ETFs 101: The Basics of ETF Investing

SSI believes in simplifying the investment process. We refer to this as the third evolution of ETFs, where single products can provide full investment solutions for investors.

ETFs started off simple. Tracking a passive index, they combined the open-end mutual fund structure with the ability to trade the securities on the stock market throughout the course of the day. The increasing popularity of ETFs over the past several years has opened the ETF structure to a number of innovative products that provide access and ease the trading of previously less-liquid asset classes, strategic investing, and alternative weightings. What once was simple has become a bit more complicated.

The following is meant only as a brief introduction to understanding ETFs. We encourage you to expand your understanding by researching other sources on the Internet.

What are ETFs?

- An ETF is an open-end fund that trades in real-time on the stock market.
- ETFs are managed funds similar to mutual funds but with important differences.
- An ETF can provide exposure to a wide range of assets in a single trade.
- ETFs are purchased and sold through brokerage firms in the same way one purchases shares of a company.
- Most ETFs typically track an index; however, some track specific assets such as a commodity or currency.

Types of ETFs?

- Broad market
- Sector and industry
- Size and style
- International/global
- Commodities
- Currency
- Dividend and income
- Fixed income / bonds
- Passive or active management
- Leveraged or hedged strategies
- Factor-based strategies
- Capitalization weighted / “smart beta”

How to buy ETFs?

ETFs are listed primarily on the three major stock exchanges (NYSE, NASDAQ, BATS) making the ability to purchase and sell ETFs straightforward. You buy and sell through your broker at any time during normal market trading hours just as you would the common shares of a company stock. ETF prices are posted on financial websites using the ticker for the fund. Settlement of the trade typically takes place three business days after the transaction.

Benefits of ETFs

Market Trading
ETFs are bought and sold through your broker during normal stock market trading hours, just as one would ordinary shares.

Portfolio Diversification
ETFs provide exposure to a basket of securities in a single transaction. Investors can get exposure to securities across markets, sectors, styles, and asset classes, including those difficult to acquire in a market transaction. A portfolio comprised of many securities reduces the stock-specific risk of an individual security performing poorly.

Lower Fees
ETF funds typically have smaller management fees than similar products offered by mutual and hedge funds.

Transparency
ETFs tracking a passive index provide transparency into the holdings of the underlying index.

Liquidity
The ease of trading ETFs has expanded liquidity in a number of asset categories whose underlying securities are difficult to trade. This varies from ETF to ETF.

Tax Efficiency
The ETF process is designed to be tax efficient, with the in-kind exchange of shares leading to only a few funds distributing capital gains, historically. Passive indexes typically have low turnover so securities are usually bought and sold only when the composition of the index is changed or rebalanced.

Accurate Price Tracking
Unlike closed end funds that can trade at a premium or discount, there is an arbitrage element of ETFs that is designed to keep prices close to their net asset value.

Transaction Costs

Brokerage
Transaction fees to trade an ETF are typically the same as what you would pay to trade shares of stocks.

Management Expense
ETF managers charge a fee to manage the fund and it is calculated as a percentage of the fund's NAV so it is reflected in the price of the ETF. For a fund with a 0.50% fee, an investor would pay $5 per year per $1,000 invested.

Bid/offer Spread
The spread is the difference between the highest price a buyer is willing to pay (bid) and the lowest price a seller is prepared to sell (ask). The tighter the spread, the better it is for investors. This can be a few cents for heavily traded ETFs and wider for thinly traded or non-equity products. Market makers are incentivized to keep the spreads tight to encourage trading and some can receive rebates as an incentive from the exchanges.

Inside the ETF Process

To buy and sell ETFs, you really don't need to know the underlying mechanism but if you'd like a bit more insight into how ETFs operate, then here are some details.

- **How are ETFs created?**

Financial institutions called Authorized Participants (APs) apply to the ETF fund sponsor for the ability to create and redeem units in the ETF. Each unit consists of a number of shares, typically 25,000, 50,000, or 100,000. The AP then delivers a basket of securities that reflects the ETF holdings and/or cash equal to the value of the ETF. Once complete, the AP can sell individual shares on the secondary market.

- **Primary vs. secondary market**

The creation and redemption of units by the APs take place in what is referred to as the primary market. The transaction that occurs in your brokerage account happens in the secondary market. It is really just nomenclature as you will see no difference than if you traded shares of any stock in your account.

- **Who holds the underlying securities?**

When ETFs are created, the individual, underlying securities are transferred to a custodian chosen by, but independent of, the ETF sponsor who is responsible for holding them.

- **How does the market making process work?**

The ETF sponsor publishes daily the composition reflecting the underlying basket of securities. This enables market makers to calculate the NAV of the ETF throughout the trading day. When there are no orders present in the market for an ETF, they place quotes for investors to trade with--a spread around the NAV resulting in a bid price at which they will buy ETFs and an offer price at which they will sell ETFs. This spread will vary throughout the trading day. Market makers are also APs which means they have the right to redeem units with the ETF issuer or have units created.

- **Why does the price of an ETF, track the value of the NAV?**

When the price diverges from the value of the ETF, it presents an arbitrage opportunity for financial professionals to swap either the underlying holdings for shares of the ETF or shares of the ETF for the underlying holdings.

- **Will I always be able to sell my ETFs?**

Under normal market conditions, the role of the market maker is to facilitate trading. That said, there is no guarantee and in times of extreme volatility trading may become difficult.

Taxes

How the creation / redemption process can produce tax benefits
When an Authorized Participant (AP) creates or redeems an ETF unit, it is done so as an "in-kind" exchange; there is a transfer of the portfolio holdings and the ETF shares. Since it is an exchange vs. a sale, there are no capital gains due in the trade. This allows the fund to remove high basis holdings.

Realized Capital Gains
The fund may still realize capital gains and losses during the year when it sells the underlying assets. Any net capital gains is passed on to the ETF shareholders.

Capital Gains from Trading
Investors are still responsible for any net capital gains as the result of trading. These are separate from any capital gains associated with the fund.

For any other tax-related questions about your personal situation, investors should consult with a tax professional.

Distributions

- ETF funds are required to distribute at least annually any excess dividends to the fund.
- Reinvesting dividends is not something performed by the ETF fund sponsor but by your broker. Investors should contact their broker to inquire about distributions.

Where Can I Find and/or Search for Detailed Information on Specific ETFs?

- ETF portals with extensive databases and resources to screen ETFs include ETF.com, ETFdb.com, ETFChannel.com, etc.
- Fund sponsor websites. According to SEC rules, fund sponsors are required to have details about their funds including links to their prospectus, summary prospectus, and fact sheets easily available for digital download and review from their website.
- Financial publication websites (such as Bloomberg, Barrons, etc)
- Financial portals (such as Google Finance, Yahoo Finance, Marketwatch, etc.)

Complicating the Simple

As the ETF industry has grown, new products have entered the market that expand beyond the initial concept of tracking a passive, transparent underlying index.

- **ETFs vs ETNs**

Although they trade on the exchange like an ETF and are regularly included in the databases of exchange traded products, ETNs (exchange traded notes) are a type of unsecured unsubordinated debt security that tracks the performance of a market index minus applicable fees. ETNs are debt notes issued by a bank which promised to pay you a return based on the underlying. The ETN structure can be linked to anything but typically it tracks commodities, currencies, and other products. The tax treatment of ETNs is different from that of ETFs.

- **Leveraged ETFs**

A number of products exist that offer leverage and inverse leverage--2x or 3x, typically on a daily basis. It is important to understand that the leverage is on a daily basis and that these products decay over time. When leveraging, both the long and the short can lose money over time due to the decay.

Additional Terms You May Come Across:

Managing the ETF

We advise you to carefully read the prospectus prior to investing in an ETF. When you do, you may come across some additional terms that may seem confusing.

Replication vs. Representative Sampling

The holdings of a fund that follows the "replication" method exactly matches the composition of the index and in the same proportion/weighting.

In a fund that employs "representative sampling," the fund manager may or may not hold all of the assets in the index or not in the same ratio. For example, it may not make sense or be possible to match the index exactly in the case of a thinly traded bond, small cap stock, or a security in a market that is currently closed. The manager has the flexibility to select assets to achieve a similar outcome.

Neither is considered preferable over the other and will depend on the underlying index and the holdings.

Index Construction

Regardless of the type, style, or purpose of the index, there are a number of methodologies that can be employed. Common among the terms you will see are passive vs. active; and market vs. non-market cap/ "smart beta" weighting.

Passive ETFs: The goal of the fund is to match the performance of a target index or benchmark before fees.

Actively-managed ETFs: Holdings can be changed at the discretion of the investment manager. They do not mirror a specific index.

Market Cap: Weighting is based on the market capitalization of the holdings in the index.

"Smart beta": Term coined to reflect alternative weighting strategies such as equal weighting, revenue weighting, or modified strategies that put a cap or minimum on the weightings.

ETF Risks

Like all investments, ETFs involve risk. They offer exposure to a diverse range of assets, so risk profiles vary significantly between different ETFs.

Market / Sector / Style Risk
The value of the portfolio can decline due to a news events or general market conditions. Similarly, if the product you own tracks a specific sector or element of the market this is called Sector Risk or Style Risk

Currency Risk
When an ETF holds positions in an international security or product that primarily trades on a non-U.S. exchange, these are typically priced in the currency of the overseas market and must be converted into U.S. dollars. Certain types of commodities might also be priced in a foreign currency.

Liquidity Risk
Liquidity is simply how easy and quickly you can sell and whether you get a "fair price." The liquidity of an ETF is a balance of several factors and varies from ETF to ETF.

- Underlying Holdings—If the ETF holds products that trade frequently, it will be easier for market makers to buy and sell units.
- Compared to an actively traded ETF that has a "tighter" spread and better pricing, a thinly traded ETF with low turnover might produce a wider range between the bid and ask prices.

Mispricing and Divergence from NAV
In the short term, the price of an ETF can diverge from the NAV. If the spread becomes too large, an arbitrage investor will get involved and profit from reducing the mispricing.

Tracking Errors
An ETF may not exactly follow the price of the index it is designed to track or the portfolio the index holds. This can be because of the way the portfolio is traded.

What ETF Did I Buy?
An ETF is more than just its name. ETFs competing in the same market can track indexes with significantly different methodologies and can produce differing results. It is possible to get confused simply by looking at the name. That is why it is recommended to review the prospectus, the methodology of the fund, and the list of holdings their respective weights. It is important to know what product you are investing in, and to understand the risks involved.

About SerenityShares Investments LLC

SerenityShares™ Investments LLC is a Registered Investment Advisor that designs strategies to simplify the investment process. The exchange traded fund (ETF) industry is entering into its Third Evolution when single products should have the potential to provide full investment solutions for investors. Our goal is to provide investors with a better way to invest their core holdings, as well as the ability to make an impact with their investments. Utilizing the benefits of ETFs, we are an innovator that employs rules-based, passive index methodologies to solve problems and meet the needs of investors.

Disclaimers

 This document does not constitute an offer of services in jurisdictions where SSI, its affiliates, or partners do not have the necessary licenses. All information provided by SSI is impersonal and not tailored to the needs of any person, entity, or group of persons.

This material has been prepared solely for informational purposes based upon information generally available to the public and from sources believed to be reliable. No content contained in these materials or any part thereof may be modified without the prior written permission of SerenityShares. The Content shall not be used for any unlawful or unauthorized purposes. SerenityShares, and SSI Indexes and its third-party data providers and licensors, do not guarantee the accuracy, completeness, timeliness or availability of the Content. SSI Indexes and its third party data providers are not responsibility for any errors or omissions, regardless of the cause, or for the results obtained from the use of the Content.

The Content is provided on an "as is" basis. SERENITYSHARES INVESTMENTS AND SSI INDEXES DISCLAIM ANY AND ALL EXPRESS OR IMPLIED WARRANTIES, INCLUDING BUT NOT LIMITED TO, ANY WARRANTIES OF MERCHANTABILITY OR FITNESS FOR A PARTICULAR PURPOSE OR USE. In no event shall SSI or SSI Indexes be liable to any party for any direct, indirect, incidental, exemplary, compensatory, punitive, special, or consequential damages, costs, expenses, legal fees, or losses (including, without limitation, lost income or lost profits and opportunity costs) in connection with any use of the Content even if advised of the possibility of such damages.

SSI Indexes LLC may receive compensation in connection with licensing its indices to third parties. Past performance of an index is not a guarantee of future results. It is not possible to invest directly in an index. Exposure to an asset class represented by an index is available only through investable instruments based on that index. SSI Indexes does not sponsor, endorse, sell, promote, or manage any investment fund or other investment vehicle that is offered by third parties and that seek to provide an investment return based on the performance of any index. SSI Indexes makes no assurance that investment products based on the index will accurately track index performance or provide positive investment returns. SSI Indexes LLC is not an investment advisor and makes no representation regarding the advisability of investing in any such investment fund or investment vehicle. A decision to invest in any such investment fund or other investment vehicle should not be made in reliance on any of the statements set forth in this document. Prospective investors are advised to make an investment only after carefully considering the risks associated with investing in such funds, as detailed in an offering prospectus or similar document. Inclusion of a security within an index is not a recommendation by SSI Indexes to buy, sell, or hold such security, nor is it considered to be investment advice.

Carefully consider the Funds' investment objectives, risks, charges, and expenses before investing. This and additional information can be found in the statutory and summary prospectus, which may be obtained by calling 202-349-3917 or visiting www.serenityshares.com. Read the prospectus carefully before investing.

Investing involves risk, including the possible loss of principal. The fund is new with limited operating history. Shares of any ETF are bought and sold at market price (not NAV), may trade at a discount or premium to NAV and are not individually redeemed from the Fund. Brokerage commissions will reduce returns. Because the methodology of the Index selects securities of issuers for non-financial reasons, the Fund may underperform the broader equity market or other funds that do not utilize impact criteria when selecting investments. The Fund may invest in foreign securities which involve political, economic and currency risks, greater volatility and differences in accounting methods. The Fund may invest in smaller companies, which involve additional risks such as limited liquidity and greater volatility than large cap companies. To the extent the Fund invests more heavily in particular sectors of the economy, its performance will be especially sensitive to developments that significantly affect those sectors, including investments in Industrials and Technology sectors.

The SerenityShares Impact ETF is distributed by Quasar Distributors, LLC.

Any tax or legal information provided is not exhaustive. Investors must consult their tax advisor orlegal counsel for advice and information concerning their particular situation. Neither the Fund nor any of its representatives may give legal or tax advice.

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