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# What Investors Should Know About ETFs

## Many People Don't Fully Understand Them, a Schwab Study Shows

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Exchange-traded funds are some of the fastest-growing investments today. And apparently not all that understood.

That growth may be part of the problem. With around 1,400 ETFs now and more being created, the ETF universe is getting ever-tougher to navigate. Investors feel it: A survey by a unit of Charles Schwab Corp. SCHW +0.48% found that about 40% of a sampling of Schwab investors wished they had a better handle on ETFs.

In some ways, choosing an ETF is similar to picking a traditional mutual fund. But because most ETFs aren't run by people who actively buy and sell the securities in the portfolio, investing in them is more of a do-it-yourself effort.

The most basic thing to understand, of course, is what an ETF is. ETFs trade through the day like stocks and typically own a basket of stocks or bonds tailored to replicate the performance of a certain market area. While many earlier ones were broad in scope, some newer ETFs track narrow areas of the market. Five key points to know:

**1. Start Simple.** If you have a smaller portfolio—say, less than $25,000—and want to own stocks, it isn't necessary to invest in multiple ETFs, says wealth adviser Vern Sumnicht in Appleton, Wis. One or two broad funds could work.

Mr. Sumnicht likes SPDR S&P Dividend ETF SDY +0.52% and First Trust Value Line Dividend Index, FVD +0.66% which are broadly diversified and focus on companies that consistently pay dividends. Such companies often get significant revenue from overseas, Mr. Sumnicht says, reducing the need to invest in an international fund for diversification.

He suggests avoiding ETFs focused on niche areas. The narrower the funds, the more of them you will need to diversify.

**2. Check an ETF's index.** ETF portfolios mimic indexes that often are created specifically for the fund. Indexes that seem similar can have differences when you look at them closely, says Ben Johnson, director of passive-funds research at Morningstar Inc. MORN -0.62% For example, iShares MSCI Emerging Markets EEM +1.31% holds more than 800 companies, but about 90% are large-cap and megacap issues. In contrast, the similar-sounding iShares Core MSCI Emerging Markets IEMG +1.07% ETF holds more than twice as many companies, with more small-cap and midcap issues.

Mr. Johnson likes iShares Core MSCI because of its greater portfolio diversity and lower expenses—0.18% of assets annually versus 0.67% for iShares MSCI.

**3. Be cautious about ETFs that promise better performance in certain markets.** Market-cap-weighted ETFs have more of their money in stocks with the biggest market capitalizations, and then add even more if the share price rises. As such, in aging bull markets these ETFs end up having their largest holdings in the stocks that may be more vulnerable to a drop.

Some newer ETFs seek to reduce that risk by giving equal weight to every company.

Is one a better choice than the other? Perhaps in short stretches, analysts say. But cap-weighted funds often outperform over long periods because of lower management fees.

The best solution may be a mix, says Greg Sarian, a partner in Sarian Group at High Tower Advisors in Wayne, Pa, who blends active and passive funds.

**4. ETFs work for most asset classes.** Some investors prefer actively managed funds for less active markets such as small stocks and emerging markets. They figure managers can ferret out value, justifying the higher expenses their funds charge.

But most markets today are quick to digest news. Only for some municipal and high-yield bonds is trading so infrequent that it is usually harder to create good index-based funds.

A Vanguard study of comparative performance for the decade ended in 2013 found that 71% of active emerging-markets funds and 84% of active small-cap blend funds underperformed index funds. Higher fees were a reason, says Vanguard senior investment analyst Chris Philips.

**5. Some ETFs may be less expensive to trade than others.** Some ETFs work for frequent trading; others are a better fit for a buy-and-hold strategy.

Among funds that work well for frequent trading is SPDR S&P 500, SPY +0.03% which is among the world's most active securities, says Mr. Johnson. Conversely, Vanguard S&P 500 VOO +0.75% ETF has an annual expense ratio of just 0.05 percentage point and other qualities that make it good for long-term investors, Mr. Johnson says. The fund trades closely in sync with securities in its underlying index, which tends to improve returns over long periods.