ETF Fund Investment: A Beginner's Guide

Learn how ETF fund investment works, and how to choose the best ETF for you.

Twin Oak Editorial Team

Exchange-traded funds, or ETFs, have transformed the way millions of people invest. They take the diversification of mutual funds and add in tax efficiency, transparency, and flexibility—all while retaining low cost. But how do ETFs fit into a beginner's long-term financial strategy?

Below, we'll unpack what ETFs are, how they differ from other investment options, and how to choose the right ones based on your goals, risk tolerance, and time horizon.

What Does "ETF Fund Investment" Mean?

An ETF is an investment vehicle that pools money from many investors to buy a basket of assets — typically stocks, bonds, or commodities. Each ETF share represents partial ownership in that basket.

The key differences between ETFs and other investment products include how they are managed and traded:

- **ETFs vs. Mutual Funds:** Mutual funds are priced once a day, after the market closes. ETFs, by contrast, trade on stock exchanges throughout the day, just like individual stocks. This gives investors the ability to buy or sell shares instantly at market prices.
- **ETFs vs. Individual Stocks:** Buying a single stock exposes you to the ups and downs of one company. An ETF spreads your risk across dozens or even hundreds of holdings, offering instant diversification.
- **ETFs vs. Direct Portfolios:** Building and maintaining your own diversified portfolio requires time, research, and trading costs. Investing in ETFs offers a low-maintenance way to achieve similar diversification automatically.

Beyond these considerations, an ETF could passively track an index, like the S&P 500, or be actively managed, with a customized array of securities. Actively managed funds are becoming more popular, and ETFs in general have become the foundation for a successful investment strategy.

At Twin Oak, we seek to leverage tax aware investing to out-perform passive alternatives on an after taxes and after fees basis.

The Benefits of Investing in ETFs

ETFs have grown rapidly for good reason. They offer a combination of accessibility, efficiency, and transparency that appeals to both retail and accredited investors.

- **Diversification:** One ETF can provide exposure to hundreds of companies or bonds, reducing the impact of any single investment's performance.
- **Liquidity:** ETFs trade on major exchanges, so they can be bought or sold quickly during market hours. This type of flexibility is unmatched by mutual funds.
- **Low Costs:** Because most ETFs are passively managed (they track an index rather than rely on active managers), they tend to have lower expense ratios than mutual funds. Even small cost savings can compound significantly over time.
- **Tax Efficiency:** ETFs are typically more tax-efficient due to their in-kind creation and redemption process, which minimizes capital gains distributions. Investors often pay taxes only when they sell their ETF shares. More specialized, tax-aware ETFs can also be customized for investors' needs.
- **Transparency:** Most ETFs publish their holdings daily, allowing investors to see exactly what they own.

The Risks or Downsides of ETF Investing

While ETFs are efficient, they're not risk-free. For example, if an ETF's holdings are primarily bonds, but the equities have seen a rise in value, the ETF will underperform the market. Conversely, if an ETF is overconcentrated in a thematic bundle of assets, such as technology stocks, investors can be opened up to concentrated risk, where losses could exceed broad-based stock market pullbacks.

As ETFs have grown in popularity, more complex products have been embedded in them as a way to provide exposure to esoteric investments while retaining the benefits of the ETF wrapper. For example, leveraged and inverse ETFs are designed for short-term trading, not long-term investing. Beginners should approach these with caution.

How to Choose Among ETFs

With thousands of ETFs on the market, choosing the right ones can seem overwhelming. But following a few key metrics makes the process easier.

- **Expense Ratio:** This annual fee, expressed as a percentage, reflects how much you'll pay to invest in the fund. For long-term investors, passive exposure between .05% and .20% is preferable, whereas active exposure between .25% and .50% is acceptable.

- **Tracking Error:** Compare the ETF's performance to its benchmark index. A low tracking error means it closely mirrors the index's returns. A high tracking error means gains will be left on the table.
- **Fund Size (Assets Under Management):** Larger funds tend to be more liquid and stable, reducing the risk of closure.
- **Underlying Index or Strategy:** Understand what you're buying. Broad-market ETFs (like those tracking the S&P 500) are ideal for core holdings, whereas thematic ETFs are better for satellite exposure. Actively managed ETFs, however, can be beneficial for a variety of investors. For example, some active strategies, like tax-efficient ETFs, are well-suited for high-net-worth investors and family offices.

Before investing, always read the prospectus to understand the fund's objective, holdings, and risks.

Matching ETFs to Your Investment Goals and Time Horizon

Different investors use ETFs for different purposes. Here's how to align your ETF choices with your goals:

- **Retirement Savings:** Broad-market stock ETFs and low-cost bond ETFs can form the foundation of a diversified retirement portfolio. Younger investors may lean more heavily on equities; those nearing retirement may add bonds for stability.
- **Tax-Efficient ETFs:** Some actively managed ETFs, like those designed for high-net-worth investors or family offices, can provide a tax-efficient strategy, where capital gains taxes are deferred to the end of the investment horizon.
- **Short-Term Goals or Hedging:** Investors with near-term objectives may prefer conservative, low-volatility ETFs or cash-equivalent ETFs like Treasury bills. Some may use gold or inverse ETFs to hedge against downturns, and some may leverage dividend-focused ETFs that can provide regular income.
- **Tactical or Thematic Investing:** For investors who want to express specific views (like sustainability, artificial intelligence, or emerging markets) thematic ETFs can offer targeted exposure. An actively managed ETF is better suited than a passive ETF for this type of strategy.

No matter the goal, ETFs offer flexibility. You can mix and match based on your risk tolerance and time frame.

Are ETFs Right For You?

ETFs are one of the most accessible and efficient ways to participate in the markets. For beginners, ETFs provide instant diversification, low costs, and transparency within a structure that's easy to trade and tax-efficient to own.

The key is to choose ETFs that align with your objectives and stay focused on long-term growth rather than short-term market noise. Whether you're saving for retirement, generating income, or simply starting to invest, ETFs can serve as the foundation of a smarter, more resilient portfolio.

Definitions (as used by Twin Oak):

1. **Cost-effective ETFs:** As defined compared to hedge funds, which commonly charge a 2% management fee as well as 20% of the profits.
2. **Institutional Grade:** Investment strategies generally only accessible in private fund formats to accredited investors.
3. **Tax Alpha:** The amount of a gross return lost to the tax drag of an investment vehicle through realized taxable events.
4. **Low Cost:** Defined on a case-by-case basis but generally refers to solutions that are cheaper than private funds (2% management fees and 20% carry).

An investor should consider the investment objectives, risks, charges, and expenses of the Fund(s) carefully before investing. The prospectus and the summary prospectus contain this and other information about the Fund(s). You may obtain a prospectus and a summary prospectus by visiting twinoaketfs.com. Please read the prospectus or summary prospectus carefully before investing.

All investments are subject to risks, including the possible loss of principal. There is no assurance that the objectives of any strategy or fund will be achieved or will be successful. PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS; there is no guarantee that Twin Oak will be able to successfully implement the strategy.

1. **New fund risk:** The Fund is a newly organized, management investment company with no operating history.
2. **Non-diversification risk:** More of the Fund's assets may be invested in the securities of a single issuer than could be invested in the securities of a single issuer by a diversified investment company. This may make the value of the Shares more susceptible to certain risks than shares of a diversified investment company. The Fund has a greater potential to realize losses upon the occurrence of adverse events affecting a particular issuer.
3. **Counterparty Risk:** Some of the Fund's derivatives contracts are privately negotiated in the over-the-counter market. A counterparty defaulting on its payment obligations to the Fund will cause the value of an investment in the Fund to decrease.
4. **Derivatives Risk:** The Fund may use derivative contracts which can disproportionately increase losses and reduce opportunities for gains when stock prices, currency rates, or interest rates are changing.
5. **Illiquid Securities Risk:** The Fund may invest up to 15% of its net assets in illiquid investments which are instruments that the Fund reasonably expects cannot be sold or disposed of in current market conditions within 7 calendar days or less without the sale or disposition significantly changing the market value of the investment.
6. **Leverage Risk:** The Funds use of options, swaps, or other derivative instruments may result in losses to the Fund or may adversely affect the Fund's NAV or total return, because these instruments are more sensitive to interest rate changes.
7. **Options Risk:** Purchasing and writing put and call options are highly specialized activities and entail greater than ordinary investment risks from which the Fund may not fully benefit.
8. **New advisory risk:** This is a newly registered investment advisory and as a result, there is no long-term track record against which an investor may judge the Adviser, and it is possible the Adviser may not achieve the Fund's intended investment objective.

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