



# Do ETFs have a place in your portfolio?

When building your portfolio, you may think of buying stocks, bonds, or stock and bond mutual funds. However, you can consider additional types of investments, including exchange-traded funds (ETFs).

ETFs can be used as the building blocks of your portfolio or as a complement to other investments you already own, providing further diversification. It all depends on your individual circumstances.

## What Is an ETF?

- ETFs are similar to traditional mutual funds because they hold a variety of securities in one investment but are different in that they are generally passively, not actively, managed.
- ETFs trade on an exchange, like stocks, and therefore experience price changes throughout the day.
- Most ETFs are managed in a rules-based manner that is designed to track the performance of a particular index, typically done by invest-ing in the same securities as the index.

## Considering ETFs for Your Portfolio

Broad stock ETFs are diversified and can give you exposure to multiple sectors and individual securities and, in the case of international ETFs, a number of countries. This results in the ETFs' performance being driven by a number of different factors, rather than relying too much on the performance of a certain type of company or individual country.

Similarly, broad bond ETFs, like government and corporate ETFs, invest in different areas of the fixed-income market, such as corporate and government securities, which makes their returns less dependent on the performance of specific sectors of the market.

The relative tax efficiency and low cost of these ETFs compared to actively managed mutual funds can make them attractive long-term investments.

**Use as Building Blocks**

Broad-based ETFs can make up the core building blocks of your portfolio. If you are interested in investing in a specific asset class, such as large- or small-cap equity, international equity or fixed income, chances are there is an ETF available that covers it.

Additionally, you can incorporate ETFs representing various investment styles – for example, dividend income or capital appreciation – into your portfolio. Their specific investment styles could make them attractive options for building a portfolio.

**Use alongside individual stocks and bonds**

ETFs can provide low-cost, broad exposure to asset classes that can help further diversify your portfolio. For example, if you already own several individual large-cap domestic stocks, a broadly based international or small-cap ETF can help further diversify your portfolio. Similarly, if you do not own many individual bonds, you could benefit from a broad intermediate- or short-term fixed-income ETF.

**Complement a mutual fund portfolio**

ETFs can be used with mutual funds to achieve additional diversification.

For example, an ETF could fill a gap in a portfolio of mutual funds. If you already own a number of large-cap domestic equity and international equity, as well as fixed-income mutual funds, you can increase diversification by adding exposure to the mid- or small-cap asset classes. If the mutual fund family does not have a fund that meets your needs, consider adding a mid- or small-cap ETF instead.

ETFs also can provide exposure to certain asset classes with a more limited number of fund choices, such as emerging markets or international small cap.

If you already have a well-diversified portfolio of mutual funds with different investment categories and asset classes, ETFs may not be necessary. Before you consider supplementing your portfolio with other investment types such as ETFs, see if you are eligible for break-points – or lower fees – if you invest a certain amount with a specific mutual fund family.

**Which ETFs Are Right for You?**

When selecting ETFs, we recommend you keep several criteria in mind.

**Track record** – It is important to assess an ETF's track record to evaluate whether it has met its performance objective. In general, at least one year of actual performance history is necessary. Most ETFs should perform similarly to the underlying benchmark. Review how the benchmark index itself has changed over time, as this can cause the ETF to perform differently.

**Low expenses** – Many ETFs have relatively low expenses due to their passive management. Since passively managed ETFs representing a certain asset class tend to be similar (for example, large-cap stocks), an important difference can be costs. Consider the following guidelines for ETF expenses:

Category	ETF Expense Ratio
Foreign/Global Equity & Fixed	Less than 0.40%
Domestic Equity & Fixed	Less than 0.20%

**More than \$25 million in assets under management (AUM)**

– Hundreds of ETFs have been launched over the past several years, and many are still quite small. We suggest investing in ETFs that have at least \$25 million in AUM, which is the level we believe is helpful to sustain their operations.

**The ETF's share price premium or discount relative to its net asset value (NAV)**

– The price of an ETF is determined primarily by the NAV of the fund's underlying holdings in addition to the supply of and demand for shares in the market. This could cause an ETF to trade at a premium or discount to its NAV.

Investors should seek funds trading at minimal premiums or discounts to NAV. Most broad-based ETFs trade within 2% of the fund's NAV, although this spread could widen in periods of market volatility. Also, the premium or discount could be more significant for more narrowly focused ETFs.

## Additional Considerations

### Potential tax implications

An ETF's holdings may affect capital gain or dividend distribution taxes. Also, some ETFs hold other domiciled ETFs which can create potential foreign withholding tax depending on asset class. The fund structure and tax implication details can be found in the ETF's prospectus. Be sure to talk to your qualified tax professional about your situation.

### ETF underlying holdings

Understanding an ETF's underlying holdings can help identify significant weightings to individual securities, industries, sectors or geographic locations, which may indicate the ETF is not as diverse as it seems. Knowing how the ETF is invested can lead to fewer performance surprises.

### Placing ETF orders

Because ETFs trade on an exchange like stocks, you can place different types of orders. The time of day when an order is placed can affect the price you receive. ETF prices may be more volatile near the market's open and close. Talk with your financial advisor to understand the various order types and their implications.

### Understand the Benefits and Trade-offs

ETFs offer certain benefits, such as low cost and diversification, which can make them attractive investments. However, you should consider your goals, risk tolerance and preference for owning certain types of investments when determining whether ETFs are appropriate for you. If you are considering investing in ETFs, work with your financial advisor to determine the role ETFs might play in your portfolio.

### Use Caution with These ETFs

Earnings recharacterization ETFs - Earnings recharacterization ETFs employ derivatives for the sole purpose of recharacterizing for tax purposes. We believe the use of derivatives to limit tax liabilities presents many concerns for fund investors, including regulatory risks, counter party risks, additional expenses and lack of transparency. Therefore, we do not believe they are appropriate for most investors.

**Narrowly focused ETFs** - In general, we do not recommend ETFs focusing on individual industries, countries or commodities. The more narrowly focused an ETF, the more dependent the fund's performance will be on a certain kind of company or individual country.

Additionally, these funds can have large allocations to single companies. This can lead to higher volatility over time, with potentially more downside than an investor may expect. We believe most investors should focus on broad-based ETFs that offer diversification and can be held for the long term.

**Leveraged and inverse ETFs** - Leveraged ETFs seek to provide a return that is a multiple (such as two or three times) of the benchmark index's return. Inverse ETFs seek to provide a return that is the opposite, or the inverse, of the benchmark index return. Returns for these ETFs can lead to unexpected performance results over longer periods. Therefore, we do not believe they are suitable long-term investments.

Exchange-traded funds are sold by prospectus. The prospectus contains more complete information, including the fund's investment objectives, risks, and charges and expenses as well as other important information that should be considered. Your advisor can provide a prospectus, which should be read carefully before investing.