

A Seagull's View of an Exchange-Traded Fund

Mediterranean Charters owns one boat, a 70-foot motor yacht named *Caroline* that is moored in Naples, Italy. Summer cruises on the *Caroline* cost \$10,000 a week, and the schedule is full.

To raise new capital, the owner of the *Caroline* decides to sell shares in his boat. He has no trouble selling 100,000 shares at \$10 per share. Each share represents a 1/100,000 interest in the *Caroline*.

The yachting world is small and soon a *secondary market* develops in *Caroline* shares as new investors buy shares from old investors.

The value of shares in the *Caroline* depends on two factors: (1) the value of the boat and (2) what buyers are willing to pay for the shares. Those two are not always the same. Investor interest is greater in the spring and the price of *Caroline* stock rises. Prices tend to ease in the fall when cold weather arrives.

One day, the owner decides to sell the *Caroline*, so he buys back all of the outstanding shares. He pays \$11 for each share as the boat has increased in market value in the interim.



secondary market

the traditional exchanges, over-the-counter markets, and electronic exchanges where securities previously issued are bought and sold by investors.

The sponsor of an exchange-traded fund (ETF) does somewhat the same. He (or she) accepts shares of the actual index stocks and secures them in a trust fund. He creates ETF share certificates, each of which represents a sliver of ownership of the stocks in the trust; and, he wire transfers the ETF shares to the person who gave him the stocks. That

person sells the ETF shares to investors, who are then free to trade them on the stock exchange.

The *value of ETF shares* likewise depends on two factors: (1) the value of the stocks in the trust and (2) the market price set by bids and offers on the exchange trading floor.

The process that created the ETF can also be reversed. The sponsor can accept ETF shares and give back the actual shares of the index stocks that he has been holding in trust.

**ETF value**

The value of ETF shares depends on two factors: the value of the stocks in the trust, and the market price set by bids and offers on the exchange.