

# Not All ETFs Are Created Equally

Exchange-traded funds, or ETFs, have been around since the 1980s. Early ETFs were designed to track broad market indexes, offering investors a variety of benefits that included tax efficiency, low costs, trading flexibility and transparency. As the ETF market has matured, ETF providers have looked for new types of products to attract investors. Many of these aren't diversified and may not be as low cost as you may think. With more ETFs being launched, it's important to understand not all ETFs are created equally – and they're not all in a long-term investor's best interest.

We believe one of the most misunderstood and potentially dangerous types of ETFs is a leveraged ETF. In addition, exchange-traded notes (or ETNs) and structured products are similar to ETFs but have risks that may make them behave differently from what you would expect. Therefore, we don't believe leveraged and inverse ETFs, ETNs, and structured products are suitable for long-term investors.

## Leveraged and Inverse ETFs

Leveraged ETFs seek to provide a return that is a multiple (such as two or three times) of the underlying benchmark index's return. Inverse ETFs seek to provide a return that is the opposite or the inverse of the benchmark index return, while leveraged inverse ETFs seek to provide a multiple of the opposite return. This may sound like a way to take advantage of a view on which direction the market is headed. However, it's important to understand the goal of these ETFs is to provide the opposite or magnified return of the index on a daily basis, which can lead to unexpected results over longer time periods.

For example, let's assume you invest \$100 each into three different ETFs: a one-time inverse ETF, a three-times leveraged ETF, and a three-times leveraged inverse ETF. Suppose the underlying benchmark index goes up 10% on day one. At the end of the day, the index and the ETF values and returns are as follows:

At the End of Day 1				
	Initial Value	Total Return Day 1	Value at End of Day 1	Total Return
Index Value	100	10.0%	110	10.0%
1X Inverse ETF	\$100.00	-10.0%	\$90.00	-10.0%
3X ETF	\$100.00	30.0%	\$130.00	30.0%
3X Inverse ETF	\$100.00	-30.0%	\$70.00	-30.0%

Source: Edward Jones calculations. These are for illustrative purposes only and do not represent any available investments.

All the ETFs in the example have provided returns as expected.

Now let's assume the underlying benchmark index goes down 10% the next day:

At the End of Day 2				
	Value at Beg. of Day 2	Total Return Day 2	Value at End of Day 2	Total Return over 2 Days
<b>Index Value</b>	110	-10.0%	99	-1.0%
<b>1X Inverse ETF</b>	\$90.00	10.0%	\$99.00	-1.0%
<b>3X ETF</b>	\$130.00	-30.0%	\$91.00	-9.0%
<b>3X Inverse ETF</b>	\$70.00	30.0%	\$91.00	-9.0%

Source: Edward Jones calculations. These are for illustrative purposes only and do not represent any available investments.

In this example, the index lost 1% over the two-day period. The inverse ETF provided the same return as the index, also losing 1%. Both of the leveraged ETFs, however, are down 9% and worth \$91. The longer the ETF is held, the more profound the differences may be. Assume the same pattern of returns (positive 10% one day followed by negative 10% the next day) continued for 30 days. The index will have lost about 14%, and so would the inverse ETF, but both leveraged ETFs would have lost more than 75% of the initial amount invested.

At the End of Day 30		
	Value at End of Day 30	Total Return over 30 Days
<b>Index Value</b>	86	-14.0%
<b>1X Inverse ETF</b>	\$86.01	-14.0%
<b>3X ETF</b>	\$24.30	-75.7%
<b>3X Inverse ETF</b>	\$24.30	-75.7%

Source: Edward Jones calculations. These are for illustrative purposes only and do not represent any available investments.

When the index returns are more volatile, as shown in the table below, the ETF returns also will vary significantly.

Again, these returns are probably not what investors expected when they bought the leveraged or inverse ETF. In the example below, all three types of ETFs underperformed the index and offered dramatically different ending results. In total, the index ended less than 2% higher at the end of five days. However, the three-times leveraged ETF actually ended down about 3%, the inverse ETF was down over 4%, and the three-times leveraged inverse ETF lost more than 19%.

At the End of Day 5 (Increased Volatility)								
	Initial Value	Total Return Day 1	Total Return Day 2	Total Return Day 3	Total Return Day 4	Total Return Day 5	Value at End Day 5	Total Return Over 5 Days
<b>Index Value</b>	100	10.0%	-10.0%	5.0%	-5.0%	3.0%	101.72	1.7%
<b>1X Inverse ETF</b>	\$100.00	-10.0%	10.0%	-5.0%	5.0%	-3.0%	\$95.79	-4.2%
<b>3X ETF</b>	\$100.00	30.0%	-30.0%	15.0%	-15.0%	9.0%	\$96.96	-3.0%
<b>3X Inverse ETF</b>	\$100.00	-30.0%	30.0%	-15.0%	15.0%	-9.0%	\$80.95	-19.1%

Source: Edward Jones calculations. These are for illustrative purposes only and do not represent any available investments.

The recent market volatility has highlighted this risk, as many leveraged and inverse ETFs have performed very differently from what investors had expected. Therefore, we don't believe that leveraged and inverse ETFs are suitable long-term investments. Investors also need to recognize that leveraged ETFs have an increased potential for capital gains distributions and significantly higher expense ratios than the traditional broadly based stock market ETFs. These factors can negate some of the benefits of purchasing an ETF.

## Exchange-traded Notes (ETNs)

Like ETFs, ETNs can be bought and sold on an exchange throughout the day, and their returns are based on an underlying index. However, ETNs have several distinct characteristics that may create risks and make these investments unsuitable for most investors. These risks include:

- **Counterparty risk** – ETNs are unsecured debt instruments, backed only by the credit of the ETN issuer and not by an underlying basket of securities. If the issuer's creditworthiness declines, this decline can cause the ETN's return to decline, regardless of the performance of the underlying index.
- **No periodic payment** – ETNs have a maturity date (30 years, for example) and don't pay an annual coupon or dividend.
- **Risk of default** – If the ETN is held to maturity, the return is paid based on the return of the index, less the annual expense ratio. Because the ETN's return is based on the index, investors aren't guaranteed return of their principal investment at maturity. It's also possible that an ETN investor may not receive the appropriate return at maturity if the issuer defaults and is unable to pay, which occurred during the market turmoil in 2008.

## Structured Products

Structured products can encompass many different types of investments, including Principal Protected Notes and split share corporations. Typically, they're a hybrid of something that pays regular interest, such as a bond, and an investment with a variable return. This variable return can be related to the stock market or to currency, for example. The general concept is that your principal will be returned at maturity if the return of the variable investment goes down, and you'll receive at least some of the return if it goes up. Although this scenario sounds like the best of both worlds, we believe there are several major risks that make these investments inappropriate for long-term investors, including:

- **Counterparty risk** – As with an ETN, a structured product is typically an unsecured debt instrument. It's not backed by an underlying investment. Instead, you own the promise from the bank or institution to pay you the principal and any other return.
- **Partial return and fees** – If the variable investment goes up, you may receive part of that return. Fees tend to be high, which lowers the possible return.
- **Potential difficulty to sell before maturity** – Investors may not be able to sell the structured product prior to maturity if there is a lack of liquidity in the market.

## Next Steps

We believe broad-based, low-cost ETFs offer valuable benefits, namely diversification and potential tax efficiency. Investors should be aware, however, that not all ETFs are created equally, and not all are suitable for long-term investors. We believe many investors may be surprised by the risks of investing in leveraged and inverse ETFs, ETNs and structured products. Additionally, these securities tend to have higher expenses. Leveraged ETFs also have an increased potential for capital gains distributions.

Talk with your Edward Jones advisor to discuss the benefits and risks of including ETFs as part of your long-term financial strategy.

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For more information on ETFs that may be appropriate for long-term investors, as identified by our Mutual Fund Research department, contact your Edward Jones advisor.

Diversification does not guarantee a profit, nor does it protect against loss in a declining market.

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