



Your due diligence guide to ETFs

The tremendous growth of the exchange-traded fund (ETF) marketplace poses a number of challenges for investment professionals evaluating and selecting them. There are crucial differences in products, practices, and policies across issuers—even among the large ETF brands—and it can be time consuming to narrow down the list of ETFs that best meet your clients' needs.

This guide will help you evaluate:

Issuer background

ETF structures and exposures

Cost of ownership

Third-party affiliations
and index providers

Risk management philosophy

Fixed income approaches

Asking these questions can help you identify the ETFs you prefer and the issuers that have the culture, commitment, and consistency of a partner worthy of a long-term relationship.

What is the ETF issuer's background?



Questions to ask



Why it matters

How long has the ETF issuer offered ETFs? How many ETFs does it currently offer? What exposures, generally, are its ETFs associated with?

The tenure and number of ETFs generally reflect the issuer's commitment to the product line. Some of the benefits of ETFs may include, but are not necessarily limited to, lower costs, potential tax efficiency, transparency, market exposure, and diversification. An ETF issuer may take into account these primary considerations, among others, to determine the breadth of its ETF offering and lineup.

Has the issuer ever closed or delisted an ETF? If yes, why?

The speed and swiftness at which an ETF issuer launches and delists an ETF may offer insight into the issuer's overall business strategy. Review historical asset levels in closed funds to determine if an ETF is in or around that threshold. Such asset levels could indicate whether the ETF is at risk of closure.

What is the level of ETF experience of the firm's investment professionals?

A portfolio manager's experience level and the depth and expertise of the ETF capital markets desk will impact the efficiency of trading the ETF.

What is the firm's capital markets support structure?

An appropriately resourced capital markets desk can affect how efficiently the firm's ETFs trade. These desks are often composed of individuals with significant ETF trading backgrounds, specialized knowledge of the firm's products, and strong relationships across the authorized participant (AP) and market maker community. They are often involved in product structuring, ongoing ETF market quality oversight, representation of the firm to regulators and industry groups with respect to market structure developments, and providing guidance to clients to help enhance trading outcomes.

Does the ETF issuer offer guidance on execution strategy?

Several factors contribute to achieving exemplary execution in ETFs. Some of these factors include trading infrastructure, human capital constraints, liquidity profile of the ETF, objective for the trade, and trading strategy. Understanding how these factors intersect can be challenging for clients without significant trading backgrounds and ETF-specific expertise. Some issuers have a specific team dedicated to helping clients assess these considerations and develop a trading strategy aligned with their objectives.

How does the ETF's exemptive relief benefit or impede the ETF's tradability?

Each exemptive relief approved by the SEC has unique benefits and challenges that can either aid or hinder an ETF issuer's ability to mitigate capital gains, manage creations and redemptions, and mimic an index. Understanding the legal parameters an ETF operates under may help an investor better anticipate the outcomes of the investment experience.

How does the ETF issuer disclose the liquidity profile of its ETFs?

Knowing where to access data about the ETF is critical for understanding the tradability of the product.

How is the ETF structured?

Questions to ask

Why it matters

What is the legal structure of the ETF?

The legal structure of an ETF can have a profound impact on the investor's experience and the fund's reporting requirements and tax profile. Examples of different structures include, but are not limited to, grantor trusts, unit investment trusts, open-end management investment company, limited partnerships, and exchange-traded notes.

How does the legal structure impact the ETF's tax profile?

The type of exposure the ETF provides impacts the fund's tax profile. Some considerations are as follows: (a) grantor trusts that hold precious metals investments, such as gold, may be taxed as collectibles rather than as capital gains; (b) commodity futures contracts held within limited partnerships may be marked to market; and (c) certain fund structures require a Schedule K-1 to be issued rather than a Form 1099 to be distributed.

Is the ETF restricted from certain investments? What assets can be held within the ETF?

The range of securities an ETF can hold vary greatly from product to product. In some instances, an ETF may hold less-liquid or high-risk securities that may negatively impact redemptions from the fund during challenging markets.

Is the ETF predominantly a fund of funds vehicle?

Certain investors may be restricted from holding fund of funds products.

If the ETF is active, why? How does the active management style differ from the indexed approach in enabling the ETF to achieve its desired result?

Index and active ETFs have different exemptive relief constraints and reporting requirements. Understanding why an ETF issuer has chosen to offer an ETF via an active structure versus an index structure will better help an investor understand the overall purpose and rationale for the fund.

How are securities within the ETF weighted?

Today, ETFs are offered across the entire weighting spectrum. From market cap weighting to equal weighting to fundamentally weighted and everything in between, the weighting scheme of an ETF will have a profound impact on the results, tax profile, and performance of the fund.

Does the ETF disclose holdings daily?

While the more recent generic exemptive relief orders require ETFs to disclose holdings on a daily basis, certain fund complexes may have grandfathered clauses that allow them to disclose holdings on a less frequent basis.

How closely do the underlying holdings mimic the index? Does the ETF generally seek to replicate or optimize the index?

Index ETFs generally seek to track the performance of their underlying indices. However, to achieve this result, the portfolio manager may have the ability to hold securities not included in the index. Understanding if the ETF seeks to replicate or optimize around the index will provide greater insight into the fund's risk profile and performance differentials.

Is the fund diversified?

Certain ETFs provide access to very small niche segments of the market and/or are heavily concentrated in one market sector, increasing the risk profile of the fund.

Has the underlying index for the ETF ever changed? If so, from what to what? Why?

The underlying index of an ETF may be revised for a number of reasons including, but not limited to, a change in fund strategy, activities that occur at the index provider level, and/or regulatory events. Note that a change in the underlying index may cause anomalies in the performance of the product.

What is the ETF's exposure?

Questions to ask

Why it matters

What is the investment objective of the ETF?

One of the most important steps in selecting an ETF is to first understand the ETF's investment objective to ensure it fulfills a need in the investment portfolio. Often the name of the ETF is not reflective of the overall objective of the fund.

To which countries does the ETF provide exposure?

Country inclusion/exclusion may vary between index providers and will typically follow a rules-based approach, as defined in each respective provider's methodology documents.

How does the ETF's investment objective and/or investment focus impact the tax profile of the fund?

How an ETF seeks to gain exposure and what it seeks to provide access to can have a significant impact on the tax profile of the product.

Does the ETF invest in futures or other derivatives to achieve its stated objective?

When matching an investor's risk profile to an ETF, the risks of the underlying investment vehicle should be considered.

Is the ETF treated as a limited partnership for tax purposes?

Certain ETFs use futures to gain access to select segments of the market, such as commodities. ETFs that hold primarily commodities futures are generally structured as limited partnerships and report each shareholder's share of partnership income on a Schedule K-1 instead of a Form 1099. A Schedule K-1 is distributed independently from the Form 1099 and may be received late in the tax season. Investors should know whether to expect this tax form.

Are the securities held within the ETF required to be marked-to-market at year-end? If so, how does this impact the ETF's tax profile?

Several ETFs that invest in commodities do so via futures contracts. At the end of the fiscal year, the ETF may be required to mark-to-market all its outstanding futures contracts. If a security is marked-to-market, an investor may incur ordinary income, losses, or gains in their portfolio depending on the rise and fall of the stock from the initial purchase price to the last day of the fiscal year.

How does the ETF's exposure overlap the existing exposures within an investor's portfolio?

Many index providers do not provide "pure slices" of market segments. Often a security will appear in more than one index in a family of indices.

What is the total cost of ownership?

Questions to ask

Why it matters

What is the expense ratio of the ETF?

The expense ratio reflects the fees paid annually by the ETF. An expense ratio may have a significant impact on the performance and tracking difference of a fund.

What is the bid-ask spread of the ETF?

The bid-ask spread is the difference between the lowest price point at which a trader is willing to sell an ETF and the highest price a buyer is willing to pay. It represents an additional cost when trading the ETF and should be considered when evaluating the total cost of an ETF.

What is the historical tracking error of the ETF?

Historical tracking error may or may not reflect the portfolio manager's ability to closely track the index.

What is the frequency of distributions from the ETF?

The regularity or irregularity of distributions may be important to the overall strategy of an investment portfolio.

Has the ETF historically paid capital gains?

This provides insight into the tax profile of the fund.

Does the ETF participate in securities lending?

Most ETFs participate in securities lending, however, the securities lending program an ETF participates in can differ greatly from issuer to issuer. The differences in the nature of lending programs can affect the risk/return profile of the ETF.

How is the ETF's securities lending revenue split between the ETF and the issuer?

If the ETF participates in securities lending, it is important to understand the revenue split rate between the ETF issuer, lending agent, and the ETF itself. The amount paid to the fund can have a positive impact on the fund's overall performance.

Is the ETF trading (or has it ever traded) at a significant premium or discount to its net asset value (NAV)?

Understanding the drivers of premiums or discounts is important in determining whether an ETF is functioning efficiently in the secondary market. Significant, prolonged premiums or discounts may indicate a structural problem.

Does the ETF charge a creation or redemption fee? Is this fee reasonable relative to those of competing products?

To purchase or redeem a creation unit, you must be an AP or transact through a broker who is an AP. The fees tend to vary by fund and may be fixed or variable in nature. The size of the fee can influence bid-ask spreads.

What are the third-party affiliations?

Questions to ask

Why it matters

Who is the distributor of the ETF?

How reputable is the distributor? How long has it been distributing ETFs and for how many issuers? The answers can help you understand the counterparty risk the fund carries.

Is the ETF sub-advised?

How reputable is the sub-advisor? What has been the sub-advisor's performance history? The answers can help you understand the day-to-day management strategies and operational/trading capabilities of the fund.

Who is the custodian of the ETF?

Where is the ETF custodied? How knowledgeable is the custodian about ETFs? The answers can help you understand a number of custodial oversight functions such as settlement procedures, transaction fees, and the general protection and monitoring of assets.

Who manages the securities collateral?

Is the cash collateral fund affiliated with or independent from the ETF? If the cash collateral is in an affiliated fund, what revenue does the issuer earn from investments in the fund? Is the third-party manager reputable? The answers can help you understand the counterparty risk the fund carries.

Who is the index provider for the ETF?

How reputable is the index provider? What has been its history with reporting errors, etc.? The answers can help you understand how the underlying indices are constructed, calculated, classified, and defined.

Does the ETF's derivative usage carry counterparty risk?

How risky are the derivatives used within the ETF? What is the investor's level of counterparty risk associated with these investments?

What are the index provider's capabilities and practices?



Questions to ask



Why it matters

Who is the index provider for the ETF?

How reputable is the index provider? What has been its history with reporting errors, etc.? The answers can help you understand the counterparty risk the fund carries.

How long has the index provider been managing indexes? What are the flagship indexes?

Index management is a complex and elaborate process. Different index providers approach index management responsibilities in different ways.

How is the index weighted?

In today's market, index providers may provide several different weighting schemata, such as market capitalization weighted, equal weighted, dividend weighted, factor tilted, or fundamentally weighted.

How long has the index provider been managing the weighting scheme?

Many index providers traditionally provide market capitalization weighted indices. Issuing indices not following a traditional weighting scheme is a new business model for many and requires complex and elaborate management and oversight.

How often does the index rebalance?

Rebalancing schedules differ across index providers. The frequency at which an index rebalances can have an impact on transaction costs, performance, and taxes.

How does the index treat initial public offerings (IPOs)?

IPOs have historically shown they can be volatile events. Understanding when an IPO is considered for inclusion in an index provides insight into the index's objective.

How does the index manage additions and deletions?

An addition or deletion from an index can lead to increased transaction costs and taxable events for ETF shareholders.

Is the index part of a modular family of indexes? If yes, how do the exposures overlap?

Many index providers do not provide "pure slices" of market segments. Often a security will appear in more than one index in a family of indices.

Does the index definition of size and style match the investor's investment objective?

Across index providers, "large," "mid," and "small" may be defined differently. Additionally, the evaluation criteria for "growth" and "value" stocks may differ immensely from provider to provider.

Does the index have an established track record? (vs. hypothetical)

New indices are released every year. It is important to understand the inception date of the index. A number of indices tracked by ETFs (without real-time performance history) may offer hypothetical data for comparative purposes.

How easily understood is the index provider's construction and methodology guide?

Every index has a published document describing the construction and methodology that a stated index seeks to maintain. It is the governing document of the index and details specifics such as treatment of IPOs, rebalancing frequency, security qualifications, etc. These documents range in complexity from straightforward and simple to highly complicated and quantitatively written.

How does the ETF manage risk?

Questions to ask

Why it matters

What is the firm's securities lending practice?

Many ETF issuers manage their own lending program, while others may engage with third parties to help manage negotiating loans and the cash collateral reinvestment. Additionally, some ETF issuers may choose a revenue split between the issuer and the shareholders of the ETF, while others may seek to reinvest all revenue back into the ETF. Each lending program is unique and should be fully understood.

How does the securities lending program invest the cash collateral? Is the cash held in a Rule 2a-7 fund?

A securities lending program can invest the cash collateral in a variety of ways, ranging from money mark portfolios operating under Rule 2a-7 of the Investment Company Act of 1940 to short-term repos to broader investments. Each variation has its own level of risk and should be fully understood by the investor.

How does the ETF manage counterparty risk?

Securities lending programs are subject to several layers of counterparty risks and should therefore be fully reviewed and validated.

How does the ETF manage currency risk?

For non-U.S. exposures, depending on how the underlying securities are held, currency risk may have a significant impact on the overall performance of the ETF.

How does the ETF manage non-U.S. equity exposure risk?

Investing internationally has its own level of risk. It is important to understand how the issuer has historically managed global events such as Russia sanctions, Chinese market halts, and the closure of the Greek stock market. Events like these limit the accessibility and liquidity of securities in the market, impacting transaction costs and performance.

What are the firm's risk management processes?

A robust risk management plan reflects a firm's concern for and management of shareholder's investments.

What is the ETF's approach to fixed income?

Questions to ask

Why it matters

How does the ETF price its underlying bonds?

The pricing of bonds can vary greatly depending upon seller, buyer, quantity, and several other factors. How each underlying bond is priced can greatly impact an ETF's NAV.

Does the ETF issuer price the bonds held within the fund in the same manner that the index provider (if applicable) does?

Index providers and ETF issuers often use different pricing sources. This can affect returns and the performance of the fund.

Is the ETF rated by the National Association of Insurance Commissioners (NAIC)?

Depending on an investor's profile, an NAIC rating may be important for future investments.

What is the average duration of the underlying securities?

Duration is a measure of the sensitivity of a bond's price to changes in interest rates. Understanding a bond ETF's duration will inform an investor of the level of interest rate risk he or she may incur when investing in the fund.

How does the bond exposure overlap with core fixed income holdings within an investor's portfolio?

Many index providers do not provide "pure slices" of bond market segments. Often a bond will appear in more than one index in a family of indices.

Are holdings within the ETF subject to phantom income?

To best understand the tax profile of the fund, an investor would need to understand the tax characteristics of the different types of securities held within the fund, such as zero-coupon bonds.

For more ETF insights and strategies, visit
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