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# An Overview of Exchange Traded Funds (ETFs)

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***Abstract***

*Exchange-Traded Funds (ETFs) have emerged as one of the most popular investment instruments in modern financial markets, offering a unique blend of flexibility, diversification, and cost efficiency. This article provides an overview of ETFs, exploring their fundamental concepts, structure, and types of ETFs. Also covers the factors considered while investing in ETFs, such as liquidity, expense ratio, and AUM, while also addressing how ETFs are different from mutual funds. By presenting key insights into the functioning and types of ETFs, this article aims to equip readers with a foundational understanding of these versatile investment tools, making it a valuable resource for novice and seasoned investors alike. The ETFs are the alternative investment avenue for investors apart from the traditional avenues like banks and post deposits, insurance, mutual funds, and shares. ETFs offer steady returns at minimum risk. As an investment option, ETFs are suitable for risk avoiders, especially salaried employees and long-term investors.*

***Key Words**: Exchange Traded Funds (ETFs), mutual funds, index, nifty.*

## 1. Introduction

Exchange-Traded Funds (ETFs) are investment funds that trade on stock exchanges, similar to individual stocks. They are designed to track the performance of a specific index, sector, commodity, or asset class, providing investors with a way to gain exposure to a diversified portfolio with the flexibility of stock-like trading.

The first ETF in India, the Nifty Benchmark Exchange (Nifty 50 Index)-Traded Scheme (Nifty BeES), was launched in 2001 by Benchmark Mutual Fund (later acquired by Goldman Sachs and subsequently by Nippon India Mutual Fund). This marked the introduction of passive investing through ETFs in the Indian market. Following the success of Nifty BeES, more ETFs were launched, including those focused on specific sectors and themes like gold. In 2007, Gold ETFs were introduced in India, providing an alternative to physical gold investment. *Gold BeES*, launched by Benchmark Mutual Fund, was among the first gold ETFs.

ETFs in India reflect the country's growing financial market sophistication and the increasing preference for low-cost, diversified investment vehicles. With government support, institutional participation, and innovative offerings, ETFs have become a key component of the Indian investment landscape. The future of ETFs in India looks promising as awareness and adoption continue to rise.

ETFs have revolutionized the investment landscape by offering a cost-effective, diversified, and flexible way to access a wide range of asset classes and markets. They cater to both novice and experienced investors, making them a cornerstone of modern portfolio management.

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ETFs combine the features of mutual funds and stocks. They offer diversification by investing in a portfolio of assets like mutual funds, and they can be bought or sold on stock exchanges throughout the trading day like stocks.

**National Stock Exchange (NSE), India** "ETFs are funds that trade on the stock exchange like any other security and hold assets such as stocks, commodities, or bonds. ETFs aim to track the performance of a specific index or underlying asset."
ETFs pool money from multiple investors to invest in a basket of securities, providing diversification, cost efficiency, and flexibility for investors.

ETFs are a versatile financial instrument combining the benefits of diversification, transparency, and liquidity. They are an excellent choice for investors seeking cost-effective exposure to various asset classes, from equities to commodities and bonds.

**Exchange Traded Funds**

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A fund that chooses investments based on a market index or sector. ETFs trade on a stock exchange. They are not actively managed, so costs tend to be lower than regular mutual funds.

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An Exchange Traded Fund (ETF) is a type of financial asset that groups different securities such as stocks, bonds or commodities together.

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**Types of ETFs**

ETFs come in different types, each designed to cater to specific investment goals, risk appetites, and market strategies. The main types of ETFs are discussed below:

**Equity ETFs:** ETFs that track stock indices or a portfolio of stocks. Equity ETFs combine equity stock and mutual fund investments. These ETFs, like any other company stock, are traded on the stock exchange, allowing investors to purchase or sell them at market prices in real time. To provide exposure to the stock market or a specific sector, region, or market capitalization. Examples: Nifty 50 ETF, S&P 500 ETF.

An equity ETF is further classified as follows:

- **Market-Based**: ETFs are classified as small-cap, mid-cap, or large-cap based on their market capitalization.
- **Factor-Based:** ETFs monitor indices based on a variety of parameters, such as volatility, momentum, size, alpha, and so on.
- **Sector-Based:** Rather than investing in diverse firm stocks from various sectors, sector ETFs invest in different companies within a given sector, such as Bank ETFs, Pharmaceutical ETFs, Automobile ETFs, etc.

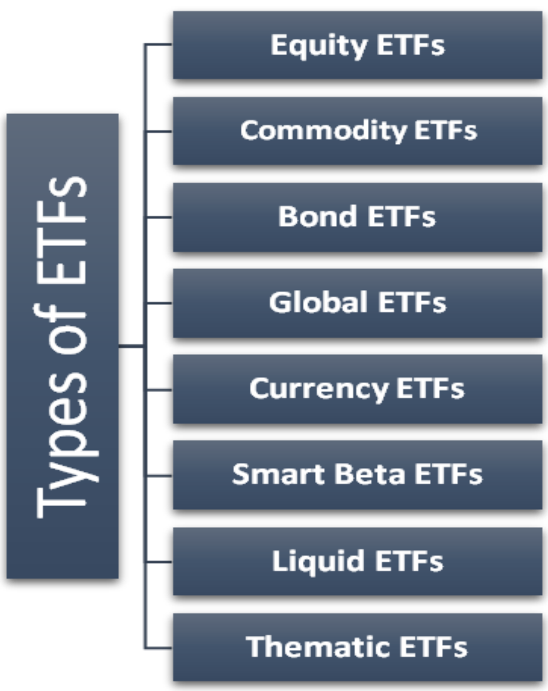


Figure 1: Types of ETFs

**Bond ETFs:** ETFs that invest in bonds or other fixed-income securities. Bond ETFs provide fixed-income investors with the simplicity and flexibility that ETFs offer. These funds invest in a diverse portfolio of bonds, offering exposure to a wide range of debt instruments, including government bonds, corporate bonds, municipal bonds, and even international bonds. Bond ETFs provide investors with access to fixed-income markets without the need to acquire individual bonds, making them an affordable and liquid option.*Examples:* Bharat Bond ETF, iShares Core U.S. Aggregate Bond ETF.

Popular Subcategories:

- **Government Bond ETFs:** Invest in sovereign bonds.
- **Corporate Bond ETFs:** Focus on bonds issued by companies.
- **Municipal Bond ETFs:** Invest in bonds issued by state or local governments.
- **High-Yield Bond ETFs:** Target high-yield or "junk" bonds for higher returns.

1. **International/Global ETFs:** ETFs that provide exposure to international markets or specific regions. International ETFs can help investors diversify their portfolios outside domestic markets. These funds provide exposure to overseas stocks, allowing investors to benefit from global economic growth. International ETFs may concentrate on specific regions, such as emerging markets or developed countries, or they may target individual countries. *Examples:* I Shares MSCI Emerging Markets ETF, Motilal Oswal NASDAQ 100 ETF.

Popular Subcategories:

- **Regional ETFs:** Focus on areas like Europe, Asia-Pacific, or Latin America.
- **Country-Specific ETFs:** Target specific countries like China, Japan, or Brazil.

2. **Currency ETFs:** Currency exchange-traded funds (ETFs) that track the value of currencies relative to others or a basket of currencies. These provide retail investors with exposure to the foreign exchange market through a professionally managed fund, eliminating the need to trade independently. Currency exchange-traded funds (ETFs) are widely used by investors to profit from currency price variations across nations or within groups of countries. **Examples:** Invesco Currency Shares Euro Trust.

**Smart Beta ETFs:** ETFs that combine active and passive strategies by tracking indices based on specific factors. Stocks in smart beta exchange-traded funds (ETFs) are chosen according to specific criteria. Often, the criterion consists of one or more variables, such as momentum, value, quality, or low volatility. For instance, a Nifty Smart Beta ETF that focuses on low volatility would buy companies from the 50-stock index that are less volatile than their counterparts. *Examples:* iShares MSCI USA Value Factor ETF.

**Liquid ETFs:** Liquid ETFs invest in money market instruments or government securities or short-term debt securities with short-term maturity tenures. This type of ETF is designed to minimize market volatility risk to offer returns resembling the underlying market index it tracks. *Examples:* Liquid BeES.

**Thematic ETFs:** Thematic exchange-traded funds (ETFs) focus on specific industries, trends, or themes, such as technology, sustainability, or developing markets. It is used to target niche markets or capitalize on specific trends like clean energy, AI and robotics, infrastructure, etc. They allow investors to invest in themes or trends that are relevant to their interests or investment approaches. *Examples:* Technology ETFs, ESG ETFs.

## 2. Discussion

### Factors to be consider while investing in ETFs

Investing in Exchange-Traded Funds (ETFs) can be a smart way to diversify your portfolio and achieve specific financial goals. Here are key factors to consider before investing in ETFs:

**Investment Goals and Strategy:** Determine investment objective, such as income generation, capital appreciation, or hedging. Assess whether the ETF aligns with your short-term or long-term goals and understand how much risk the investor is willing to take.

**ETF Type and Focus:** Before investing it is to decide whether investor want exposure to equities, fixed income, commodities, or real estate. Investor choose between domestic, international, or emerging market ETFs and consider sector-specific ETFs (e.g., technology, healthcare) or thematic ETFs (e.g., ESG, AI-focused funds).

**Expense Ratio and Costs:** Investors check the annual fee as a percentage of investment as well as be aware of brokerage fees for buying and selling ETFs. Lower is generally better. ETFs are typically tax-efficient but review potential tax implications.

**Assets Under Management (AUM):** The size of the ETF scheme is an important consideration when selecting any ETF, because a larger AUM (Assets Under Management) indicates adequate liquidity and stability in the scheme. A longer track record can provide better insight into the ETF’s performance and management

**Liquidity and Trading Factors:** Higher trading volume generally means better liquidity and tighter bid-ask spreads. Also compare the bid-ask spread to avoid paying excessive costs when trading

**Underlying Index and Holdings:** Investors should understand the benchmark index the ETF tracks and evaluate its composition and also assess the level of diversification within the ETF (e.g., number of holdings, sector balance)

**Performance and Tracking Error:** Look at past performance, but remember it doesn't guarantee future results. Lower and consistent tracking Errors suggest that the ETF is efficient. The tracking error (TE) of an ETF scheme represents the fund's performance deviation from its underlying benchmark

**Peer Comparison:** Compare similar ETFs based on costs, returns, and other characteristics to identify the most suitable option.

By thoroughly evaluating these factors, investor can make informed decisions and choose ETFs that align with financial objectives.

**Example of How ETFs Work**

The following is an example for how ETFs works:

**Step 1:** An ETF provider, say XYZ, decides to launch an ETF tracking the Nifty 50 index.

**Step 2:** Authorized participants buy all 50 stocks in the index in the same weightage as the Nifty 50.

**Step 3:** Authorized participants deliver these stocks to the ETF provider and receive ETF shares in return.

**Step 4:** ETF shares are listed on the stock exchange and available for investors to trade.

**Step 5:** Investors can buy shares on the stock exchange at the market price and sell them anytime during market hours.

**Difference between Exchange-Traded Funds Mutual Funds**

Exchange-Traded Funds (ETFs) and mutual funds are both pooled investment vehicles that allow investors to diversify their portfolios. While they share similarities, they differ significantly in structure, trading, costs, and management style. Below is a comprehensive comparison:

| Features | Exchange-Traded Funds | Mutual Funds |
|---|---|---|
| **Management** | ETFs are typically passively managed, tracking an index or asset class (e.g., Nifty 50, Gold). Some ETFs, actively managed ETFs, combine passive and active strategies. | Mutual funds can be actively managed (fund managers select securities to outperform the market) or passively managed (like index funds). |
| **Trading** | ETFs traded on stock exchanges like individual stocks. | Mutual funds are bought and sold directly through the fund house or distributor. |
| **Pricing** | ETF prices fluctuate throughout the trading day based on market demand and supply. Investors buy/sell shares at the prevailing market price. | MF transactions occur at the end of the trading day based on the fund's Net Asset Value (NAV). |
| **Liquidity** | ETFs are highly liquid, as they can be bought or sold during market hours, and liquidity depends on the trading volume of the ETF. | Mutual funds areless liquid compared to ETFs, and redemption takes longer (typically 1–3 business days). |
| **Accessibility** | ETFs require access to stock markets through a trading account, and prices may be slightly higher or lower than the NAV due to supply-demand dynamics. | Mutual funds easy to invest directly via fund houses, apps, or distributors and always bought/sold at NAV, ensuring fair pricing. |
| **Transparency** | ETFs have high transparency; holdings are disclosed daily. Investors can see the exact composition of the ETF portfolio. | Mutual funds moderate transparency; holdings are disclosed periodically (usually monthly or quarterly). |
| **Minimum Investment** | ETFs required No minimum investment; investors can buy as little as one share. | Mutual funds have a predefined minimum investment amount (e.g., ₹500–₹5,000 for a lump sum or SIPs). |
| **Investment Strategy** | ETFs are ideal for passive investors looking for market returns at low cost. It is suitable for short-term or tactical trading due to real-time pricing. | Mutual funds are suitable for both active and passive investors and are better for long-term investors who prefer professional fund management. |
| **Demat Account** | For ETF transactions, a demat and trading account are required for | In mutual funds, for transactions, no demat account is needed; transactions |

| | | |
|---|---|---|
| | transactions. | can be made directly with the fund house (e.g., AMCs and brokers). |
| **Risk** | ETF risks include market fluctuations and tracking errors, and liquidity risk exists for ETFs with low trading volumes. | Mutual fund risks depend on the fund's investment strategy (e.g., equity funds are riskier than debt funds). and subject to market risk and fund manager performance. |
| **Costs and Fees** | ETFs have lower expense ratios due to passive management. Investors incur brokerage fees for trading, making frequent transactions costly. | Mutual funds havehigher expense ratios, especially for actively managed funds. It may include upfront (entry) or back-end (exit) loads, although many funds have eliminated these charges. |
| **Tax Efficiency** | ETFs are more tax-efficient due to the in-kind creation and redemption mechanism, which minimizes capital gains distributions. | Mutual funds are less tax-efficient, as fund managers actively buy and sell securities, generating taxable capital gains for investors. |

ETFs are ideal for cost-conscious investors and those seeking real-time trading flexibility, and they are well-suited for passive investing. Mutual funds are better for long-term investors seeking active management or those without access to stock markets. Both options serve different investment needs and can complement each other in a diversified portfolio.

## 3. Conclusion

Exchange Traded Funds are one of the emerging investment avenues because ETFs were introduced in India in 2001. For the retail investors, they have some awareness about mutual funds and shares, but less about ETFs; it has the features of mutual funds and shares. ETFs are a better option for the investors who avoid the high risk, and there is no need for monitoring regularly like shares. ETFs are cost-effective and give stable returns compared to mutual funds because they are passive funds that require less monitoring, and they replicate the indices. ETFs are available in various types; it offers opportunities for investors to invest their money according to their interests. ETFs have one of the important features that there is no chance of loss in funds because it replicates the indices investment amount in proportion to the indices. Investors should consider some factors like AUM, tracking error, expense ratio, past performance, liquidity, type of ETFs, and peer comparison before making investment decisions in ETFs; these factors help them to select appropriate funds according to their requirements. The ETFs are the alternative investment avenue for investors apart from the traditional avenues like banks and post deposits, insurance, mutual funds, and shares. ETFs offer steady returns at minimum risk. ETF is suitable for risk avoiders for salaried employees and long-term investors.

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