Twitter Thread by Tar ■

Tar ■
@itsTarH

It's the weekend!
Grab a cup of coffee, in this thread I will explain

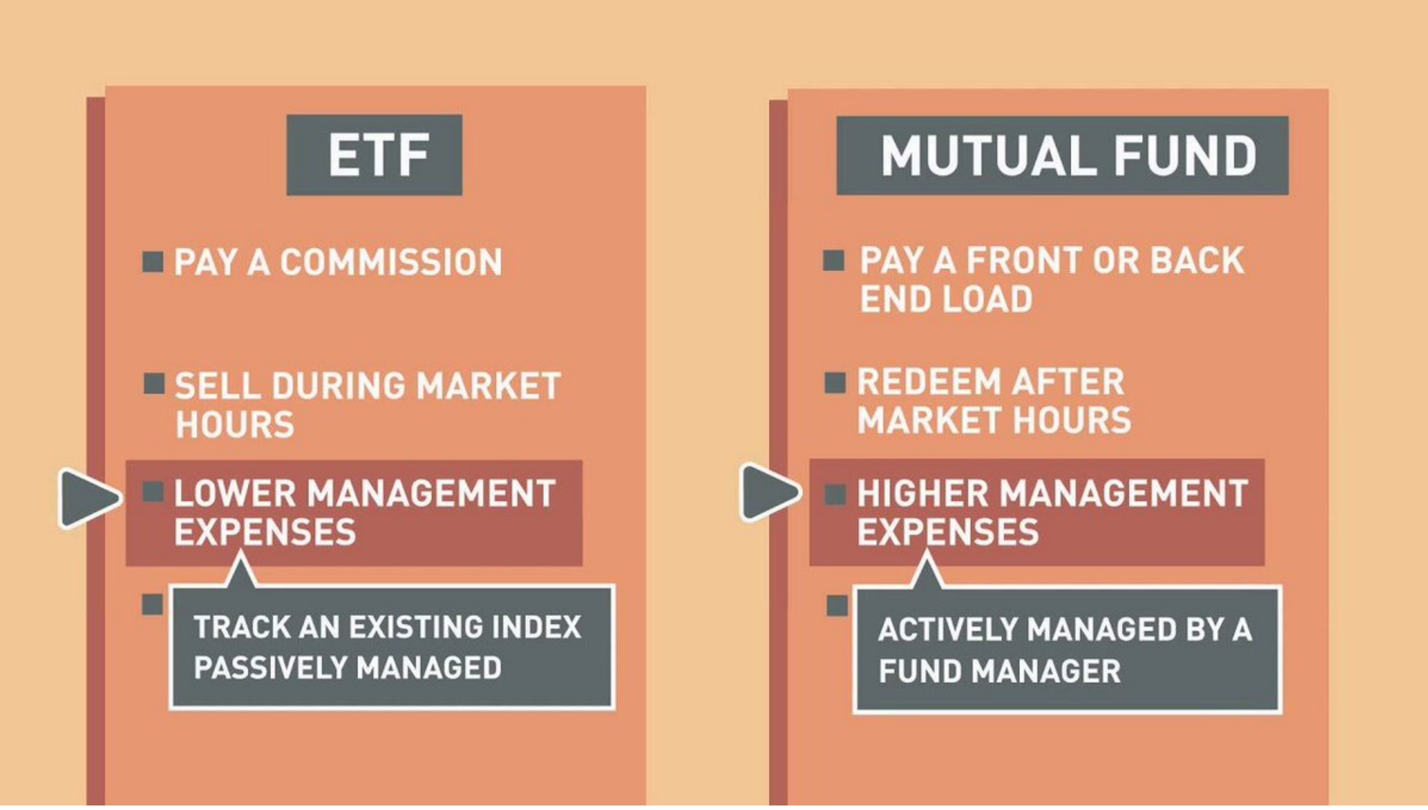
1. What are ETFs?
2. How are they different from Mutual Funds?
3. What are factors to consider while investing in ETFs?

Lets dive right in.

ETFs stand for Exchange Traded Funds

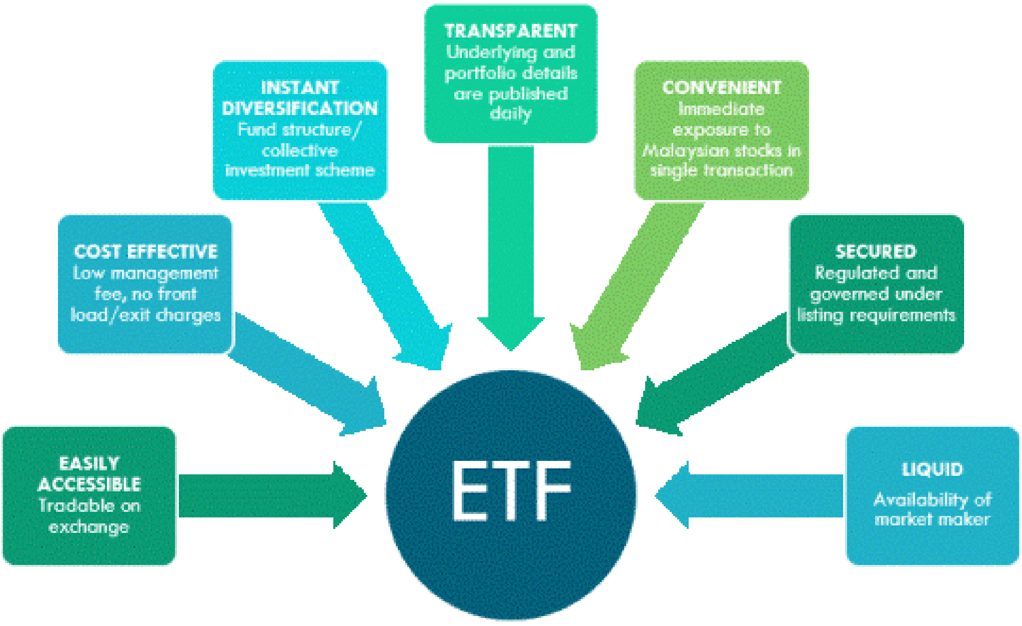
The easiest way to understand them is to think of them as Mutual Funds that are traded on the exchange just like stocks.

(technically, ETFs are nothing like Mutual Funds)



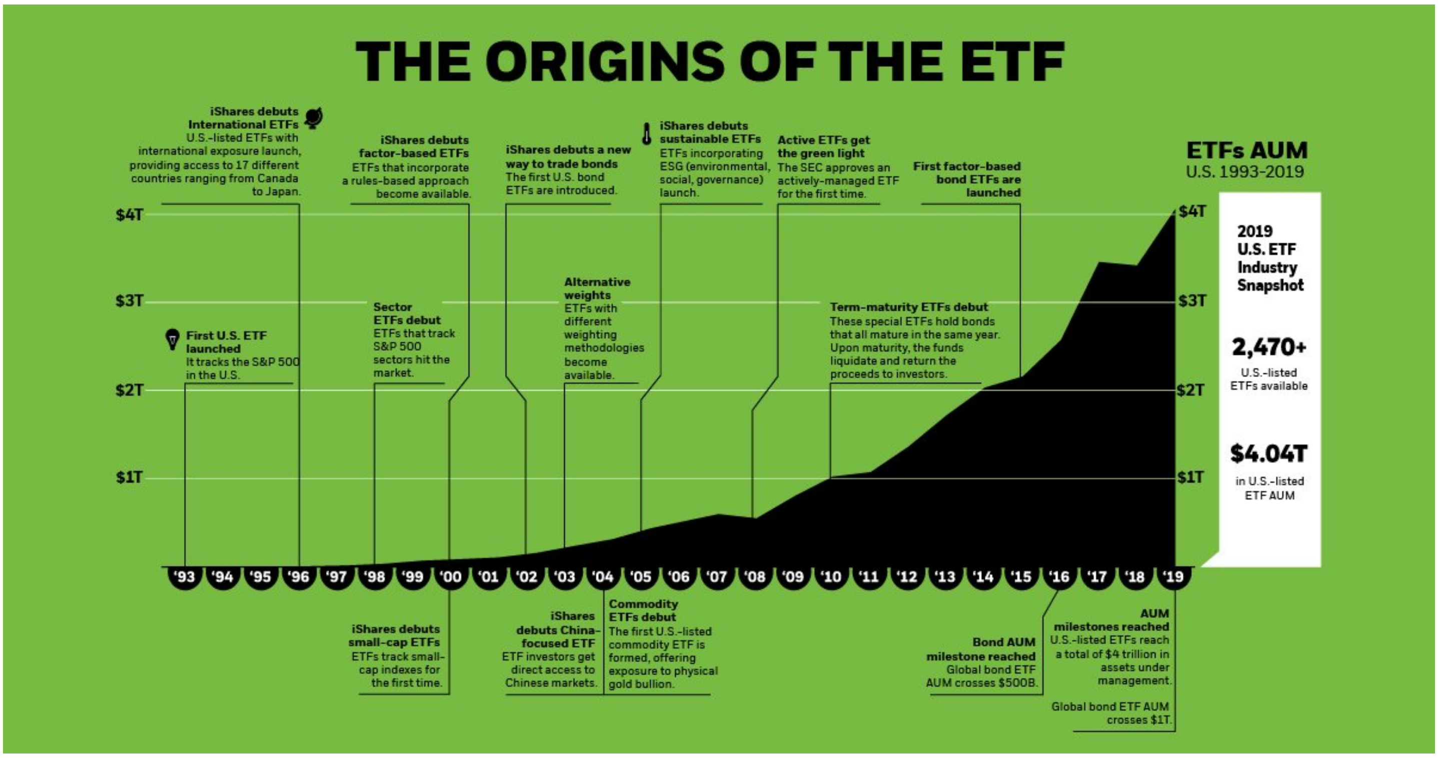
ETFs are structured as pools of investment that are inclined to

a. lower the fees associated with investment
b. shift the bulk load of fees to frequent traders of the ETF than holders
c. allow investors to invest in diverse set of securities / asset classes easily



ETFs originated after the stock market crash of 1987 in US

'Passive Investing' was the new shiny thing and investors wanted a low cost way to invest in the index without any manager actively managing their investments



Enter Nate Most

Nate Most is known as the father of ETFs
A physicist by training, Nate got the idea of ETF from warehouse receipts

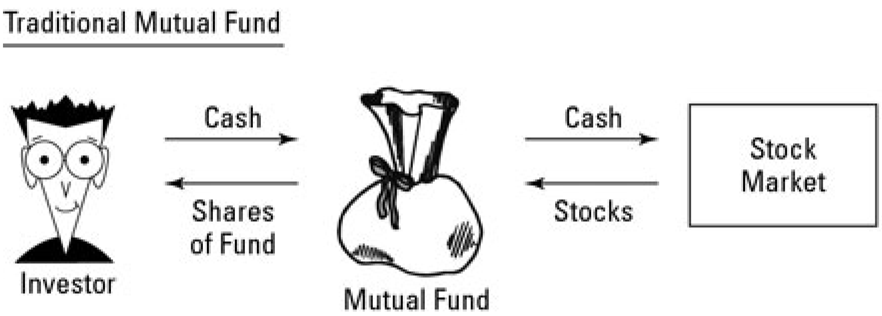
Once a commodity is stored in a warehouse, the depositor gets a warehouse receipt

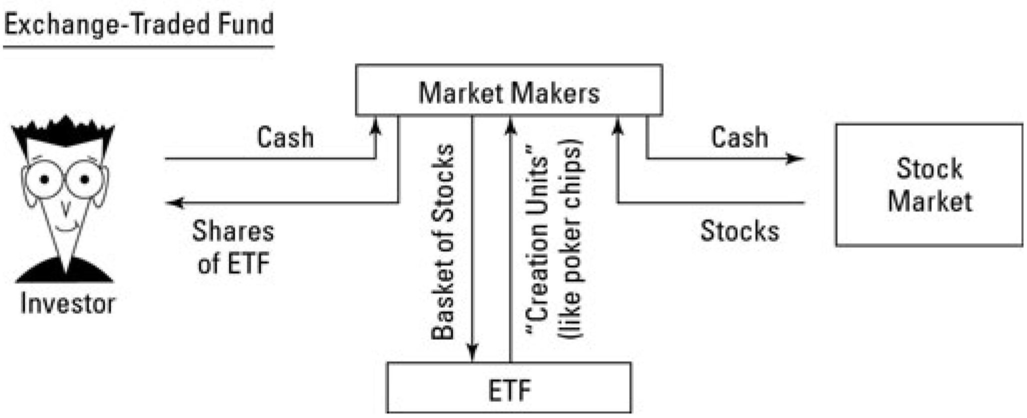
They could then use the warehouse receipt to buy, sell, loan, finance etc. without moving the commodity from the warehouse each time.

An ETF works on the same principle

When you buy an ETF, what you are indeed buying is an ownership receipt to shares deposited at a depository somewhere in the world

Similarly, when you sell the ETF, you are selling the ownership receipt instead of the underlying shares





Because each time, the buy or sell occurs, the shares do not have to be transferred out of the depository, you tend to save on a lot of expenses

This is one of the main reasons why expense ratios on ETF are so low

Type	Fund	Symbol	Expense Ratio
Index	S&P 500 Index	^GSPC	-
Mutual Funds	Schwab S&P 500 Index Fund	SWPPX	0.09%
	Fidelity Spartan S&P 500 Index Investor Class	FUSEX	0.10%
	Vanguard 500 Index Fund Investor Shares	VFINX	0.18%
	T. Rowe Price Equity Index 500 Fund	PREIX	0.37%
ETF	Vanguard S&P 500 Index Fund	VOO	0.05%
	State Street S&P 500 Index Fund (SPDR)	SPY	0.09%
	iShares S&P 500 Index Fund	IVV	0.09%

If you want to learn more about History of ETFs, you can listen to this short podcast by Bloomberg

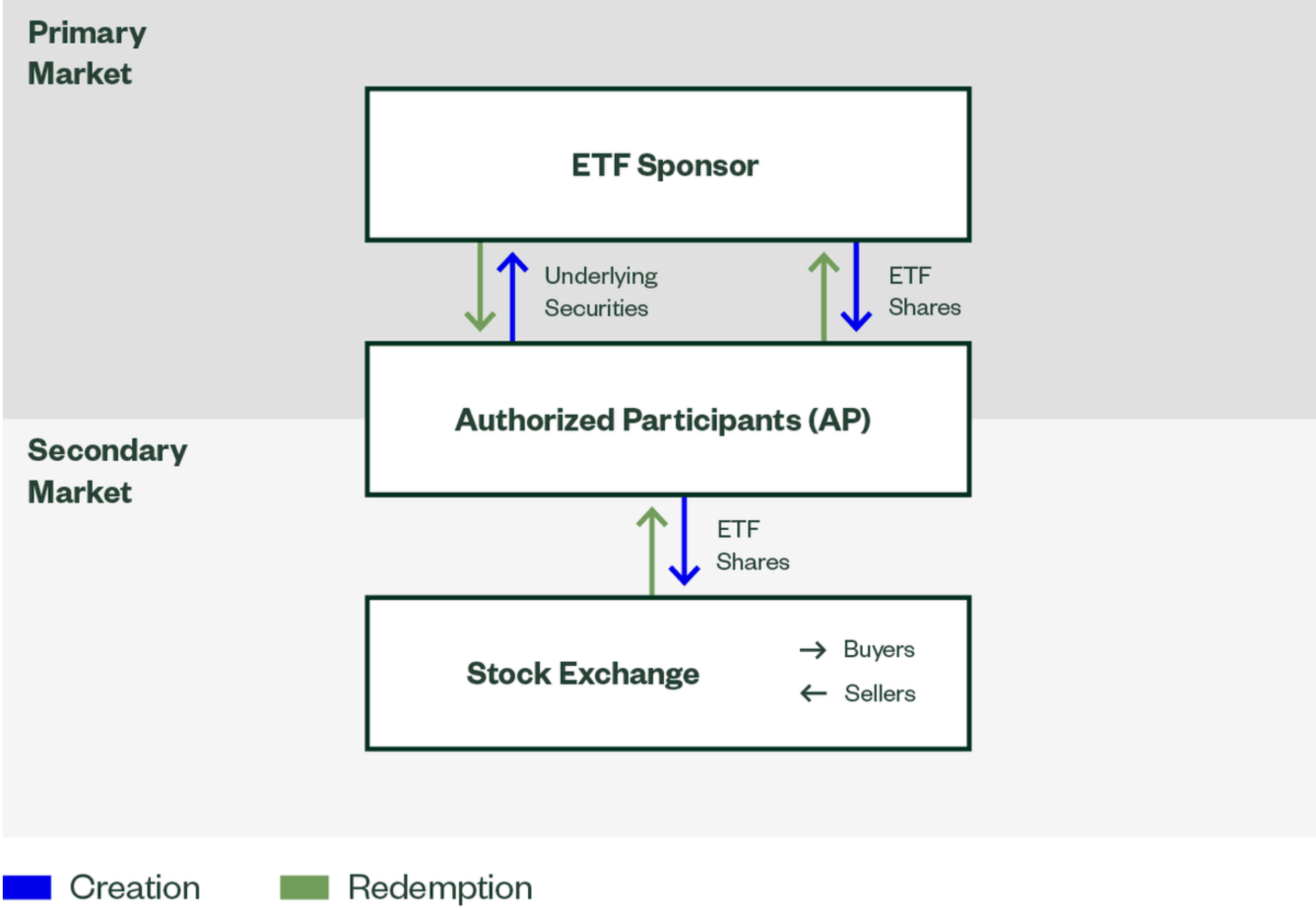
https://t.co/Ed4VdX2WOo

The way an ETF functions is also different from Mutual Funds

Typically, each ETF has an sponsor

It is the sponsors responsibility to decide what shares/securities go into the ETF in what proportions and what gets out

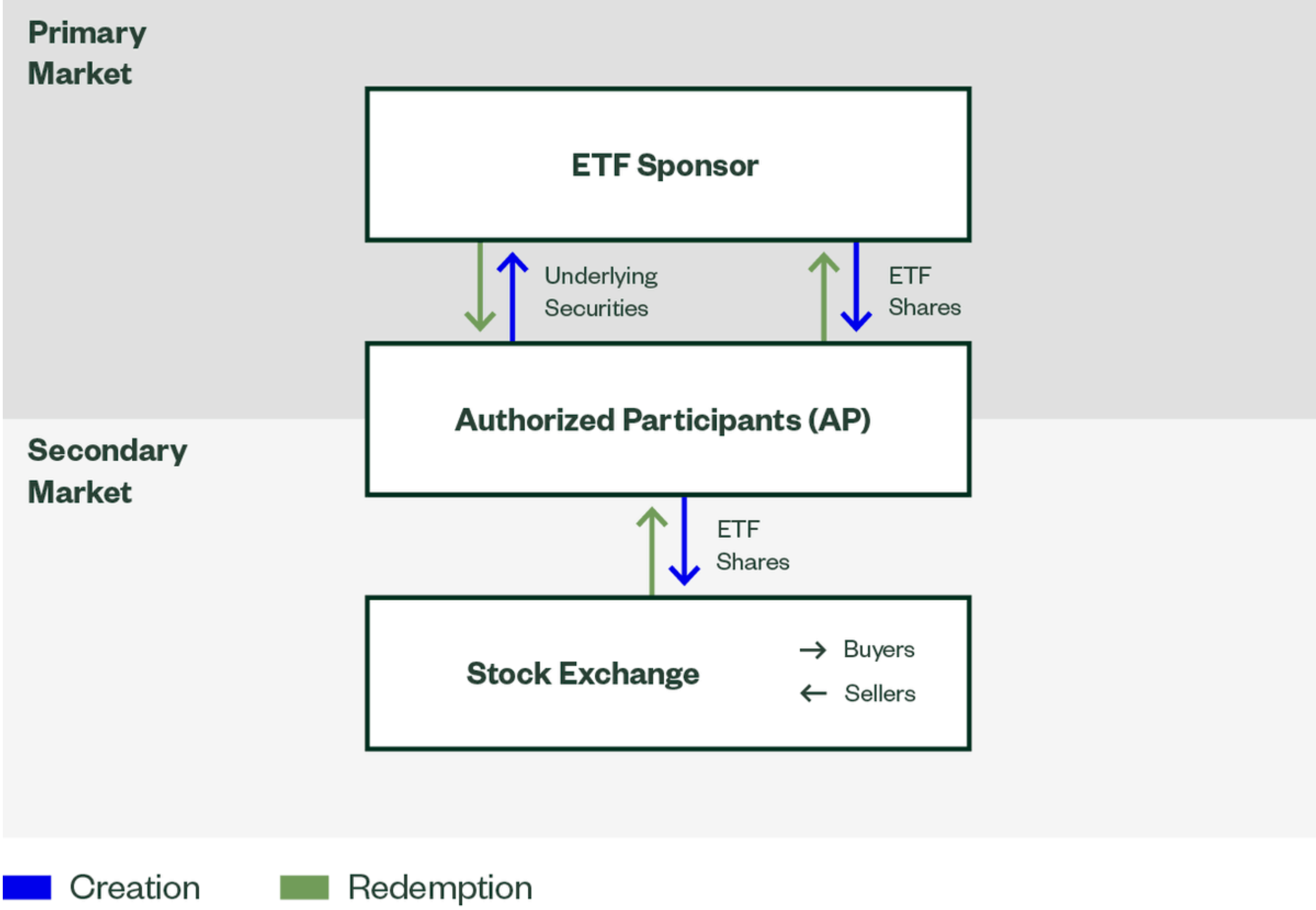
For example, Cathie Wood and ARKK Management is the sponsor of ARKK Innovation ETF



Below the sponsor are Authorized Participants (APs)

These APs are usually broker dealers who are the only authorized market participant to create or redeem units of an ETF

APs make their return via the bid and ask spread on the ETF & are the main providers of liquidity



This de-linkage between the ETF Sponsor and Authorized Participant is one of the reasons ETFs do not ever have a redemption problem

Authorized Participants take care of the creation, redemption and occasional rebalancing process

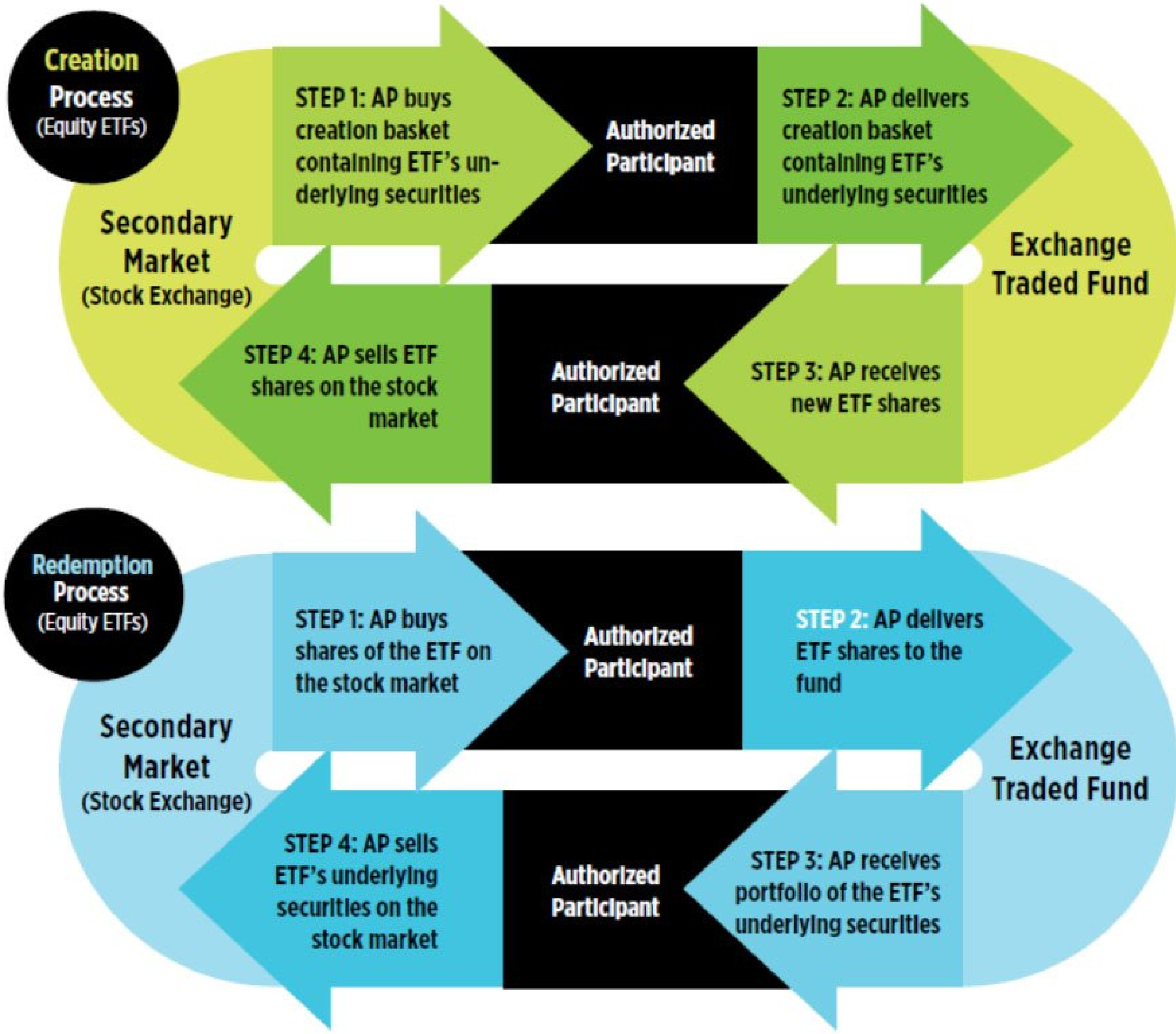
Lets understand this in detail.

ETF Creation Process

Whenever new units of ETF need to be created, the AP will simply buy the underlying stocks from market in proportions described by the ETF sponsor

AP then delivers this basket of stocks in exchange for ETF units

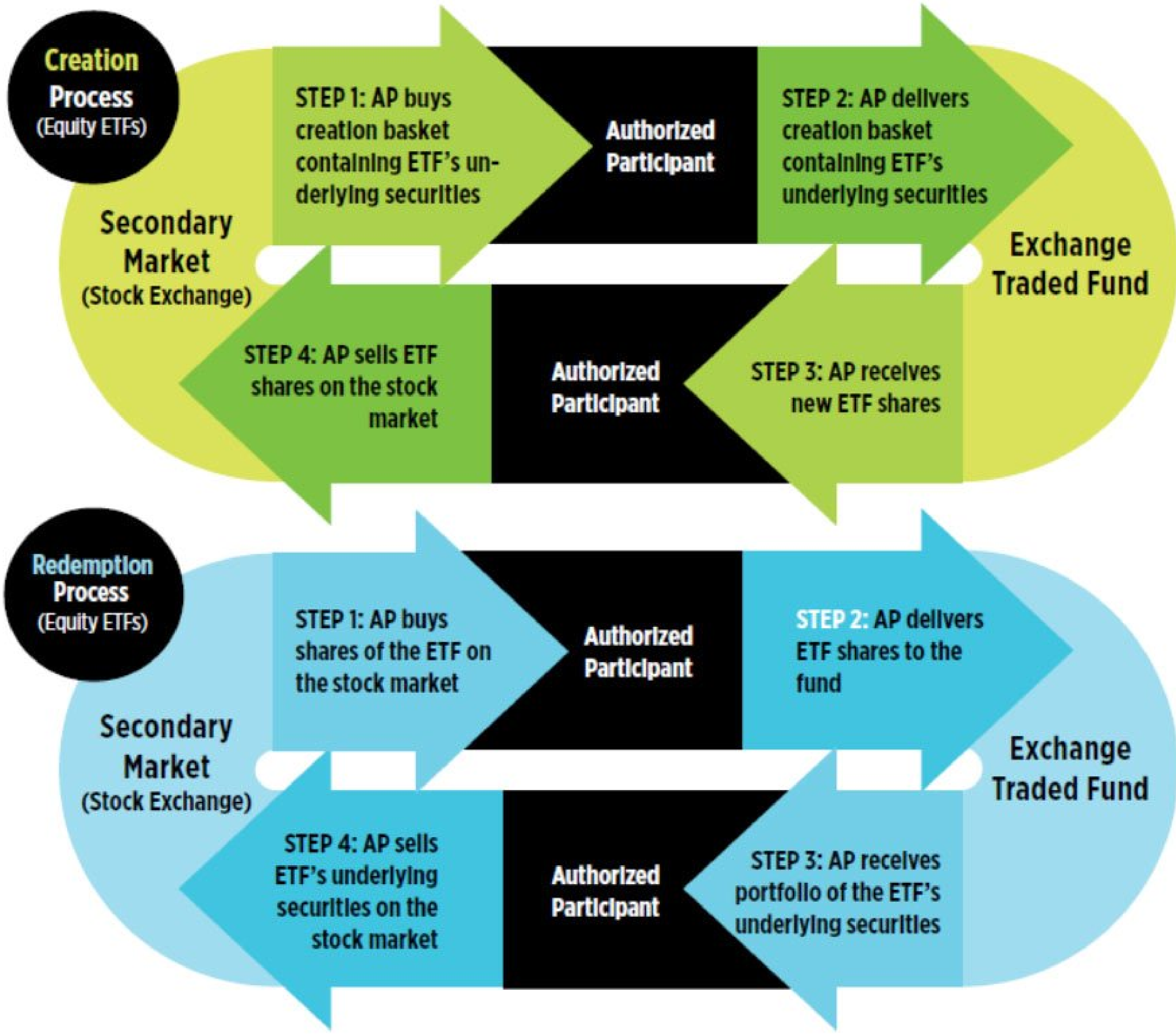
These units are then sold in the market



ETF Redemption Process

Whenever AP wants to redeem units of ETF, they will sell the units to ETF sponsor and get the basket of underlying securities

Regular buying and selling of ETF units for cash happens in the secondary market on the exchange & in no way effects the sponsor



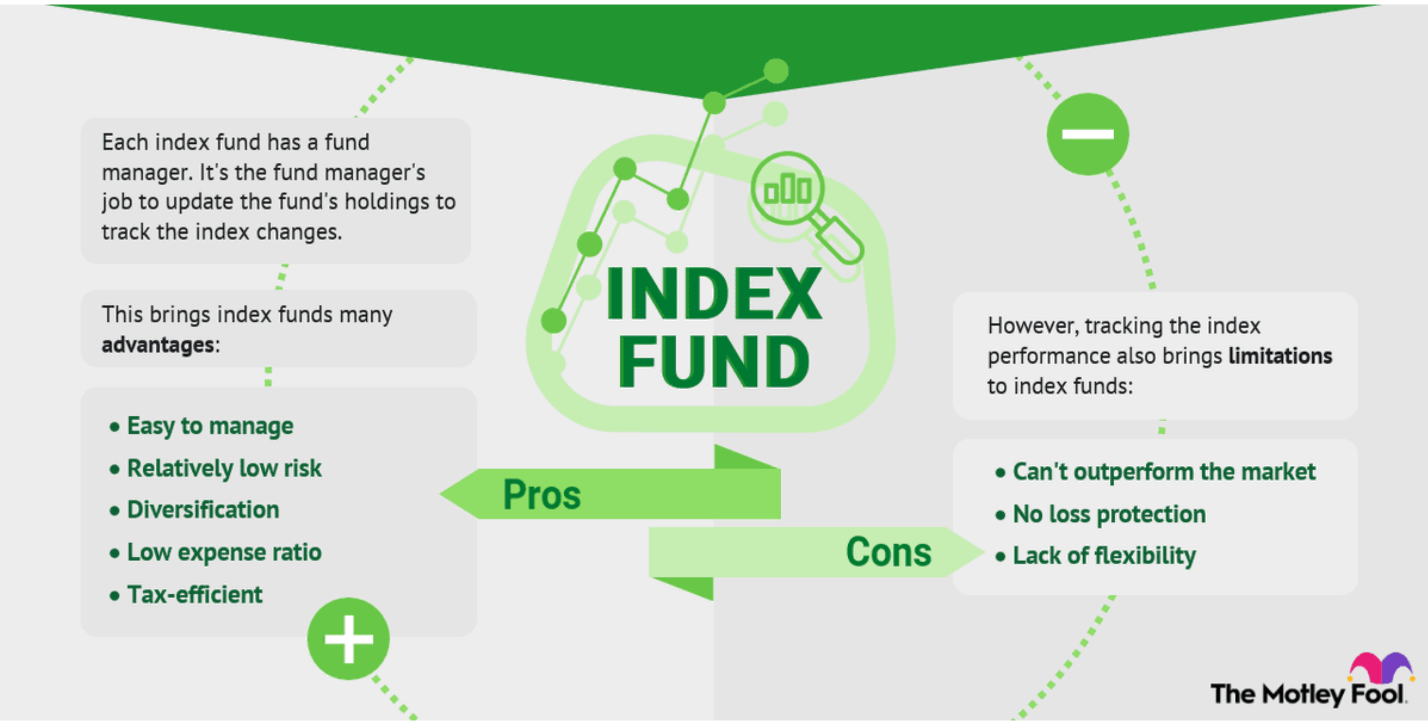
Finally, lets understand what are some of the factors to pay attention to while investing in an ETF

The first one is your reason to invest

ETFs are great for passive index investing since bulk of the cost burden is transferred to traders of the ETF than holders

However, in India, index ETFs arent popular & majority still invest via Mutual Funds

This lead to liquidity issues

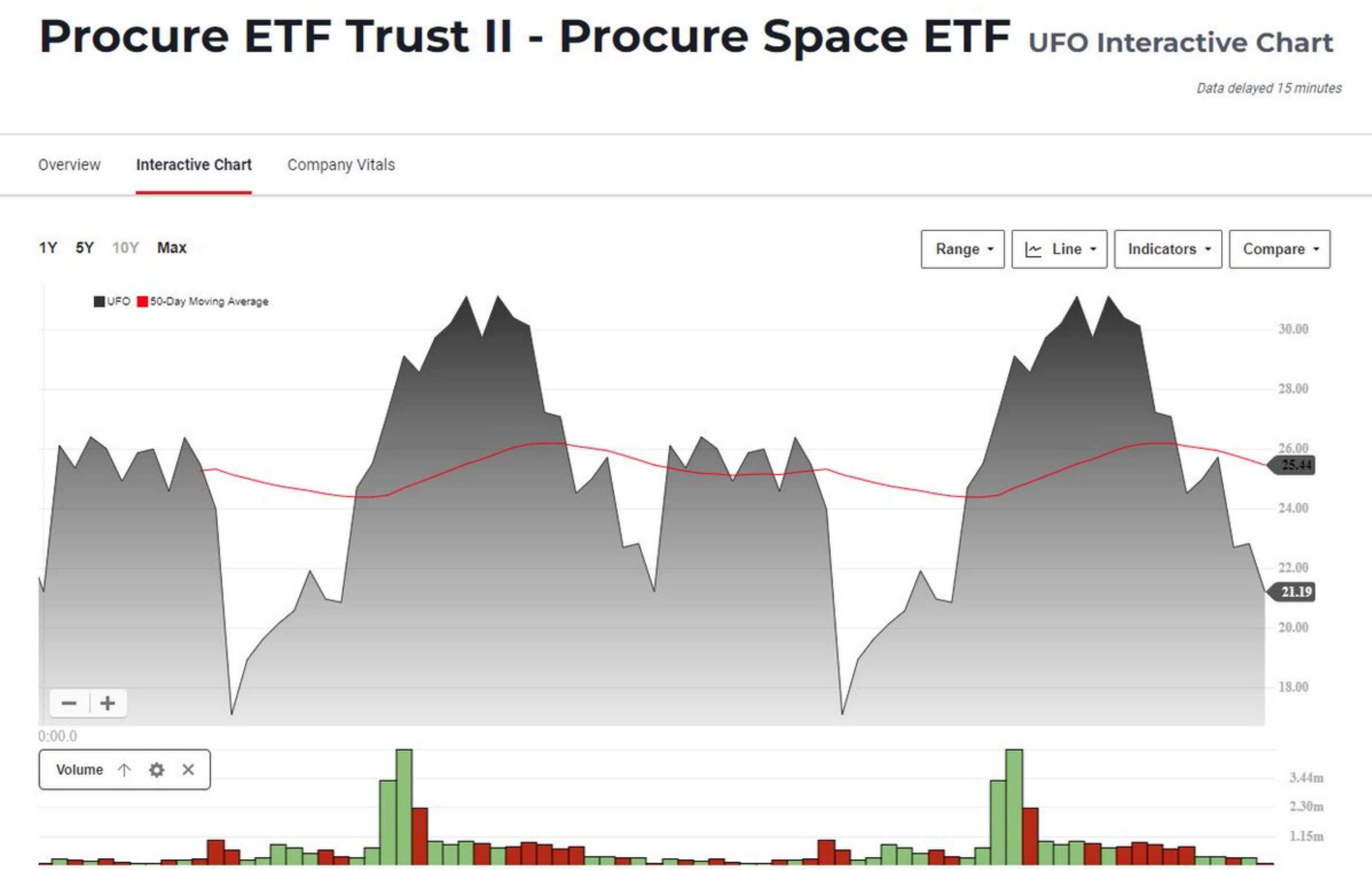


Similarly, residing in India, its better to invest into foreign indexes like Nasdaq 100, S&P 500 etc. via a domestic mutual fund instead directly into an overseas index ETF

as taxation of the ETF returns will bite away a significant chunk of your overall returns

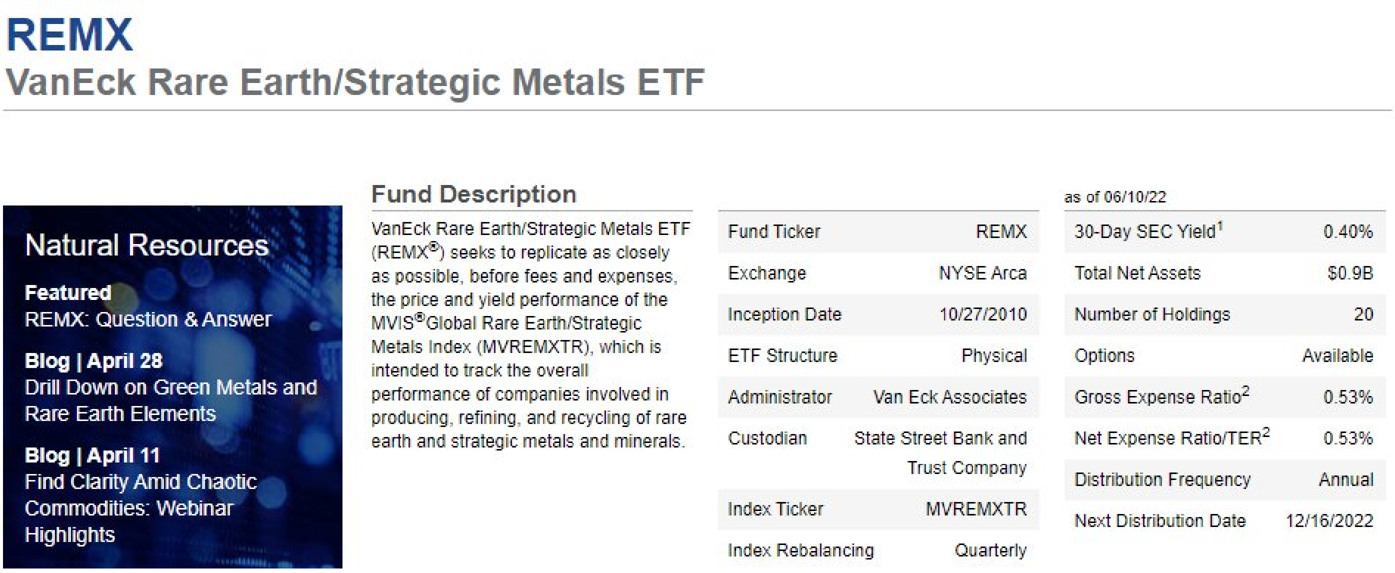
ETFs are a great way to diversify your portfolio and get exposure to certain industries without the hassle of taking stock specific risks

For example, you may buy an ETF like $UFO which invests in a variety of Space Sector companies



ETFs are also a great way to take geographic exposure without going through all the trouble of setting up brokerage accounts in the local jurisdiction to own the stock

For example, $REMX is an ETF that invests in rare earth companies around the world from Australia to China



REMX

VanEck Rare Earth/Strategic Metals ETF

Natural Resources

Featured
REMX: Question & Answer

Blog | April 28
Drill Down on Green Metals and Rare Earth Elements

Blog | April 11
Find Clarity Amid Chaotic Commodities: Webinar Highlights

Fund Description

VanEck Rare Earth/Strategic Metals ETF (REMX®) seeks to replicate as closely as possible, before fees and expenses, the price and yield performance of the MVIS®Global Rare Earth/Strategic Metals Index (MVREMXTR), which is intended to track the overall performance of companies involved in producing, refining, and recycling of rare earth and strategic metals and minerals.

Fund Ticker	REMX
Exchange	NYSE Arca
Inception Date	10/27/2010
ETF Structure	Physical
Administrator	Van Eck Associates
Custodian	State Street Bank and Trust Company
Index Ticker	MVREMXTR
Index Rebalancing	Quarterly

as of 06/10/22

30-Day SEC Yield[1]	0.40%
Total Net Assets	$0.9B
Number of Holdings	20
Options	Available
Gross Expense Ratio[2]	0.53%
Net Expense Ratio/TER[2]	0.53%
Distribution Frequency	Annual
Next Distribution Date	12/16/2022

Below are some of the checks you should perform, before investing into an ETF

Check # 1
What is the tracking error?

Tracking error refers to the standard deviation of differences in daily performance between the index and fund tracking the index

Tracking errors are usually reported & tracked for a 12 month period

Larger the tracking error, lower the return

Check # 2

How often the sponsor churns the ETF?

Cathie Wood for example is famous for churning the holding of the ETF on an almost daily basis

Higher churn rates indicate uncertainty by the sponsor of the underlying holdings

If you cant be certain of the underlying holdings, what good is the ETF?

Check # 3

Is the taxation rules for investing in ETF in your area favorable?

I see a lot of new app based brokerage houses advocating for in US based ETFs without informing their customers about the taxation rules

Check if tax rate is eating your return?

Check # 4

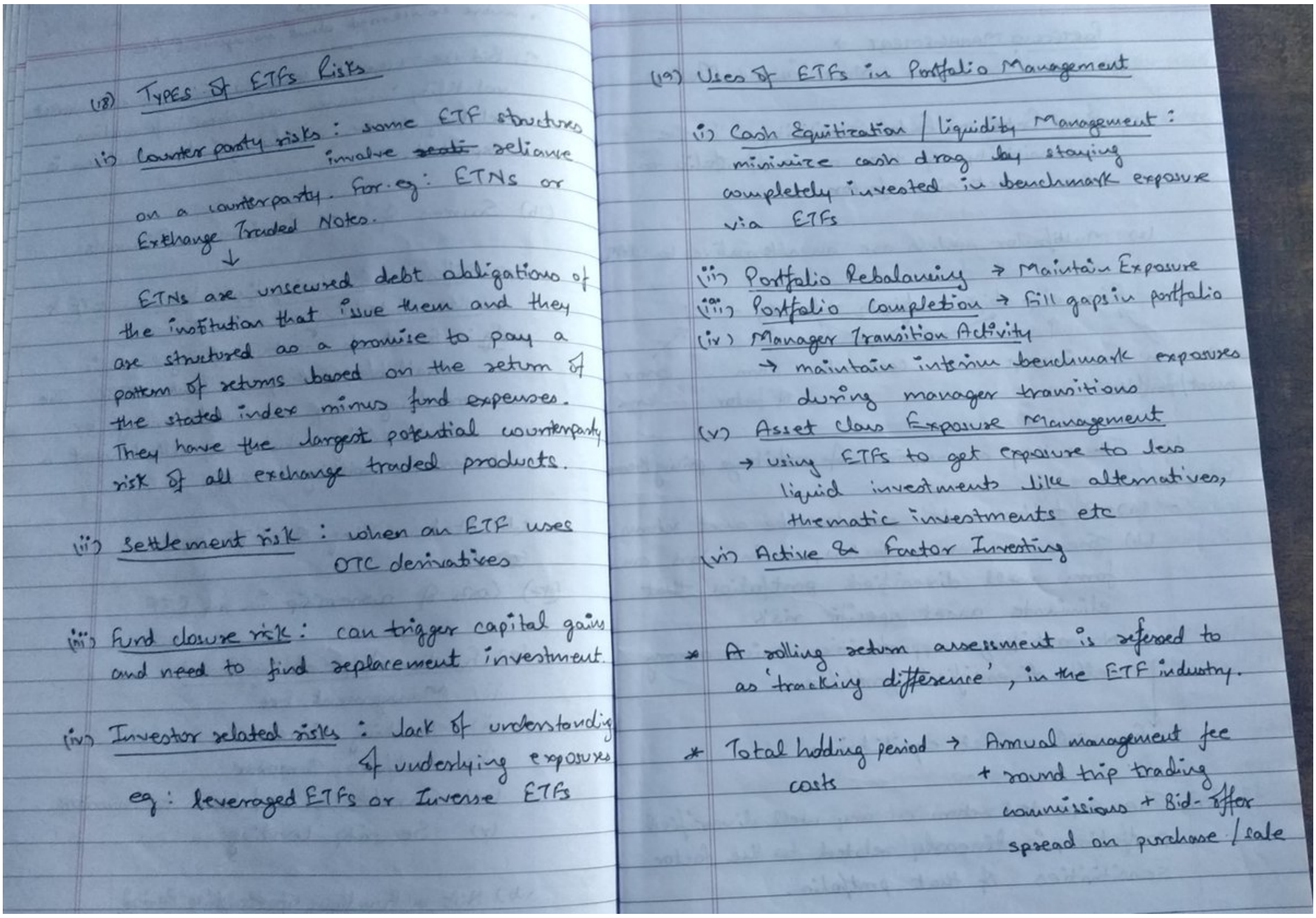
Is the ETF liquid & fund house reliable?

Liquidity shouldn't be a concern if you are investing for greater than one year but if an ETF is too small in size, that liquidity may never arrive.

Finally, Vanguard & iShares command more confidence over a random fund house

Before closing this thread,

below are screenshots of my handwritten notes of the ETF chapter in the CFA Curriculum (in case you want to go further down the ETF rabbit hole)



(18) Types of ETFs Risks

(i) Counterparty risks : some ETF structures involve ~~seati~~ reliance on a counterparty. For eg: ETNs or Exchange Traded Notes.

↓

ETNs are unsecured debt obligations of the institution that issue them and they are structured as a promise to pay a pattern of returns based on the return of the stated index minus fund expenses. They have the largest potential counterparty risk of all exchange traded products.

(ii) Settlement risk : when an ETF uses OTC derivatives

(iii) Fund closure risk : can trigger capital gains and need to find replacement investment.

(iv) Investor related risks : lack of understanding of underlying exposures

eg : leveraged ETFs or Inverse ETFs

(19) Uses of ETFs in Portfolio Management

(i) Cash Equitization / Liquidity Management : minimize cash drag by staying completely invested in benchmark exposure via ETFs

(ii) Portfolio Rebalancing → Maintain Exposure

(iii) Portfolio Completion → Fill gaps in portfolio

(iv) Manager Transition Activity

→ maintain interim benchmark exposures during manager transitions

(v) Asset Class Exposure Management

→ using ETFs to get exposure to less liquid investments like alternatives, thematic investments etc

(vi) Active & Factor Investing

* A rolling return assessment is referred to as 'tracking difference', in the ETF industry.

* Total holding period costs → Annual management fee + round trip trading commissions + Bid-Offer spread on purchase / sale

Thank you for reading!

I hope you've found this thread helpful.
Follow me @itsTarH for more.

Like/Retweet the first tweet below if you can: https://t.co/MW6snMb2FG

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>
> — Tar \u26a1 (@itsTarH) June 11, 2022

I write a new thread every weekend simplifying investing concepts.

All my previous work, can be found here
https://t.co/KkZtWxWpd5

> All my Threads so far \U0001f9f5 \U0001f447\U0001f3fc
>
> — Tar \u26a1 (@itsTarH) June 5, 2021

I also write occasional deep dives and long form articles on stocks and emerging investing trends, you can subscribe to them for free here

https://t.co/3OwTRkY8BZ

Occasionally, conduct webinars that deep dive into a sector in its true sense

Here is a 5 hour long webinar on Green and Renewable Energy ■■

Lots of India, Chinese and US companies covered along with Global Demand and Supply scenario

https://t.co/rkiK2iHlS0

Thank you for reading, here is another thread, you may like

https://t.co/MROEXvkPKN

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> 1. What is a Yield Curve?
> 2. Why is it an important indicator of Recession?
> 3. Is an Economic Recession around the corner?
>
> Lets dive right in! pic.twitter.com/7qrYbT6Scj
>
> — Tar \u26a1 (@itsTarH) April 2, 2022

You can read the unrolled version of this thread here: https://t.co/a5kT5ER8eC