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Let’s Change That

Investing. Everyone recognizes it’s important. Financial goals are easier to reach when your money can work (and grow) for you, but acknowledgment and execution aren’t one and the same.

Because we live in a digital age — with an abundance of information about available investment options — choice overload is very real. There are so many vehicles to choose from that investors may question if they’re picking the right one, or worse, fall into a state of analysis paralysis.

While there’s no one-size-fits-all investment solution, the exchange traded fund (ETF) helps investors reach their goals — however unique they may be — in a transparent, cost-effective, and tax-efficient manner. Still, you may not be familiar with the intricacies and advantages of this vehicle. With this comprehensive, digestible resource, you can confidently gain a better understanding of the expansive ETF marketplace and set a course toward your desired outcomes.

Keep reading to uncover answers to a host of questions, including:

- What is an ETF?
- What can ETFs help you do?
- What are the benefits of ETFs?
- How do ETFs compare to mutual funds and stocks?
- How should investors evaluate ETFs?
- How can investors use ETFs in a portfolio?
ETF Basics
History and a Simple Breakdown
The ETF: Offering Investors Choice and Innovation

On October 19, 1987, a day known as Black Monday, stock markets around the world experienced a sudden, massive crash. The S&P 500®, an index that tracks the stock performance of 500 large US companies, dropped by an unprecedented 20.5%, the largest one-day percentage decline in the index’s history. Wealth eroded so abruptly that the damage rivaled the Great Depression.

Black Monday led to a widespread reevaluation of regulatory policies and risk management practices, but it also catalyzed a new type of investment structure that could help avert future disaster: the ETF.

In 1993, State Street Global Advisors launched the SPDR S&P 500 ETF Trust (SPY) — then, the first of its kind in the US and, today, the world’s largest, most liquid, and most heavily traded ETF. Since then, ETFs have captivated seasoned investors and newcomers alike, as the market continues to reach new heights in breadth, size, and capabilities.

Through both active and passive management, ETFs can offer cost-effective exposure to nearly every asset class, from core broad US equities to complex emerging market debt. As a result of this democratization, a wide range of investors can now access hard-to-reach markets once only available to the largest institutions.

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What Is an ETF?

Picture an ETF as a merchant ship, carrying a mix of cargo — stocks, bonds, commodities, and other assets — out to sea. The shipbuilder (ETF manager) crafted this vessel not for one merchant (investor), but for many.

Each investor claims a share of the ship and its holdings. This collective ownership is often structured as an open-end investment with no fixed maturity date, meaning investors can sell their share(s) at any time.

In turn, the ETF can operate continuously, taking on new investors or allowing old ones to disembark at their discretion. This design provides durability and adaptability in various market conditions, whether that’s calm waters or stormy seas.

Nautical analogies aside, let’s break down exchange traded funds word by word.

- **Exchange**: A marketplace where stocks, bonds, and other assets are traded
- **Traded**: Bought and sold
- **Fund**: Pooled money that’s invested in a variety of assets

All together now: ETFs are baskets of assets that trade on an exchange, much like a stock does. These baskets may track a wide range of indexes, like the S&P 500® or the Nasdaq 100.

Alternatively, they may strive to replicate the performance of a specific market segment, such as an asset class (e.g., bonds), geography (the US), sector (technology), or investment theme (innovation). Or, they could aim to outperform their benchmarks altogether — a common objective of active ETFs.

What Can ETFs Help Investors Do?

In short, a lot. You’ll sometimes hear ETFs referred to as investment vehicles. Much like their four-wheel equivalents, some can get you to your destination faster than others, but with added risk. Some won’t break any speedometers, but they have a sterling track record of getting from A to B safely. Some give you protection in inclement weather and rough terrain, while others come with professional chauffeurs who charge a little more for their services.

Ultimately, their goal is to move you toward your financial goals. ETFs are particularly appealing in this regard because they can be deployed in many ways.

Specifically, you can use ETFs to:

- Gain exposure to the broader market or an index, like the S&P 500®
- Seek ways to outperform the broader market
- Invest in promising sectors, industries, and even themes
- Diversify across asset classes, geographies, and strategies
- Quickly pivot and adjust portfolios as economic conditions change
- Manage risk, hedge against inflation, and reduce volatility
More Tools at Your Disposal
The Benefits of ETFs
Unlocking the Power of ETFs

Adding ETF strategies to your portfolio gives you a bigger toolbox, potentially bolstering your DIY arsenal with more utility and functionality.

**Diversification**: If, for example, your holdings are concentrated in only a few securities, your entire portfolio could be weighed down if those securities underperform.

By diversifying across asset classes, geographies, and sectors, you may be able to mitigate concentration risk and also increase your exposure to various growth opportunities — because when one asset class or sector underperforms, another might thrive, balancing the portfolio and potentially smoothing out returns over time.

**Cost Efficiency**: Fees and expenses can erode returns. However, ETFs usually have lower fees and expenses compared to their mutual fund peers. Transaction costs are also minimal when portfolio turnover is low, which is often the case for ETFs that primarily track indexes.

**Portfolio Turnover**: The percentage of the fund’s underlying securities that were sold in a given year. A high turnover rate indicates that holdings are traded frequently, perhaps due to an active management strategy.

**Investment Variety**: There are countless ways to invest with ETFs. You could gain broad exposure to an entire asset class or selective exposure to a subset of companies, such as biotech or financial services. Or, you could target companies focused on dividends, growth, or momentum. In essence, the expanding universe of ETFs provides ample opportunities for investors to construct a portfolio that aligns with their risk tolerance, investment goals, and values.

**Transparency & Trading Flexibility**: Most ETFs publish and update their holdings daily. In turn, investors know what they own in real time, which enables them to make more informed investment decisions. Further, at any time during the trading day, investors can buy and sell ETF shares through brokerage accounts at their current market prices. Contrarily, mutual funds are priced and traded after the market closes.

**Tax Efficiency**: Like transaction costs and management fees, taxes can also eat into returns. Thanks to their tax-efficient structure though, ETFs can help investors with taxable accounts keep more of what they earn.

First, portfolio turnover can be minimal for ETFs that track low-maintenance indexes, which generally results in lower capital gains taxes. Second, the way ETF shares are created and redeemed means ETF portfolio managers don’t need to buy or sell any of the individual holdings.

In contrast, when an investor decides to sell shares of a mutual fund, the fund manager may sell a portion of the fund’s holdings to cash out an investor’s position. This sale could generate a realized taxable gain, leaving the remaining shareholders in the fund to absorb the associated taxes.

**Enhanced Liquidity**: Liquidity refers to how quick and easy it is to buy or sell an asset without significant price fluctuations. High liquidity implies that there are numerous buyers and sellers, suggesting more trading flexibility.

Because they trade throughout the day on an exchange (known as the secondary market), ETFs are considered liquid investments. However, ETFs also gain a liquidity boost from the primary market — this is where securities are created and initially sold.

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**Markets Are Generally Divided Into Two Categories**

**Primary Market**: Where securities are created and sold for the first time (e.g., an Initial Public Offering). Investors buy securities directly from the issuer, such as a company or government, who then receives the proceeds of the sale.

**Secondary Market**: Where investors trade securities among themselves, without involving the issuing companies. This is the market most people think of as the stock market, where stocks, bonds, ETFs, and other securities are bought and sold after the initial issuance.

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**Source**: State Street Global Advisors. For illustrative purposes only.
How the Creation and Redemption Process Works

If you’ve ever attended a Broadway show, you were undoubtedly treated to a mix of song, dance, and pageantry. It’s called a production for a reason — a lot of effort goes unnoticed behind the curtains, from props managers and stagehands moving scenery to wardrobe design and lighting technicians ensuring a radiant, visual performance.

In many ways, ETFs are similar. There’s a complex production playing out behind the scenes known as the creation and redemption process, which allows ETFs to be more liquid and cost-effective than other investment vehicles.

Creation involves buying all the underlying securities and wrapping them into the exchange traded fund structure.

Redemption is the process whereby the ETF is unwrapped back into the individual securities.

You could think of ETFs like unopened presents. The gift is purchased, boxed, and wrapped (creation); this represents a unified ETF. Then, if you need to return the present, the gift is unwrapped and given back (redemption).

This is a back-and-forth process between two parties: ETF sponsors (like us at State Street SPDR ETFs) and large financial institutions (known as authorized participants, or APs).

As an investor, you don’t need to deeply understand the nuances of how ETF shares come to be, but it does help shed light on why ETFs are more liquid, tax-efficient, and accurately priced than mutual funds (which only trade once a day after the market closes).

We’ll dive deeper into product differences in the next section.
Comparing Investment Options
Why ETFs Offer the Best of Both Worlds
A Best-of-Both-Worlds Structure

Investors often find themselves confronted by three investment options: ETFs, mutual funds, or individual stocks. ETFs integrate the real-time trading of stocks with the diversification benefits of a mutual fund. ETFs also provide cost efficiency and tax advantages, granted by their unique creation and redemption process. This can be particularly beneficial for investors looking to optimize their after-tax returns. Moreover, the minimum investment for many ETFs is the price of just one share, providing accessibility that can be especially attractive for new or cost-conscious investors. Mutual funds, on the other hand, usually require higher minimum investments, which can be a barrier to entry for some.

ETFs and mutual funds share several qualities — both are professionally managed, offer a variety of investment options, and can help investors diversify with a single trade. However, the structures of these fund types, as well as their investment characteristics, are very different.

ETFs
- Intraday pricing
- Trade on an exchange
- Secondary market trading capability
- Seek to track an index
- Low expenses
- Low turnover
- Tax efficient

Index Mutual Funds
- Seek to track an index
- Low expenses
- Low turnover
- Tax efficient

Mutual Funds
- Yes
- Yes
- N/A

Stocks
- No
- Not individually
- N/A

How ETFs Compare to Mutual Funds and Individual Stocks

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<th>Mutual Funds</th>
<th>Stocks</th>
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<tr>
<td>Track an Index</td>
<td>Yes</td>
<td>Yes</td>
<td>N/A</td>
</tr>
<tr>
<td>Provide Diversification</td>
<td>Yes</td>
<td>Yes</td>
<td>Not individually</td>
</tr>
<tr>
<td>Transparency</td>
<td>Higher (Holdings disclosed daily)</td>
<td>Lower (Holdings disclosed quarterly)</td>
<td>N/A</td>
</tr>
<tr>
<td>Liquidity</td>
<td>High, intraday trading</td>
<td>Varies, end-of-day trading</td>
<td>High, intraday trading</td>
</tr>
<tr>
<td>Average Net Expense Ratio</td>
<td>0.57%</td>
<td>0.85%</td>
<td>N/A</td>
</tr>
<tr>
<td>Pricing</td>
<td>Market price</td>
<td>Closing net asset value (NAV)</td>
<td>Market price</td>
</tr>
<tr>
<td>Minimum Investment</td>
<td>None</td>
<td>Some require minimum</td>
<td>No minimum requirement*</td>
</tr>
<tr>
<td>Tax Treatment</td>
<td>More tax-efficient due to in-kind redemptions</td>
<td>Less tax-efficient due to capital gains distributions</td>
<td>Varies by individual stock and strategy</td>
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Source: Morningstar Direct, Morningstar, as of December 31, 2023. Oldest share class of mutual fund used.

* The brokerage through which you purchase individual stocks may have a minimum account requirement.
Evaluating ETFs
What You Need to Know (and Do)
What to Consider
Before Investing in ETFs

Clothes don’t fit you perfectly unless they’re tailored to your exact dimensions. Portfolios are no different. Before you can explore potential investments, you should first determine your measurements: your financial goals, investment horizons, and risk tolerance. And remember that, just like your measurements, your investment goals may change over time.

While you don’t necessarily need a concrete reason to start investing, it’s generally prudent to outline life goals and their associated price tags, whether that’s buying a house, having kids, retiring, or all of the above. Nothing is set in stone, but adding figures and dates gives your portfolio something to build toward.

Risk tolerance is the degree of variability in investment returns that you are willing (and able) to withstand. Are you comfortable with the high-risk, high-reward tradeoff of a significant equity concentration, or do you prefer the steady returns of conservative investments? A self-assessment is crucial in directing the makeup of your ETF portfolio. In general, the higher the risk, the higher the reward, and vice versa.

To summarize, you’re deciding what you want and need ETFs to do for you. Once you’ve assessed your risk tolerance and detailed your financial goals (including estimated timelines), then you can evaluate the merits of specific ETFs.

There are thousands of ETFs circulating the market though — which one makes the most sense for you?

Here are some factors to consider.

Cost

Returns matter, but, more specifically, net returns matter. There are costs to weigh when owning funds of any kind. The first one to know is a fund’s expense ratio — this annual fee (expressed as a percentage) covers the fund’s expenses, including management fees, administrative fees, and other operational costs.

Trading costs and tax implications are also important variables of ownership cost. For instance, mutual funds frequently make capital gains distributions, which could trigger steep tax liabilities. ETFs can avoid these tax hits thanks to the creation and redemption process. However, cost of ownership is not limited to expenses, fees, and taxes; the point-in-time liquidity of your investments matter, too.

In that way, you can imagine your total cost of ownership like an iceberg — there’s the purchase price you see, and then there are the additional “Unseen” factors lingering below the surface.

Figure 5
Expense Ratios: Only the Tip of the Iceberg in the Total Cost of Ownership Equation

Source: State Street Global Advisors. For illustrative purposes only.
Of course, investment performance is understandably high on any investor’s list — but there are metrics to consider beyond returns, specifically tracking error. This indicates how closely an ETF follows its benchmark index.

Tracking error occurs when there’s a discrepancy between the performance of the ETF and the index it’s designed to replicate. Fund expenses, transaction costs, difficulty in acquiring components of the index, dividend reinvestment timing, and sampling (a strategy in which a fund holds a representative sample instead of the entire index) can all possibly create a divergence.

There are two ETF structures to know:

**Physical ETFs** purchase the securities within the target index. For example, a physical ETF tracking the S&P 500® will hold shares of the companies within that index.

**Synthetic ETFs** use derivatives like swaps to replicate the performance of an index. They enter into a contract with a counterparty (usually a bank or another financial institution) that agrees to provide the index’s return to the ETF.

Any investment carries some degree of risk, ETFs included. While the individual risks of an ETF will vary depending on its holdings and structure, some to be mindful of are:

- **Market Risk** There’s always a possibility of loss due to factors that affect an entire market or asset class. During periods of high market volatility, even the most stable ETFs can experience declines.
- **Interest Rate Risk** Bond ETFs are particularly susceptible to interest rate changes. Generally, when interest rates rise, bond prices fall, and vice versa.
- **Credit Risk** For bond ETFs, there’s the risk that the bond issuers might default on their payments. In other words, they may not be able to pay back their investors. Higher-yield bonds, often referred to as “junk” bonds, carry higher credit risk.
- **Leverage Risk** Some ETFs use leverage (debt) to amplify returns. While this can offer higher potential gains, it also increases potential losses and can be more volatile.
ETFs in Action

It’s easy to see the benefits of ETFs at a high level. But when push comes to shove, how are you actually supposed to implement these instruments in your portfolio? Answering this question can be like explaining all the ways to cook a gourmet meal — the possibilities are nearly endless. Still, we’ve highlighted several of the most relevant approaches.

**Strategic Asset Allocation**

Many individual investors prefer long-term, buy-and-hold strategies. Perhaps you want to add stability and recurring income to your portfolio through investment-grade bonds. Instead of sifting through and handpicking bonds to hold, investors can purchase bond ETFs to quickly and efficiently allocate a portion of their portfolio to fixed income — ETF sponsors handle the “wrapping” and asset management for you.

**Tactical Asset Allocation**

Markets are fluid, constantly ebbing and flowing as economic cycles unfold and conditions change. The future is forever unpredictable, but sometimes it’s prudent to make real-time adjustments to portfolio allocations to take advantage of short-term opportunities. For instance, during the COVID-19 pandemic, market prices broadly fell amid the social and economic uncertainty. With ETFs, investors could pivot and re-position immediately.

**Core-Satellite Strategies**

You might be familiar with the age-old active-vs-passive debate — that is, whether it’s worthwhile to seek “alpha” and outperform the market (active) or to simply mirror the market’s returns (passive). The core-satellite strategy is essentially a blend of the two. The first and central objective is to replicate the broader market’s return, while the second objective is to find alpha and diversification opportunities. For instance, a market-based ETF (the core) could be paired with a sector, commodity-based, or other active ETF (the satellite).

**Access to Hard-to-Reach Markets**

Some assets are more difficult to invest in than others, at least that was the case historically. ETFs changed that, democratizing access to markets like fixed income, commodities, currencies, and even managed portfolios, which can help diversify and balance a portfolio.
Talk with your advisor about ways to use these diverse, multifaceted vehicles in your portfolio.

There are innumerable paths forward. No matter which you choose, advisors are your guide and ETFs are your all-terrain vehicle. With both at your service, you can go anywhere and trailblaze a path to achieving your unique financial goals.

Want to Go Deeper?
Explore how to further evaluate, trade, and deploy ETFs in our ETF Education Hub.