

# What are ETFs?

With the current popularity of exchange-traded funds (ETFs), it’s essential to understand how they work. Below we explain the basics—including what ETFs are, how they differ from mutual funds and the potential benefits of ETFs for investors.

## Like mutual funds, ETFs are a collection of securities you can invest in

ETFs are baskets of investments—similar to mutual funds. They can invest in various assets, such as stocks, bonds and commodities—giving investors exposure across multiple sectors or asset classes.

Some ETFs may target a specific niche rather than holding a broadly diversified portfolio. These specialized ETFs may concentrate on a particular sector like technology or healthcare, a specific type of commodity like gold or even a thematic focus such as renewable energy—providing targeted exposure to a defined area of focus.

While sector funds have been available in mutual fund form for many years, what distinguishes many newer ETFs is the varied and specialized approaches seldom seen in mutual funds, such as inverse equity and leverage (and leveraged-inverse equity); as well as specialized sector funds within countries such as Chinese Internet and India Financials. These have proliferated with the expansion of indexes against which indexed-ETFs are managed.

While the first wave of ETFs leaned heavily toward passive index tracking funds, the number of active ETFs coming to market that resemble traditional actively-managed mutual fund offerings is increasing.

## Tax treatment is one key difference between ETFs and mutual funds

Although ETFs and mutual funds are similar in many ways, there are a few critical differences.

A key distinction between ETFs and mutual funds is their tax treatment. The way that ETFs are structured, they are not subject to capital gains taxes in the same manner as mutual funds. They allow for in-kind transactions, which can reduce tax implications resulting from portfolio adjustments or investor redemptions. There isn’t the buildup of unrealized capital gains, which newer shareholders may have to pay for even if they’ve owned the fund for a short time.

Another difference is how both types of vehicles are bought and sold.

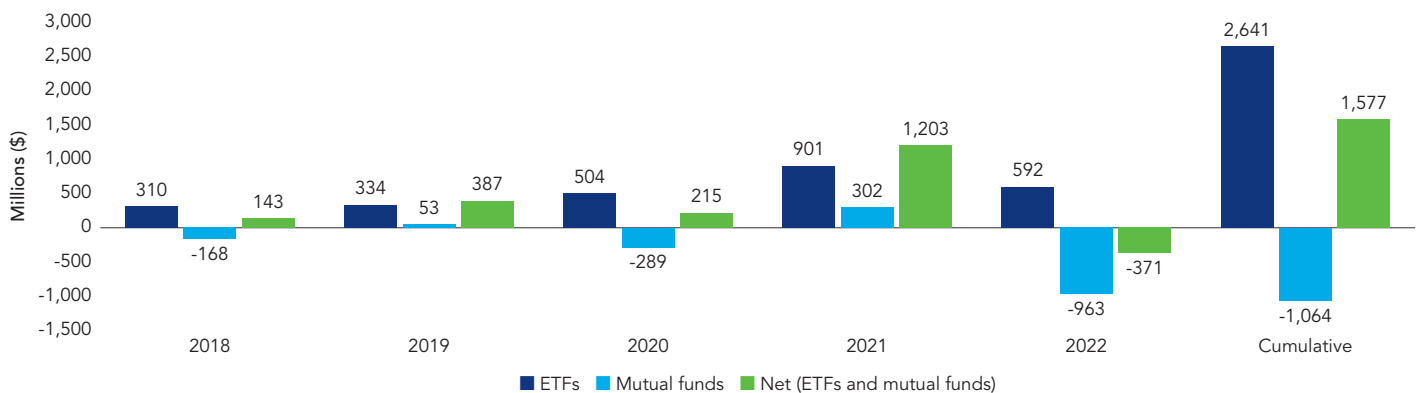
Shares of mutual funds are valued at the end of each trading day based on the fund’s net asset value. That is the price at which shares are bought or sold. ETFs can be bought or sold on stock exchanges through a brokerage account throughout the day like individual stocks, with prices known by the buyer at the time of purchase or sale. Since the funds can be traded throughout the day, ETFs give investors much greater control over the price at which they can buy or sell the ETF. Since they trade like stocks, investors can institute limit and stop loss orders and other features that can mitigate risk. Intra-day trading can be crucial on days when markets are volatile.

Another feature of ETFs that some investors may find beneficial is their transparency. For several reasons, mutual funds may only share details on their holdings once per month or even quarterly, and often with a considerable lag. Many ETFs disclose their holdings daily, providing clarity on the assets owned by the fund.

## Growing in popularity

ETFs are increasingly popular with investors and their advisors likely due to some of the features outlined above. From 2018 to 2022, net fund flows into ETFs had a 17% annualized growth rate. During the same period, net flows into mutual funds declined.

Exhibit 1: Mutual fund and ETF asset flows



Sources: Morningstar, Inc.; Federated Hermes. Data is through 12/31/22.

## Active vs. passive ETFs

As with mutual funds, investors can choose between passively-managed indexed or actively-managed ETFs. Indexed ETFs are built to match or track the components of a specific market index, such as the S&P 500.

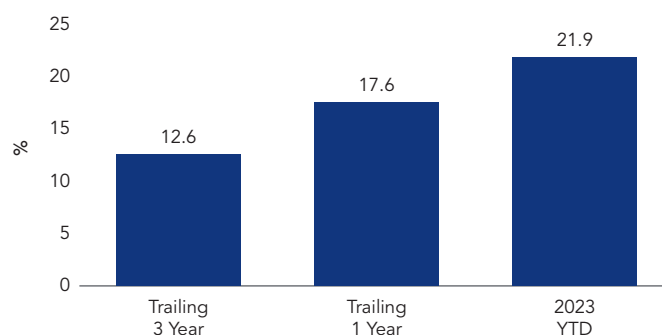
Portfolio managers construct active ETFs with the goal of outperforming a particular index. Although indexed ETFs typically have a lower cost than actively managed funds, active ETFs offer some important features for investors to consider:

- **Freedom to pursue outperformance.** Active ETFs aren't restricted to replicating an index. Instead, portfolio managers can strategically select investments they believe will perform better than a specific index or benchmark and have the flexibility to adjust to volatile or fast-changing markets.
- **Broader opportunity set.** While index ETFs are confined to the securities within a specific index, managers of active ETFs may be able to invest in securities outside the benchmark for greater return/risk potential.
- **Risk-management advantages.** Based on their knowledge of market dynamics and economic indicators, managers of active ETFs or mutual funds can work to mitigate risks, such as by reducing exposure to specific sectors or by managing duration, an unmanaged risk in indexed fixed-income ETFs. Index-tracking ETFs or mutual funds are designed to track an index, with no attempt to reduce risk or increase performance.

Regarding how the underlying strategies are managed, neither ETFs nor mutual funds hold a distinct advantage. The portfolio management approach would be the same regardless of the fund structure. That is, an active ETF and an active mutual fund managed in the same style would be expected to have the same performance profile.

## Exhibit 2: Active ETFs increasing share

Active ETF asset flows as a percent of total ETF fund flows



Source: Morningstar, Inc.; as of 6/30/23

## Consider goals, risk tolerance and time horizon

Understanding the fundamentals of ETFs—including their potential advantages over mutual funds and the differences between active and passive ETFs—can empower investors and their advisors to make informed decisions about their investment portfolios. As with all investments, individual goals, risk tolerance and investment horizon should be the guiding factors in the decision-making process. With the proper knowledge, strategy and advice, ETFs can be a robust tool in the portfolio construction process.

**Investors should carefully consider the fund's investment objectives, risks, charges and expenses before investing. To obtain a summary prospectus or prospectus containing this and other information, contact us or visit [federatedhermes.com/us](https://federatedhermes.com/us). Please carefully read the summary prospectus or prospectus before investing.**

Mutual funds and ETFs are subject to risks and fluctuate in value.

Funds whose investments are concentrated in a specific industry, sector or geographic area may be subject to a higher degree of market risk than funds whose investments are diversified. There is no guarantee that active ETFs will outperform passive ETFs and they may underperform. Active ETFs typically have higher expenses than passive ETFs, which can reduce performance.

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