ETF BASICS PART 3: THE BENEFITS OF THE ETF STRUCTURE

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There are many exchange-traded products on the market today. But would it surprise you to learn that the term “exchange-traded funds” is actually overused? The truth is that although the term “ETF” is now used as a sort of catchall, in reality, we believe only those exchange-traded investments registered under the Investment Company Act of 1940 (“registered”) are truly exchange-traded funds. Designed to ensure managers act in the investors’ best interests, the Investment Company Act of 1940 (“’40 Act”) is an important piece of legislation that defines how investments registered under the ’40 Act are built and managed. In general, investments registered under the ’40 Act must meet strict anti-fraud rules and diversification minimums and must prohibit excessive use of alternative strategies like leverage (taking out a loan to buy shares of securities, or using stock shares as collateral in an effort to leverage existing portfolios beyond their initial investments) or short selling (borrowing shares of securities to sell now in the hopes of buying them back more inexpensively later and profiting from the difference). The ’40 Act helps protect investors by requiring investment companies to disclose their holdings, strategies and financial conditions on a regular basis. However, it is important to note that ETFs registered under the '40 Act should not be considered safe investments and it’s still possible to lose money when investing in ETFs.

ETFs are exchange-traded products registered under the ’40 Act as open-ended investment companies (funds that do not restrict the number of shares that can be created). And thanks to certain Securities and Exchange Commission (SEC) guidelines, ETFs are allowed to have their shares traded on the secondary market (a market where investors purchase or sell securities or assets from or to other investors, rather than from issuing companies themselves—exchanges such as the New York Stock Exchange and the NASDAQ—are secondary markets). ETF investors could benefit from the rules of the ’40 Act by gaining access to ETF holdings, strategy and other operational information. In fact, most ETFs are fully transparent—disclosing their holdings on a daily basis.

It’s worth noting that these protections do not apply to all exchange-traded products, only to ’40 Act registered ETFs. Some exchange-traded products are registered under the Securities Act of 1933, the first major piece of financial legislation after the crash of 1929 that attempted to minimize fraud and increase transparency. This law does not contain the same regulations regarding leverage, concentration and diversification as the ’40 Act.

So, for example, a non-’40 Act investment employing triple leverage (borrowing funds to invest three times its net assets) may be referred to as an exchange-traded fund, but strictly speaking, it is an exchange-traded product, not an ETF. This type of alternative fund may be registered under the Securities Act of 1933, but it won’t offer investors the some protections as those with ’40 Act registration. Some strategies that invest in alternative asset classes like commodities and currencies can be registered under the ’40 Act. This protection—as well as the ETF structure itself—can be particularly meaningful these investors:

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- '40 Act alternative ETFs help protect investors from the excessive use of leverage, short selling and over-concentration that can be part of non-'40 Act alternative investments.
- Traditional alternative strategies, like hedge funds, typically do not disclose their holdings to investors, whereas all ETFs disclose their holdings on a daily basis.
- The structure may help reduce some of the risks of these asset classes by providing a diversified fund approach.
- Although some alternative assets or markets cannot be converted to cash on a daily basis, ETF shares can be sold at any time during a business day.
- Where many traditional, non-ETF alternative strategies have strict investor qualifications, any investor can buy shares in any ETF.
- Most traditional, non-ETF alternative strategies have minimum investment requirements that can be prohibitive, to say the least. As ETFs have no minimum requirements, an investor can purchase a single share if they so desire.
- It is often costly and risky to purchase alternative assets like commodities and currencies on your own. Though subject to trading fees, ETFs typically have low management fees and can be quite cost effective.
- Traditional non-ETF alternative investments can have complicated tax consequences. For example, hedge fund investors must wait for their K-1 (a partnership tax form that outlines the gains or losses of the alternative investment) in order to file their taxes. ETFs have no such requirement—and may actually be used to help manage taxes through tax-loss harvesting or other tax management strategies.

When considering different exchange-traded investment options, take into account whether the fund offers the protections of the Investment Company Act of 1940.

WisdomTree has a full family of '40 Act-registered ETFs.

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