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THE CONCEPT OF ETFS

1. Definition

What is an ETF?
An exchange-traded fund (ETF) is a basket of securities—such as stocks or bonds—that tracks an underlying index.

How are ETFs traded?
An ETF is called an «exchange-traded» fund since it’s traded on an exchange just like stocks.

Therefore, an ETF is a marketable security, meaning it has an associated price that allows it to be easily bought and sold. Indeed, the price of an ETF’s shares will change throughout the trading day as the shares are bought and sold on the market.

Cash Invested in ETFs
The dollar amount, in trillions, invested in exchange-traded funds worldwide.

2. The different types of ETFs

<table>
<thead>
<tr>
<th>BOND ETFS</th>
<th>STOCK ETFS</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Type(s) of securities</strong></td>
<td>Bonds</td>
</tr>
<tr>
<td><strong>Description</strong></td>
<td>A bond ETF tracks an index of bonds and tries to replicate its returns</td>
</tr>
<tr>
<td></td>
<td>Might include government bonds, corporate bonds, and state and local bonds — called municipal bonds</td>
</tr>
<tr>
<td><strong>Examples</strong></td>
<td>iShares Core U.S. Aggregate Bond ETF</td>
</tr>
<tr>
<td></td>
<td>Vanguard Total Bond Market ETF</td>
</tr>
</tbody>
</table>

The growth of ETFs
The growth of cash invested in ETFs was remarkable after their mass introduction in the early 2000s, and they continue to grow in number and popularity. The emergence of the investment vehicle has been great for investors, as new low-cost opportunities are now available for nearly every asset class in the market.
A GREAT CHOICE FOR BEGINNER INVESTORS

1. Variety of ETFs

ETFs have a number of features that make them a great investment choice for a beginner investor.

Variety of ETFs (risk management & diversification)

**1st**

ETFs introduced

<table>
<thead>
<tr>
<th>Type(s) of securities</th>
<th>Description</th>
<th>Examples</th>
</tr>
</thead>
<tbody>
<tr>
<td>Multiples</td>
<td>Track a particular industry, such as technology, banking, or the oil and gas sector</td>
<td>Vanguard Real Estate Index Fund</td>
</tr>
<tr>
<td></td>
<td>Might include stocks, bonds, ...</td>
<td>Financial Select Sector SPDR Fund</td>
</tr>
</tbody>
</table>

**1'800**

U.S.-based ETFs

<table>
<thead>
<tr>
<th>Type(s) of securities</th>
<th>Description</th>
<th>Examples</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commodities</td>
<td>Invest in commodities including crude oil or gold</td>
<td>Invesco DB Commodity Index Tracking Fund</td>
</tr>
<tr>
<td></td>
<td></td>
<td>iShares S&amp;P GSCI Commodity-Indexed Trust</td>
</tr>
</tbody>
</table>

The first ETFs were introduced in the late 1980s and early 1990s. They were relatively plain-vanilla products that tracked equity indexes such as the S&P 500 and the Dow Jones.

Since then, as we saw earlier, the range of available ETFs has exploded to include practically every asset class – stocks, bonds, real estate, commodities, currencies, and international investments – among any sectors you would be looking to invest in.

As of mid-2018, there were more than 1'800 U.S.-based ETFs, according to data from research and consultancy firm ETFGI.

For young investors, this wide range of available ETFs offers a wide variety of investment choices that are not available with index funds.
2. Liquidity

**A liquid vehicle**

Most ETFs are very liquid and, as we saw, can be traded throughout the day.

This makes a major advantage over index mutual funds, which are priced only at the end of the business day.

This is an especially critical differentiating factor for a beginner investor, who may like to exit a losing investment immediately in order to preserve limited capital.

**Quarterly ETF Share Price**

Quarterly share price of 10 popular ETFs, 2009 to 2019.

- **SPDR S&P 500 ETF Trust**
- **iShares Russell 1000 Value ETF**
- **Invesco QQQ Trust Series 1**
- **Vanguard S&P 500 ETF**
- **Vanguard Tata/Stack Market ETF**
- **iShares Care S&P 500 ETF**
- **SPDR Gold Shares**
- **iShares MSCI Emerging Markets ETF**
- **Financial Select Sector SPDR Fund**
- **VanEck Vectors Gold Miners ETF**

Source: Bloomberg

3. Others

**Lower fees**

ETFs generally have lower expense ratios than mutual funds. The average mutual fund still has an internal cost well over 1%, whereas most ETFs will have an internal expense ratio typically between 0.30-0.95%.

Additionally, many online brokers offer commission-free ETFs, even for investors with small accounts.

**Tax-Friendly Investing**

Unlike mutual funds, ETFs are very tax-efficient. Mutual funds typically have capital gain payouts at year-end, due to redemptions throughout the year. On the other hand, ETFs minimize capital gains by doing like-kind exchanges of stock, thus shielding the fund from any need to sell stocks to meet redemptions. Therefore, it is not treated as a taxable event.

**Investment management strategy**

ETFs enable investors to manage their investments in the style of their choice – passive, active or somewhere in between. Sector ETFs also enable investors to take bullish or bearish positions in specific sectors, or markets.

**XSD/US**

SPDR S&P Semiconductor ETF

- **Open:** 86.8400
- **Prev. close:** 84.3700
- **Change:** +2.4700 (+2.93%)**
- **Volume:** 605,384

Source: Bloomberg

*That would increase its portfolio exposure to an upward in that sector, without being overexposed to only one/few specific companies.*
ASSESSING YOUR RISK TOLERANCE

1. Investor profile

As you build a portfolio, it helps to understand your risk tolerance by determining your investor profile. These range from conservative (seeking lower investment risk) to aggressive (able to tolerate greater investment risk). Higher-risk investments may have the potential for higher returns, but they also have greater potential for losses as illustrated below.

<table>
<thead>
<tr>
<th>Profile</th>
<th>Stocks</th>
<th>Bonds</th>
<th>Cash</th>
<th>Return</th>
</tr>
</thead>
<tbody>
<tr>
<td>CONSERVATIVE</td>
<td>31.2%</td>
<td>8.0%</td>
<td>-8.1%</td>
<td></td>
</tr>
<tr>
<td>MODERATELY CONSERVATIVE</td>
<td>40.8%</td>
<td>9.3%</td>
<td>-15.2%</td>
<td></td>
</tr>
<tr>
<td>MODERATE</td>
<td>45.8%</td>
<td>9.9%</td>
<td>-22.4%</td>
<td></td>
</tr>
<tr>
<td>MODERATELY AGGRESSIVE</td>
<td>50.9%</td>
<td>10.5%</td>
<td>-29.5%</td>
<td></td>
</tr>
<tr>
<td>AGGRESSIVE</td>
<td>55.6%</td>
<td>10.9%</td>
<td>-36.2%</td>
<td></td>
</tr>
</tbody>
</table>

DETERMINING YOUR ASSET ALLOCATION

1. Definition

The percentage of investments including stocks, bonds and cash that a portfolio holds. Asset allocation is a strategy that can help you balance portfolio risks and rewards.

<table>
<thead>
<tr>
<th>Profile</th>
<th>Stocks</th>
<th>Bonds</th>
<th>Cash</th>
<th>Allocation</th>
</tr>
</thead>
<tbody>
<tr>
<td>SAFE</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>MODERATELY CONSERVATIVE</td>
<td>50%</td>
<td>50%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>MODERATE</td>
<td>70%</td>
<td>30%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>MODERATELY AGGRESSIVE</td>
<td>25%</td>
<td>5%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>AGGRESSIVE</td>
<td>10%</td>
<td>90%</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Stocks ■ Bonds ■ Cash
2. The importance of diversification

**DIVERSIFICATION**

**By asset class**

Investors should diversify their investments across asset classes.

Commodities, bond prices, stocks and currencies... all four markets work together — some move with each other and some against.

**EXAMPLE OF A TYPICAL INTERMARKET CYCLE**

- **As commodity prices rise**
  - The cost of goods moves upward.
- **Inflation**
  - Interest rates also rise to reflect the growing inflation.
- **Inverse relationship**
  - Bond prices fall since there is an inverse relationship between interest rates and bond prices.
- **Stock/bond markets correlation**
  - Stocks will eventually follow, and head down as well.

Investors can reap further diversification benefits by investing in securities from different countries/regions, because they tend to be less closely correlated.

For example, forces depressing the U.S. economy may not affect Japan’s economy in the same way. Therefore, holding Japanese stocks gives an investor a small protection against losses during an American economic downturn.

**By country**

**DIVERSIFICATION**

It is also crucial to diversify your portfolio by having a balance across the multiple different industries in the economy.

For example, just like with the home country bias, people also tend to overweight their home industry. The chart shows in those living in the West tend to overweight Technology (many tech companies based here). The Northeast favors Financials, the Midwest Industrials, and the South, Energy.

**INVESTOR ALLOCATION BY REGION**

Likelihood of owning stocks in an industry vs. national average***

<table>
<thead>
<tr>
<th>Industry</th>
<th>West</th>
<th>Northeast</th>
<th>Midwest</th>
<th>South</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financials</td>
<td>-2%</td>
<td>-12%</td>
<td>+9%</td>
<td>-8%</td>
</tr>
<tr>
<td>Technology</td>
<td>+10%</td>
<td>-7%</td>
<td>+0%</td>
<td>-5%</td>
</tr>
</tbody>
</table>

Building a diversified portfolio also means investing in a mix of large, stable corporations and smaller companies with growth potential.

Investing in small-cap companies is an important element of your investment strategy. Smaller companies tend to have a greater chance of large growth, faster. Large-cap companies should also have a significant weight in your portfolio, especially if you have a low risk tolerance, as large-cap companies tend to be safer.

**By size**
1. Asset allocation – Conservative

20% – STOCKS

<table>
<thead>
<tr>
<th>TYPE</th>
<th>NAME</th>
<th>WEIGHT</th>
<th>EXAMPLE</th>
<th>OBJECTIVE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stocks – 10%</td>
<td>Company 1 – Small/Mid Cap – Sector 1</td>
<td>5%</td>
<td>Apple</td>
<td>Exposure to a US company stock</td>
</tr>
<tr>
<td></td>
<td>Company 2 – Large Cap – Sector 2</td>
<td>5%</td>
<td>Toyota</td>
<td>Balance the US tech stock exposure by increasing exposure to another sector in another country</td>
</tr>
<tr>
<td>ETF – 10%</td>
<td>EU stock index ETF</td>
<td>2.5%</td>
<td>LYXOR ETF CAC 40</td>
<td>Exposure to whole EU stock markets</td>
</tr>
<tr>
<td></td>
<td>US stock index ETF</td>
<td>2.5%</td>
<td>iShares Core S&amp;P 500 ETF</td>
<td>Balance the EU exposure by increasing US exposure</td>
</tr>
<tr>
<td></td>
<td>Sector 3 ETF</td>
<td>2.5%</td>
<td>Invesco DB Energy Fund</td>
<td>Exposure to Sector 1 companies</td>
</tr>
<tr>
<td></td>
<td>Sector 4 ETF</td>
<td>2.5%</td>
<td>iShares Transportation Average ETF</td>
<td>Balance the Sector 1 exposure by increasing exposure to negatively correlated sector</td>
</tr>
</tbody>
</table>

25% 20% 55%

| Stocks | Bonds | Cash |

55% – BONDS

<table>
<thead>
<tr>
<th>TYPE</th>
<th>NAME</th>
<th>WEIGHT</th>
<th>EXAMPLE</th>
<th>OBJECTIVE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bonds – 25%</td>
<td>Country 1</td>
<td>15%</td>
<td>German Bund 10-Y</td>
<td>Exposure to a safe gov. long-term bond</td>
</tr>
<tr>
<td></td>
<td>Company 4 – Sector 6</td>
<td>10%</td>
<td>Macquarie 5-Y Bond</td>
<td>Balance the gov. exposure by increasing exposure to corporate bonds</td>
</tr>
<tr>
<td>ETF – 30%</td>
<td>1-3 Government Bonds ETF</td>
<td>20%</td>
<td>iShares 1-3 Year International Treasury Bond ETF</td>
<td>Exposure to (i) government bonds ; (ii) short-term maturities</td>
</tr>
<tr>
<td></td>
<td>7-10 Government Bonds ETF</td>
<td>10%</td>
<td>iShares 7-10 Year Treasury Bond ETF</td>
<td>Balance the short-term exposure by adding longer term maturity bonds</td>
</tr>
<tr>
<td></td>
<td>HY Corporate Bonds ETF</td>
<td>15%</td>
<td>Vanguard High Dividend Yield (VYM)</td>
<td>Exposure to HY corporate bonds</td>
</tr>
<tr>
<td></td>
<td>IG Corporate Bonds ETF</td>
<td>20%</td>
<td>iShares iBoxx $ investment Grade corporate Bond ETF (LQD)</td>
<td>Balance the HY exposure by increasing safer bonds (IG)</td>
</tr>
</tbody>
</table>

- If there is a local crisis in EU: your exposure to the US stock market will help compensate the potential losses. It happens that a negative event on a region is advantageous for another. In that situation, your gains on one region will offset the losses on the region in crisis
- If there is a special event that impacts all companies within Sector 1, 2, 3 or 4: your exposure to other sectors will help minimize compensate the potential losses

- If there is an increase in short-term rates: your exposure to longer maturity bonds will help compensate the potential losses. If you only had 1-3Y bonds, you would have suffered a lot more
- You can also benefit from your high yield exposure, while hedging by keeping an IG exposure
2. The Dangers Of Over-Diversifying Your Portfolio

A persona portfolio must be diversified to help lessen the inherent risk of holding only one or one kind of security. However, some investors may actually become overdiversified.

You seek to protect your assets by diversifying them — allocating them among stocks, bonds and cash. And you can further manage risk by picking more than one investment within a class: You might hold not just a single stock fund, but one fund for blue-chip stocks, another for smaller stocks and a third that invests overseas.

But it is possible to overdo diversification. If you split your savings among so many investments that you can barely keep track of them all, you may be over-diversified.

Redundancies don’t diversify
The more investments you own, the more likely you are to have duplication and overlap in your portfolio.

Just buying a bunch of stocks, bonds, mutual funds, ETFs doesn’t necessarily mean you are diversifying. You can hold five different ETFs or mutual funds that track the S&P 500 and you won’t be any more diversified than just holding one of them.

Too many funds that invest in the same type of securities, asset class or even in the same companies. Instead of more diversification, you may actually be getting less.

REASSESSING PORTFOLIO WEIGHTINGS

1. Reacting to market changes

Once you have an established portfolio, you need to analyze and rebalance it periodically, because market movements may cause your initial weightings to change.

The other factors that are likely to alter over time are your current financial situation, future needs, and risk tolerance. If these things change, you may need to adjust your portfolio accordingly.

Examples
Let’s say, for example, that Mr Warren assesses himself as moderate. If his risk tolerance has dropped, he may need to reduce the amount of equities held.

Or perhaps Mr Warren is now ready to take on greater risk and his asset allocation requires that a small proportion of his assets be held in riskier small-cap stocks.
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