

SECTION 3:

EXCHANGE-TRADED FUNDS

This section provides an overview of exchange-traded funds (ETFs), a relatively new innovation among registered investment companies.

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Exchange-traded funds are a relatively recent innovation to the investment company concept, with the first ETF introduced in 1993 after a fund sponsor received U.S. Securities and Exchange Commission exemptive relief from various provisions of the Investment Company Act of 1940. In the 12 years since, the number of ETFs has grown to about 200, and assets have reached nearly \$300 billion.

WHAT IS AN ETF?

ETFs are registered investment companies, most of which seek to mirror the return of a particular market index, such as the S&P 500 or the Russell 2000. Although most ETFs are registered as open-end funds, there are some key differences between ETFs and other open-end funds such as mutual funds.

One difference is how retail investors buy and sell shares. A retail investor in a mutual fund typically purchases or redeems shares directly with the fund. By contrast, retail shareholders in an ETF do not conduct transactions directly with the ETF but instead buy or sell ETF shares on a stock exchange, just as they would the shares of a publicly traded company. ETF shares originally enter the market through an institutional investor, known as a creation unit holder. These investors deposit with the ETF sponsor a specified basket of securities. In return for this basket of securities, the ETF issues to the creation unit holder a specified number of fund shares, which can be sold to the public through a stock exchange. A creation unit holder can liquidate its position by returning a fixed number of ETF shares to the ETF; in return, the creation unit holder

For the latest exchange-traded fund statistics, visit the Institute's website at

WWW.ICI.ORG/STATS/ETF/INDEX.HTML

receives the basket of securities it had deposited with the ETF. A retail investor in an ETF could liquidate their position by selling their ETF shares on a stock exchange.

Another feature that distinguishes ETFs from open-end funds is pricing. ETF shares may trade above or below the underlying value of the securities in the fund. Unlike a mutual fund, whose price per share is based on the fund's net asset value (NAV), an ETF's share price is influenced by the forces of supply and demand. For example, when investor demand increases, the ETF share price rises. However, ETFs are structured so that large differences between their share price and the value of the underlying basket of securities do not exist for long periods of time. Creation unit

holders counteract the impact of supply and demand for ETF shares by buying and selling ETF shares in the market, and if necessary, by creating or redeeming creation units with the fund. In doing so, creation unit holders help keep the market price of an ETF's shares close to the underlying value of its securities.

DEVELOPMENT OF THE ETF MARKET

The first ETF was a broad-based domestic equity fund that tracked the S&P 500 index, and was registered as a UIT. ETFs saw modest growth until the late 1990s, when demand for exchange-traded funds accelerated as retail investors and their financial advisers became increasingly aware of these investment companies. The market for exchange-traded funds was also bolstered by demand from

NET ASSETS OF ETFs

(millions of dollars, 1993–2005)

Year	Total	Investment Objective				Legal Structure	
		Broad-Based Domestic Equity	Sector/ Industry Domestic Equity	Global/ International Equity	Bond Index Funds	Open-End	UIT
1993	\$464	\$464	–	–	–	–	\$464
1994	424	424	–	–	–	–	424
1995	1,052	1,052	–	–	–	–	1,052
1996	2,411	2,159	–	\$252	–	\$252	2,159
1997	6,707	6,200	–	506	–	506	6,200
1998	15,568	14,058	\$484	1,026	–	1,510	14,058
1999	33,873	29,374	2,507	1,992	–	4,499	29,374
2000	65,585	60,530	3,015	2,041	–	10,257	55,328
2001	82,993	74,752	5,224	3,016	–	22,865	60,128
2002	102,143	86,985	5,919	5,324	\$3,915	35,983	66,160
2003	150,983	120,430	11,901	13,984	4,667	68,306	82,677
2004	226,205	163,730	20,315	33,644	8,516	132,013	94,192
2005	296,022	186,832	28,975	65,210	15,004	200,958	95,064

Note: Components may not add to the total because of rounding.

Sources: Investment Company Institute and Strategic Insight Simfund

institutional investors, who found ETFs to be a convenient vehicle for participating in, or hedging against, broad movements in the stock market.

As demand for ETFs grew, ETF sponsors offered more funds and a greater variety of investment objectives. In the mid-1990s, ETF sponsors introduced funds that invested in foreign stock markets. More recently, sponsors have introduced funds that invest in particular

market sectors or industries as well as bond index funds. For example, fund companies introduced 23 sector/industry ETFs in 2005. Sponsors have also introduced country-specific funds, funds that track commodities, and funds tracking highly specialized indexes. Since the mid-1990s, ETF sponsors have predominantly chosen to register their new funds as open-end investment companies. In 2005, most ETFs were open-end investment companies.

NUMBER OF ETFs
(1993–2005)

Year	Total	Investment Objective				Legal Structure	
		Broad-Based Domestic Equity	Sector/ Industry Domestic Equity	Global/ International Equity	Bond Index Funds	Open-End	UIT
1993	1	1	–	–	–	–	1
1994	1	1	–	–	–	–	1
1995	2	2	–	–	–	–	2
1996	19	2	–	17	–	17	2
1997	19	2	–	17	–	17	2
1998	29	3	9	17	–	26	3
1999	30	4	9	17	–	26	4
2000	80	27	28	25	–	76	4
2001	102	34	34	34	–	98	4
2002	113	34	32	39	8	105	8
2003	119	39	33	41	6	111	8
2004	151	60	42	43	6	143	8
2005	201	81	65	49	6	193	8

Sources: Investment Company Institute and Strategic Insight Simfund

ETF assets have grown rapidly since the late-1990s, approximately doubling every two years. Much of this increase is attributable to net issuance of new shares. From year-end 1998 through 2005, ETFs issued \$255 billion in net new shares. Investor demand for broad-based domestic equity funds accounted for much of this growth. These funds issued more than \$165 billion in net new shares during this

period, and assets of these funds reached \$187 billion by year-end 2005. Demand for global and international ETFs also rose sharply in recent years, mirroring an increase in investor interest in mutual funds investing in foreign markets. International and global ETFs issued \$39 billion in net new shares from year-end 2003 through 2005, and assets of these funds reached \$65 billion.

NET ISSUANCE OF ETF SHARES <i>(millions of dollars, 1993–2005)</i>							
Year	Total	Investment Objective				Legal Structure	
		Broad-Based Domestic Equity	Sector/ Industry Domestic Equity	Global/ International Equity	Bond Index Funds	Open-End	UIT
1993	\$442	\$442	–	–	–	–	\$442
1994	-28	-28	–	–	–	–	-28
1995	443	443	–	–	–	–	443
1996	1,108	842	–	\$266	–	\$266	842
1997	3,466	3,160	–	306	–	306	3,160
1998	6,195	5,158	\$484	553	–	1,037	5,158
1999	11,929	10,221	1,596	112	–	1,708	10,221
2000	42,472	40,920	832	720	–	6,815	35,657
2001	31,012	26,911	2,736	1,366	–	13,929	17,082
2002	45,302	35,477	2,304	3,792	\$3,729	20,383	24,919
2003	15,810	5,737	3,587	5,764	721	19,341	-3,531
2004	55,021	29,084	6,514	15,645	3,778	50,875	4,146
2005	53,871	16,941	6,719	23,455	6,756	55,381	-1,510

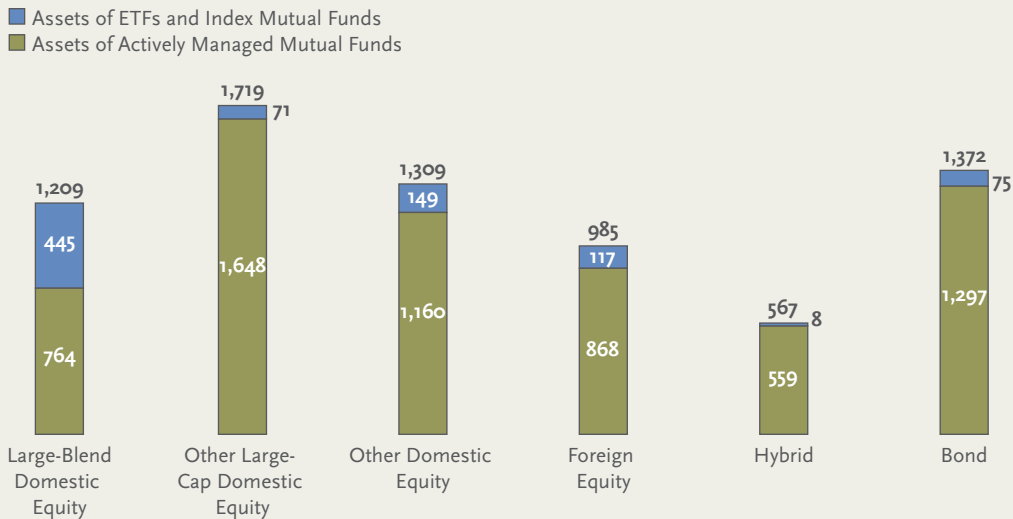
Note: Components may not add to the total because of rounding.
Sources: Investment Company Institute and Strategic Insight Simfund

DEMAND FOR ETFs AND INDEX INVESTMENTS

The growing demand for ETFs also parallels an increase in demand for indexed investments in general. By 2005, assets in index mutual funds and ETFs totaled \$865 billion, which is about 9 percent of the total assets managed by all registered investment companies. Much of this growth has occurred among funds tracking broad market indexes, especially those indexes tracking large companies. Funds indexed to

the S&P 500 manage about 40 percent of all assets invested in ETFs and index mutual funds. These funds are typically regarded as large-blend domestic stock funds. S&P 500 and other broad-based index funds now manage 37 percent of the large-blend domestic stock assets invested in registered investment companies. Index funds and ETFs are available in most other broad asset classes, but to date have attracted less investor interest than have broad-based domestic stock index funds.

ASSETS OF ETFs AND INDEX MUTUAL FUNDS ARE CONCENTRATED IN LARGE-BLEND DOMESTIC EQUITY
(billions of dollars, 2005)



Sources: Investment Company Institute and Morningstar