Not All ETFs Are Created Equally

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Early Exchange-traded Funds (ETFs) were designed to track broad market indexes, offering investors a variety of benefits, including tax efficiency, low costs, trading flexibility and transparency. Since then, providers have looked for new types of products to attract investors. However, many lack diversification and can have greater costs than expected. With more ETFs being launched, it's important to understand not all of them are in a long-term investor's best interest.

We believe certain ETF products are not suitable for long-term investors, including:

- Leveraged and inverse ETFs
- Exchange-traded notes (ETNs)
- Structured products

Leveraged and Inverse ETFs

Leveraged ETFs and inverse ETFs seek a multiple return or opposite return compared to their benchmark index, while leveraged inverse ETFs try to obtain a combination of the two return goals. It's important to keep in mind that all of these ETFs can lead to unexpected results over longer periods of time.

For example, let's assume you invest $100 each into three different ETFs: a one-time inverse ETF, a three-times leveraged ETF, and a three-times leveraged inverse ETF. Suppose the underlying benchmark index rises 10% on day one. At the end of the day, the index and the ETF values and returns follow:

At the End of Day 1				
	Index Value	1X Inverse ETF	3X ETF	3X Inverse ETF
Initial Value	100	$100	$100	$100
Total Return Day 1	10%	-10%	30%	-30%
Value at End of Day 1	110	$90	$130	$70
Total Return	10%	-10%	30%	-30%

Source: Edward Jones calculations. These are for illustrative purposes only and do not represent any available investments.

All the ETFs in the example have provided returns as expected. Now let's assume the underlying benchmark index drops 10% the next day.

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In this example, the index lost 1% over the two-day period. The inverse ETF provided the same return as the index, also losing 1%. Both of the leveraged ETFs, however, are down 9% and worth $91. The longer the ETF is held, the more profound the differences may be.

At the End of Day 2				
	Index Value	1X Inverse ETF	3X ETF	3X Inverse ETF
Value at Start of Day 2	110	$90	$130	$70
Total Return Day 2	-10%	10%	-30%	30%
Value at End of Day 2	99	$99	$91	$91
Total Return over 2 Days	-1%	-1%	-9%	-9%

If we assume the same pattern of returns (positive 10% one day, followed by negative 10% the next day) continued for 30 days, the index would have lost about 14%, and so would the inverse ETF. But both leveraged ETFs would have lost more than 75% of the initial amount invested.

At the End of Day 30				
	Index Value	1X Inverse ETF	3X ETF	3X Inverse ETF
Value at End of Day 30	86	$86.01	$24.30	$24.30
Total Return over 30 Days	-14%	-14%	-75.7%	-75.7%

Source: Edward Jones calculations. These are for illustrative purposes only and do not represent any available investments.

When the index returns are more volatile, as shown in the table below, the ETF returns also will vary significantly. All three types of ETFs underperformed the index and offered dramatically different results.

At the End of Day 5 (Increased Volatility)				
	Index Value	1X Inverse ETF	3X ETF	3X Inverse ETF
Initial Value	100	$100	$100	$100
Total Return Day 1	10%	-10%	30%	-30%
Total Return Day 2	-10%	10%	-30%	30%
Total Return Day 3	5%	-5%	15%	-15%
Total Return Day 4	-5%	5%	-15%	15%
Total Return Day 5	3%	-3%	9%	-9%
Value at End Day 5	101.72	$95.79	$96.96	$80.95
Total Return over 5 Days	1.7%	-4.2%	-3%	-19.1%

Source: Edward Jones calculations. These are for illustrative purposes only and do not represent any available investments.

Recent market volatility has highlighted this risk, as many leveraged and inverse ETFs have performed very differently from what investors had expected. Therefore, we don't believe that leveraged and inverse ETFs are suitable long-term investments.

Investors also need to recognize that leveraged ETFs have an increased potential for capital gains distributions and significantly higher expense ratios than the traditional broadly based stock market ETFs, negating some of the benefits of purchasing an ETF.

Exchange-traded Notes

Like ETFs, ETNs can be bought and sold on an exchange throughout the day, and their returns are based on a benchmark index. However, ETNs have several distinct characteristics that may create risks and make these investments unsuitable for most investors.

- **Counterparty risk –** ETNs are unsecured debt instruments, backed only by the credit of the ETN issuer and not an underlying basket of securities. If the issuer's creditworthiness declines, this can cause the ETN's return to decline, regardless of the performance of the benchmark index.
- **No periodic payment –** ETNs have a maturity date (30 years, for example) and don't pay an annual coupon or dividend.
- **Risk of default –** If the ETN is held to maturity, the return is paid based on the return of the index, less the annual expense ratio. Because the ETN's return is based on the index, investors aren't guaranteed their principal investment will be returned at maturity. It's also possible that an ETN investor may not receive the appropriate return at maturity if the issuer defaults, which occurred during the market turmoil of 2008.

Structured Products

Structured products can encompass many different types of investments. Typically, they're a hybrid of something that pays regular interest, such as a bond, and an investment with a variable return. This variable return can be related to the stock market or to currency, for example.

The general concept of structured products is that your principal will be returned at maturity if the return of the variable investment goes down, and you'll receive at least some of the return if it goes up. Although this scenario sounds like the best of both worlds, we believe there are several major risks that make these investments inappropriate for long-term investors, including:

- **Counterparty risk –** As with an ETN, a structured product is typically an unsecured debt instrument. It is not backed by an underlying investment. Instead, you own the promise from the bank or institution to pay you the principal and any other return.
- **Partial return and fees –** If the variable investment goes up, you may receive part of that return. Fees tend to be high, which lowers the possible return.
- **Potential difficulty to sell before maturity –** Investors may not be able to sell the structured product prior to maturity if the market lacks liquidity.

Next Steps for Investors

We believe broad-based, low-cost ETFs offer valuable benefits, including diversification and potential tax efficiency.

Investors should be aware, however, that not all ETFs are created equally, and not all are suitable for long-term investors. We believe many investors may be surprised by the risks of investing in leveraged and inverse ETFs, ETNs and structured products. Additionally, these securities tend to have higher expenses. Leveraged ETFs also have an increased potential for capital gains distributions.

Talk with your Edward Jones financial advisor about the benefits and risks of including ETFs in your long-term financial strategy.

For more information on ETFs that may be appropriate for long-term investors, as identified by our Mutual Fund Research department, contact your Edward Jones financial advisor.

Investing in ETFs involves risk. Your principal and investment return will fluctuate in value. Your investment, when redeemed, may be worth more or less than the original cost.

ETFs are offered by prospectus. You should consider the investment objective, risks, and charges and expenses carefully before investing. The prospectus contains this and other information. Your Edward Jones financial advisor can provide a prospectus, which you should read carefully before investing.