New Investors: 3 Things To Ask Before Buying Any ETF

Description

I love exchange-traded funds (ETFs). Their creation in the 1990s ushered in a new age for retail investors, giving us low-cost access to various previously difficult to invest in assets.

Today, investors can choose from a variety of ETFs to suit their investment goals and risk tolerance. There are ETFs tracking stocks, bonds, gold, crypto, commodities, and even derivatives. You can use ETFs to target a particular country's stock market or invest in a specific sector.

Regardless of the ETF used, some universal tips should be kept in mind. While statistically more likely to beat stock-picking, passive investing using ETFs exposes you to some of the same risks, as well as some new ones.

What is the expense ratio?

The fund manager that creates the ETF needs to be paid, so they charge you what is called a management fee. This is expressed as a percentage. For instance, a management fee of 0.50% means that every year, for every $10,000 you have invested in the ETF, the fund manager will charge a fee of $50, withdrawn slowly over time.

There are also other fees, usually in the form of trading expenses. When people buy and sell shares of the ETF, the fund manager has to buy and sell shares of the underlying stock. This generates fees, which are passed on to the investor.

Combining the management fee and trading expenses gets you the management expense ratio (MER). Keeping this as low as possible will help you ensure maximum gains over a long period of time.

What is the AUM, volume, and spread?

Recall that ETFs trade on an exchange much like regular shares of companies do. The process of buying and selling an ETF still has to deal with the bid-ask spread, which is the difference between what someone wants to buy a stock for versus what someone wants to sell a stock for.

The bid-ask spread is affected by the volume of the ETF, which is the number of shares traded over a time period, usually daily, weekly, or monthly. The volume is affected by the assets under management (AUM) of the ETF, which is essentially how much investor money it currently holds.

Why is this important? Niche, unpopular, or new ETFs typically have lower AUM. This means less investor interest or attention, and usually causes a low volume to be traded. The low volume can widen the bid-ask spread, causing you to lose money when buying and selling.

Is it an exotic ETF?

Most “Plain Jane” ETFs hold a basket of real stocks, bonds, or shares of other ETFs. These ETFs simply track the aggregate performance of their holdings, making them accurate, transparent, and simple to understand. Some ETFs however, are the opposite.

Then there are exotic ETFs, that can provide twice or three times the daily performance of their underlying assets (leveraged ETFs), opposite the daily performance of their underlying assets (inverse ETFs), or pay out extremely high distributions (covered call ETFs).

These ETFs often use complex financial products called derivatives (such as options, swaps, and futures) to enhance losses and gains. They often come with high MERs, are extremely volatile, and have unpredictable or poor long-term performance. They are generally recommended only for advanced investors looking to day trade or hedge.

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