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The ABCs of Trading ETFs

Though exchange-traded funds (ETFs) are often compared to another popular investment type, they are actually purchased and sold more like stocks and can be traded throughout the day. Developing basic trading skills and understanding the various order types may help you more effectively capture the exciting investment opportunities that ETFs represent.

BASIC ORDER TYPES

+ **MARKET ORDER:** The most basic order type, the market order is an order to buy your ETF shares at the market's price at the time of execution—which may or may not be the same as the price listed when you place the order, because execution is immediate and price indiscriminate.

+ **LIMIT ORDER:** A limit order specifies a maximum or minimum price at which you are willing to buy or sell ETF shares, respectively. The trade is executed at your price or at a better price, or it is not executed.
    - For example, if the price of an ETF is $49/share and you want to buy it but don't want to pay more than $50/share, you put in a limit order at $50/share. If the price goes above $50 before your trade can be executed, your order will not be executed.

+ **STOP ORDER:** A stop order sets a specific price after which an ETF is to be purchased or sold. Once an ETF hits the target "stop price," a purchase or sale trade is triggered as if it were a market order.
    - For example, if you bought an ETF at $50/share and it's now trading at $75/share and you are concerned the price may drop, you can set a sell stop order at $70/share. Once the ETF falls to $70/share, the order is triggered and the shares will be sold as if it's a market order. Of course, this could mean you get more or less than $70/share, depending on the price at the time of execution.

+ **STOP LIMIT ORDER:** A stop limit order also sets a specific price after which an ETF is to be bought or sold over a specific time period. However, once the target price is hit, it turns into a limit order (rather than a market order), effectively setting a price range for which you are willing to buy or sell an ETF.
    - For example, if you are interested in buying an ETF that is trading at $50/share once it starts to move upward, you can set a stop limit with a stop price of $53 and a limit price of $55. Once the stock reaches $53/share, the trade will be triggered. If the trade can be executed before the stock passes $55/share, it will be. Of course, if the stock jumps above $55/share, the trade will not be executed.

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ADVANCED TRADING STRATEGIES

+ **SHORT SELLING:** A short sale is a trade through which you hope to profit from the declining share price for an ETF you do not own. The first step is to borrow ETF shares from a broker or other investor (there will be associated costs). The next is to sell the borrowed shares with the expectation that the price will fall. When and if the price falls, surpassing your costs for borrowing, you can purchase the shares back and return them to the lender—pocketing the difference in price. Of course, at some point the shares will need to be returned, whether the price falls or not. Therefore, investors can end up losing money by having to purchase the security back for more than they sold it for.
    - It's worth noting that, unlike stocks, ETFs can be sold short when the price is on a downtick.

+ **MARGIN LEVERAGING:** Leveraging is like using a credit card. You borrow money from a broker to purchase ETF shares with the expectation that they will provide a return that is significantly higher than the interest you are paying. Of course, if they do not, you will lose money when the loan is due.

+ **TAX-LOSS HARVESTING:** Tax-loss harvesting involves using the losses in one investment to offset the gains in another for tax planning purposes. However, the "wash-sale rule" can make it difficult to realize investment losses while maintaining your asset allocation because it prohibits the rebuying of assets that are substantially identical within 30 days. You can use an ETF to replace stocks and mutual funds (and even some other ETFs) with losses as they are not considered substantially identical to these investments.

When considering different exchange-traded investment options, it may be wise to consider whether or not the fund is truly an ETF that offers the protections of the Investment Company Act of 1940.