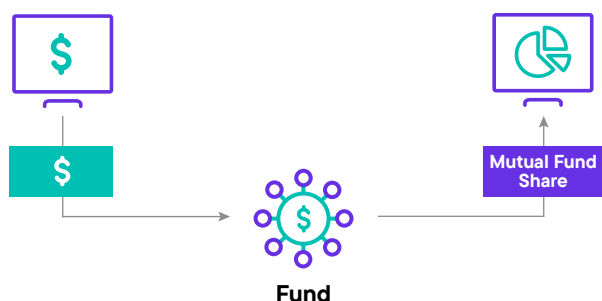


One of the hallmark differences of Exchange Traded Funds (ETFs) vs Mutual Funds (MFs) is that ETFs trade on an exchange. While an investor's experience for transacting in ETFs and mutual funds is the same, there are big differences in how the operations work behind the scenes.

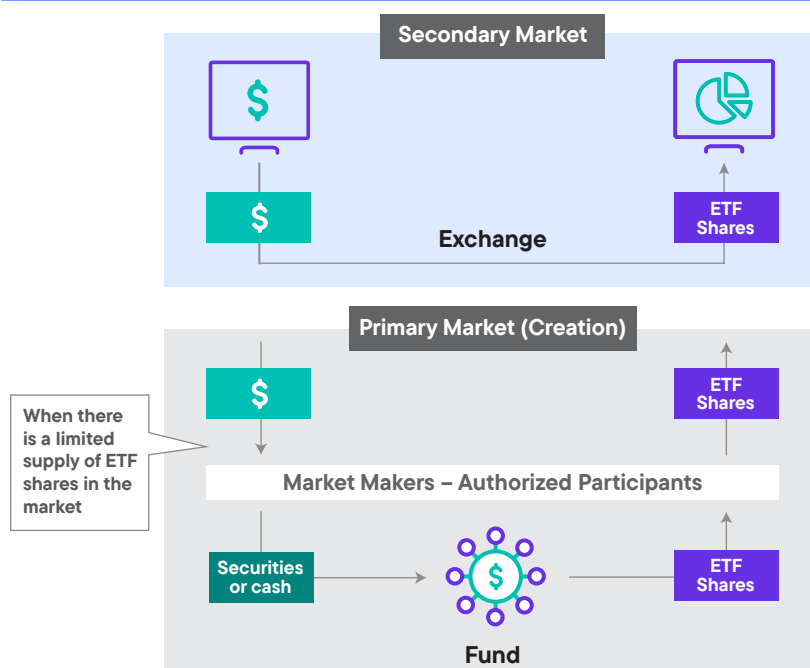
Authorized Participants (APs) and Market Makers (MMs) can use the creation/redemption process to manage their inventory if there is an imbalance between natural buyers and sellers. If there is an influx of buyers, they will meet that demand by selling ETF shares, buying the underlying basket of securities and delivering it to the sponsor as part of a creation.

Similarly, when there is an influx of sellers, the APs will buy ETF shares, deliver them to the sponsor in exchange for the basket of securities, which they will sell in the market. For established products with high volumes, buyers can transact with sellers on the exchange, often without triggering any trading in the underlying basket of securities.

Mutual fund purchase



ETF purchase



Jargon be gone

ETF trading glossary

Bid/Ask spread: The difference between the highest price an investor would buy an ETF (bid price) and the lowest price an investor would sell an ETF (ask price).

Creation unit: The smallest block of ETF shares that can be bought or sold from an ETF at net asset value (NAV). Size ranges from 25,000 to 600,000 shares.

Market price: An ETF's last reported price on a national stock exchange. An ETF price might be different than the fund's NAV.

NAV: Just like mutual funds, ETF NAV represents the value of the securities it holds (including cash), less its liabilities, divided by the number of shares outstanding. This is calculated once a day, after market close.

Primary market: Where mutual funds or ETFs shares are created to balance supply and demand on the exchanges.

Secondary market: Investors buy and sell shares of ETFs on an exchange—just like single securities.

Premium/Discount to NAV: Unlike regular mutual funds, which are bought and sold directly from the fund company at the net asset value of their portfolio securities, ETFs trade at prices determined by the market forces of supply and demand. A fund that trades at a price higher than its NAV is said to trade at a premium to its NAV. If the price of the ETF is trading below its NAV, the ETF is said to be trading at a discount.

ETF trading best practices

A

Allow time for market makers to set initial quotes. Often a single firm actively quotes new ETFs, so it is prudent to provide an opportunity for them to digest any market news as they set their initial markets, especially when some of the underlying securities may not have opened for trading. Investors should have an understanding of the normal spread for a newly listed ETF.

B

Call on capital markets for larger trades. A firm's capital markets desk works with market participants to foster healthy ETF trading. This can help both financial advisors and institutional clients have a positive experience when trading newer ETFs. For example, the capital markets desk can help connect investors with the seeding participants, who are often the best source of liquidity.

C

Don't forget what is happening in the markets. Many investors have turned to ETFs during recent periods of volatility. Yet it's best to keep in mind that volatile markets can also spell uncertainty for ETF pricing as prices of the underlying securities move sharply—leading to wider bid/ask spreads. It's always best to understand what's happening in the broader markets when entering any ETF order as well as the various options for trading (e.g., stop loss and limit orders). A limit order may be appropriate when you think you can buy at a price lower than—or sell at a price higher than—the current quote. A stop order is an order to buy or sell a stock at the market price once the stock has traded at or through a specified price.

D

Enjoy the optionality of trading throughout the day. After market open ETFs tend to trade efficiently throughout the rest of the day. Clients should be comfortable trading at any time during the trading day regardless whether the underlying markets of the stocks held by an ETF are open or closed.

For example, European stock trading overlaps with US stock trading by only two hours, yet the US market is generally proficient at estimating the price of international securities that are closed. Often called the **price discovery** mechanism, it is the market's attempt to price in the expectation of a security's next-day price based on current market conditions in the United States.

Bottom line

Innovation in the ETF marketplace has made a wide variety of new strategies available to investors—many of them designed to meet a growing range of needs that could serve as attractive additions to a portfolio. The simple steps outlined above are designed to give investors greater confidence in placing a trade in these newly introduced ETFs.

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.

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.

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 Distributors, LLC serves as the distributor of Creation Units for the ETFs on an agency basis. Franklin Distributors, LLC does not maintain a secondary market in the funds' shares.

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