charles SCHWAB INVESTMENT MANAGEMENT

Beyond the Expense Ratio: The Total Cost of Owning ETPs

Because total returns are reduced by any investment's cost, it's important for investors to understand and account for expenses when evaluating exchange traded products (ETPs[1]). ETPs entail both implicit—including the bid/ask spread—and explicit costs: Implicit costs are market-driven, whereas explicit costs are determined by the ETP provider or the broker. Some ETP costs are incurred at purchase; others are ongoing. The relative importance of the various costs is a function of how long the ETP will be held and the size of the investment.

Operating Expenses

ETPs typically incur some type of annual fee to cover administrative and management expenses borne by the issuer. Expressed as a percentage of total assets, this fee is typically known as an operating expense. With ETPs, operating expenses are typically quite low—and generally lower than those of an equivalent mutual fund. Operating expenses may be most important to investors who intend to hold for a long period of time.

Bid/Ask Spread

Whenever a security is purchased or sold on an exchange, the price is determined in part by market makers—traders who buy and sell a specific stock or ETP. They stand ready to sell shares at one price (the "ask" or "offer" price) and buy at another, slightly lower price (the "bid" price). The difference between the two is known as the spread. An ETP's spread will vary based on the liquidity and market demand of its underlying securities. Highly liquid securities, such as those that constitute the S&P 500® Index, typically trade with very narrow spreads. Others, such as smaller-cap stocks, emerging-market securities and high-yield bonds—all of which may trade less frequently or have fewer shares available—tend to have wider spreads. For investors planning to hold for less than a year, the spread may be more important than the operating or tracking expense.

Commissions

Because ETPs trade on exchanges, like stocks, a commission will typically be incurred upon both the purchase and the sale of shares. The commission on each transaction will be dependent upon the broker and the size of the transaction. Some brokers charge a fixed-rate commission; others calculate the commission based on the size of the trade and/or relationship factors. The size of the purchase will have a bearing on the importance of the commission cost: For instance, if your broker charges a flat commission rate no matter how many shares are purchased, the commission will represent a higher percentage cost for smaller transactions than for larger ones.

[1] While most investors are familiar with the term ETF (exchange traded fund), several other investment products are also exchange-traded and are therefore similarly categorized, including exchange traded notes (ETNs), commodities, unit investment trusts (UITs), grantor trusts and limited partnerships. Because ETFs represent the vast majority of these exchange traded investment products, the term is often used as a catchall. It's more accurate, however, to use the term "exchange traded product" (ETP) as the umbrella under which ETFs and other related investment products fall.

Calculating the Cost of Ownership

The total cost of ownership of an ETP, then, is the sum of the commission, bid/ask spread and expense ratio. The table below compares the hypothetical purchase of two ETPs with different cost factors, given a $10,000 trade and a one-year holding period.

HYPOTHETICAL COSTS ON A $10,000 TRADE

Costs	ETF A		ETF B	
	%	$	%	$
Expense ratio	0.72%	$72	0.25%	$25
Bid/ask spread	0.03%	$3	0.14%	$14
Trading commissions	0.09%	$9	0.00%	$0
Total cost (cost after one year)	**0.84%**	**$84**	**0.39%**	**$39**

For illustrative purposes only. The examples above do not represent investment in any particular ETF.
Source: Schwab Center for Financial Research

The Bottom Line

As competition among ETP providers has increased, total costs of ownership have been trending downward. Nevertheless, costs matter. Evaluate ETP costs based on your specific situation and intentions. The more frequently you trade, the more important it is for you to pay attention to commissions and bid/ask spreads. If you don't plan on holding a position for at least a year, look hard at commission costs. Commissions are also important when trading in small dollar amounts or making frequent transactions, such as with dollar-cost averaging. But for investors who plan to hold for the long haul, operating expenses will likely matter more.

Remember, Schwab is Here to Help

- Schwab offers a broad range of ETFs to help meet investor needs.
- We also offer support for various order types and large broker-assisted trades. Contact your dedicated Schwab resource for help, dial **1-800-435-4000**, visit **www.csimfunds.com**.

Investment Advisors

- For more information call **1-877-824-5615**, or visit **www.csimfunds.com**
- To start trading, visit **www.schwabadvisorcenter.com**

Charles Schwab Investment Management
As one of the nation's largest asset managers, our goal is to provide investors with a diverse selection of foundational products that aim to deliver consistent performance at a competitive cost.