buys and sells ETF shares on an exchange through a brokerage account

ETF Sponsor
Generally, a financial institution that creates and administers an exchange-traded fund

Authorized Participant (AP)[1]
An entity that enters into a contract with the ETF sponsor to create and redeem shares

ETF Market Maker
Normally, a financial firm that actively trades ETFs and provides markets (both bids and offers) on the stock exchange

Why the hype?

Just like mutual funds, ETFs serve as a tool for investors to easily access various exposures and portfolio outcomes. So, what are some of the reasons investors may prefer the ETF vehicle?

Trading liquidity

- Investors can have more control over when and how they buy and sell shares.
- ETF prices are updated several times per minute as stock prices change, while mutual funds are priced once per day when the market closes at 4 p.m. ET.

Generally lower costs

- While you might pay a brokerage fee for trading, ETFs do not have sales or distribution charges like many mutual funds.
- Many ETFs follow passive strategies, reducing management expenses.
- Even newer active ETF strategies try to keep management expenses lower than on a mutual fund, to compete against passive ETFs.

Tax efficiency

- With mutual funds, **a capital gains liability** can occur for **all shareholders** when the manager sells holdings for cash to shareholders who redeem their shares.
- ETFs are typically more tax efficient than mutual funds because ETF shares are frequently redeemed in-kind by the Authorized Participants. This means that an ETF may deliver specified portfolio securities to Authorized Participants who are redeeming creation units instead of selling portfolio securities to meet redemption demands.

Transparency

- Most ETFs have to disclose holdings daily. (The exception would be non-transparent ETFs that may disclose monthly or quarterly).
- This gives investors the most visibility into what they own, so they can make timely investment decisions.

Have it your way

Types of ETFs

Index ETFs

- First ETF was index tracking, launched in 1993
- Tracks a rules-based index, which may range across geographies, asset classes, and goals
- Trading coincides with index rebalances (typically semi-annually or quarterly)

Active ETFs

- First active ETF launched in 2008
- Flexibility to invest opportunistically and/or defensively outside of a stated benchmark
- Trade frequency at discretion of investment team

You're only as good as your tools

Use cases for ETFs

Whether they are being used as trading instruments or longer-term portfolio holdings, there are a variety of ways investors can use ETFs as a portfolio solution.

- **Cash equitization**
- **Transition management**
- **Rebalancing**
- **Liquidity sleeve**
- **Tactical adjustments**
- **Core holding**
- **"All-ETF" portfolios**

1. Prior to trading in the secondary market, shares of the fund are "created" at NAV by market makers, large investors and institutions only in block-size Creation Units. Each "creator" or "Authorized Participant" may create or redeem Creation Units directly with the ETFs. Retail investors buy and sell shares of ETFs at market price (not NAV) in the secondary market throughout the trading day. These shares are not individually available for purchase or redemption directly from the ETF.

IMPORTANT INFORMATION

All investments involve risks, including possible loss of principal.

ETFs trade like stocks, fluctuate in market value and may trade at prices above or below the ETF's net asset value. Brokerage commissions and ETF expenses will reduce returns.

ETF shares may be bought or sold throughout the day at their market price, not their Net Asset Value (NAV), on the exchange on which they are listed. Shares of ETFs are tradable on secondary markets and may trade either at a premium or a discount to their NAV on the secondary market.

Franklin Templeton, its affiliated companies, and its employees are not in the business of providing tax or legal advice to taxpayers. These materials and any tax-related statements are not intended or written to be used, and cannot be used or relied upon, by any such taxpayer for the purpose of avoiding tax penalties or complying with any applicable tax laws or regulations. Tax-related statements, if any, may have been written in connection with the "promotion or marketing" of the transaction(s) or matter(s) addressed by these materials, to the extent allowed by applicable law. Any such taxpayer should seek advice based on the taxpayer's particular circumstances from an independent tax advisor.

FRANKLIN TEMPLETON

franklintempleton.com

US-FTISETF-2159510-2634185
ETFB-FL-0424