

# EXCHANGE TRADED FUNDS

## DESCRIPTION, COMPARISON *and* FREQUENTLY ASKED QUESTIONS

### DESCRIPTION

Exchange Traded Funds (ETFs) are open-end index funds that are bought and sold like common stocks on a national stock exchange. This flexibility enables investors to purchase and redeem shares online or off-line through any brokerage firm or through a financial advisor. ETFs are engineered for low portfolio turnover, which helps to reduce transaction costs and minimizes capital gains tax distributions. Similar to common stocks, there is tax on any appreciation of an ETF when it's sold.

### COMPARISON

Feature	ETF	Traditional Mutual Fund
Pricing	Real-time, intra-day	End-of -day net asset value
Accessibility <sup>1</sup>	Any brokerage firm, any account	Some fund supermarkets, selective brokers, directly with fund company
Tax-efficiency <sup>2</sup>	Minimal taxable capital gains distributions due to low portfolio turnover	Varies depending on fund's portfolio turnover (generally, high portfolio turnover equals high taxable distributions); retail index funds generally offer low turnover
Fund expense ratio <sup>3</sup>	Low	Low to moderate; depending on fund
Transaction Fee	Commission on trade through broker	Typically no, transaction fees if purchased at fund company; transaction fees can be charged through fund supermarkets and brokers
Early Sales/ Redemption Fee	None	Depends on fund company rules
Two-way trading	Long or short <sup>4</sup> position	Long position only
Buy on Margin <sup>5</sup>	Yes, buy on margin (standard margin rules)	Typically no, funds can be used as collateral
Hedging	Yes, options and futures exist on some of the underlying indexes, and in some cases, on the ETF itself	Difficult to hedge, typically not available; retail index funds may offer hedging capabilities
Listed Options on Funds	Selected funds	Typically no, may be options on underlying index
Portfolio disclosure <sup>6</sup>	Monthly	Semi-annually

<sup>1</sup> iShares may be sold throughout the day on the exchange through any brokerage account. However, iShares may only be redeemed directly from the fund by Authorized Participants, in very large creation/redemption units.

<sup>2</sup> ETFs, like mutual funds, are obliged to distribute portfolio gains to shareholders by year-end. These gains may be generated due to index re-balancing or to meet diversification requirements. Trading of ETFs by an individual, too, will generate tax consequences and transaction expenses. Certain mutual funds may be tax efficient as well.

<sup>3</sup> The annual management fees of ETFs may be less than many mutual funds. ETF transactions will generate brokerage commissions.

<sup>4</sup> With short sales, you risk paying more for a security than you received from its sale.

<sup>5</sup> There are special rules associated with margin investing. As with stocks, one may be called upon to deposit additional cash or securities if account equity declines.

<sup>6</sup> Generally, ETFs fully replicate or hold a representative sample of their underlying indexes, the components of which are disclosed monthly.

## DIFFERENCES

### *Traditional Mutual Fund*

An open-end fund that offers diversification, professional management, and typically low minimums to invest. Pricing is typically available once at the end of each business day, expressed as a net asset value. Mutual funds must distribute income and capital gains to shareholders annually, resulting in annual taxation to shareholders even though shares in the fund are not sold. Mutual fund advisors rarely disclose a fund's holdings more than bi-annually.

### *Closed-End Fund*

A closed-end fund is valued on a fixed number of shares issued by an investment company, listed and traded on a national stock exchange. Due to limited shares available, and market expectations, closed-end funds often trade at a premium or discount to the current price. Required distributions are the same as traditional mutual funds.

### *Unit Investment Trust*

A trust account that purchases a portfolio of securities from money contributed by investors. Unit investment trusts have a defined lifespan. UITs typically cannot reinvest dividends into more shares immediately upon receipt. This results in potential "cash drag" that may affect the total return performance.

### *Exchange Traded Fund (ETF)*

An open-end fund that represents a hybrid between common stocks and traditional mutual funds, combining the cost efficiencies, professional management, and diversification of mutual funds, with expected lower turnover (i.e. more tax efficiency) and real-time pricing of stocks. Additional benefits that are unlike traditional mutual funds include: 1) ability of shareholders to pursue long and short investment strategies, including hedging against market declines, 2) placing execution limit orders for specific pricing levels, and 3) buying on margin.

## FREQUENTLY ASKED QUESTIONS

**Q: What investments are found in ETFs?**

A: Securities that represent the underlying index tracked by the fund. (Like managers of traditional mutual funds, ETF managers may use futures in a risk-controlled manner to match the overall return on cash dividends to fund performance.)

**Q: Any restrictions on where investors can purchase ETFs? How does this differ from traditional mutual funds?**

A: No. As investments listed on a national securities exchange, they can be accessed through any brokerage firm or financial advisor, online or off-line. This “portability” enables investors to consolidate their investments anywhere, without maintaining additional accounts with other financial institutions. Traditional mutual funds usually do not offer investors the same portability.

**Q: Aren't ETFs really short-term instruments for day-traders?**

A: Real-time pricing, marginability, and short sales do offer added flexibility to investors who trade more frequently. However, index investments are historically used by long-term investors as core portfolio holdings. Much like common stocks, investors have different strategies for their holding periods. These additional features simply make ETFs more flexible to a broader segment of investors.

**Q: How do capital gains distributions affect shareholders of ETFs?**

A: ETFs tracking an index offer two distinct advantages for investors concerned with reducing tax consequences. First, they are engineered to minimize portfolio turnover that can create higher capital gains distributions. Second, and similar to common stocks, investors pay tax primarily on the investment's appreciation at the time of sale. Capital gains may be generated due to index re-balancing, and the need to meet diversification requirements. Tax-managed retail index mutual funds offer similar advantages.

**Q: Isn't it cheaper to buy a traditional index mutual fund rather than an ETF, given commissions charged by brokers?**

A: Not necessarily. Commission costs continue to fall with increased competition and the growth of online investing. Some traditional mutual funds charge a transaction fee to buy or sell shares. In many instances, there are also transaction fees charged when funds are purchased outside of the fund company (i.e. brokerage firm fund supermarkets). The investor's cost could exceed the cost of the commission on an ETF.

**Q: Are there short-term redemption rules and fees on ETFs?**

A: No. Investors can make adjustments at any time without short-term restrictions or redemption fees. A brokerage commission is charged on the sale. Many fund companies offering traditional mutual funds have short-term redemption policies that impose restrictions on the sale of shares within a given time period after the purchase date. This can include a short-term redemption fee.

**Q: Can dividends received by the ETF be reinvested immediately by the fund?**

**A:** Yes. Dividends received from the underlying holdings can immediately be reinvested into more shares.

**Q: Is this the same with all ETF investments?**

**A:** No. ETFs that are structured as unit investment trusts cannot reinvest dividends received by the trust; rather, they deposit the income in a non-interest bearing account and distribute it periodically to the trust shareholders. This results in what is commonly known as “dividend cash drag”—where the investments’ total return is affected by a delay in reinvesting dividends immediately upon receipt by the fund or trust.

**Q: Can ETFs be margined?**

**A:** Yes. Investors can use both long and short margin strategies. Standard margin rules apply. However, there are additional risks associated with margin investing.

**Q: Are ETFs exposed more to volatility than traditional index mutual funds?**

**A:** No. Both try to match the return of the underlying index and will fluctuate in value according to the change in value of the underlying securities within the indexed portfolio.

**Q: Will ETFs ever trade at a premium or discounted price, like a closed-end fund?**

**A:** We believe that institutional investors and market makers would always take advantage of any slight differences between the NAV and the trading price of the exchange traded fund, through arbitrage opportunities, bringing the price in line with the underlying value of the fund. However, BGI cannot guarantee that those institutions and market makers will do so.

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