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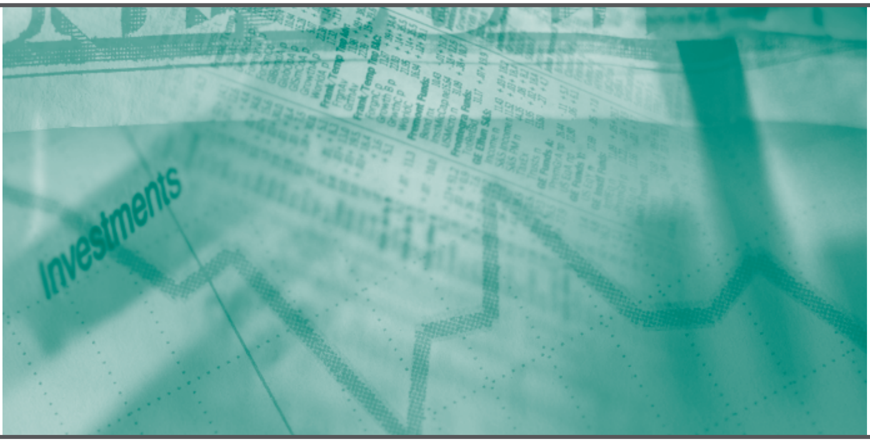

A GUIDE TO

Exchange-Traded Funds

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What Is an Exchange-Traded Fund?

An exchange-traded fund is an investment company that offers investors a proportionate share in a portfolio of stocks, bonds, or other securities. Like individual equity securities, ETFs are traded on a stock exchange and can be bought and sold throughout the day through a broker-dealer.

Exchange-traded funds (ETFs) are a relatively recent innovation to the investment company concept. Like more traditional mutual funds and other investment company offerings, ETFs offer investors, including those of moderate means, the opportunity to purchase shares in a diversified pool of securities at a competitive price.

THE ORIGINATION OF THE INVESTMENT COMPANY CONCEPT

1893: First closed-end fund is started in Belgium.

1924: First open-end mutual funds are established in Boston.

1961: First tax-free unit investment trust is offered.

1976: First retail index fund is introduced.

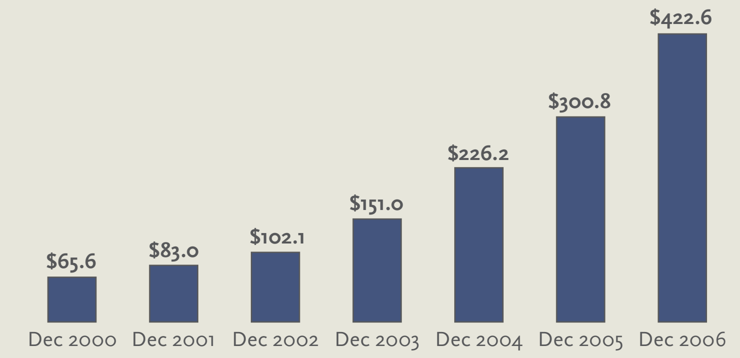
1993: First exchange-traded fund shares are issued.

Sources: Investment Company Institute, Closed-End Fund Association

ETFs make use of the basic premise underlying the investment company concept: a fund pools investor assets and employs investment diversification with an objective of meeting or beating market returns. But ETFs also offer features that differentiate them from the most common type of investment company—the mutual fund.

ETF ASSETS

(billions of dollars)



This brochure provides an introduction to ETF investing, explaining how ETFs work, their unique features and operations, and other characteristics.

Most ETFs attempt to achieve the same investment return as that of a particular market index, such as the Dow Jones Industrial Average, Standard & Poor's 500 Index, or the NASDAQ Composite Index. (See *What Kinds of ETFs Are Available* on page 10.) To mirror the performance of a market index, an ETF invests either in all of the securities in the index or a representative sample of securities in the index.

SOUND FAMILIAR?

Traditional index mutual funds are like ETFs in that they both hold investment portfolios that match a designated market index and attempt to achieve the same investment return as that index. But there are several important differences as well. See *ETFs & Index Funds* on page 9 for more information.

How Do ETFs Work?

ETFs originate with a fund sponsor, which chooses the ETF's target index, determines which securities will be included in the "basket" of securities, and decides how many ETF shares will be offered to investors.

Say, for example, a fund sponsor wants to create an ETF that tracks the S&P 500 Index. Because of the expense involved in acquiring the basket of securities that represent the securities listed on the S&P 500—which can run into the millions of dollars—the fund sponsor typically contacts an institutional investor to obtain and deposit with the fund the basket of securities. In turn, the ETF issues to the institutional investor a "creation unit," which typically represents between 50,000 and 100,000 ETF shares. (Note that, unlike shares in a traditional mutual fund that are purchased with cash, ETF sponsors require its investors to deposit securities with the fund.)

Each ETF share represents a stake in every company listed on the S&P 500 Index. The institutional investor that holds the creation unit (the "creation unit holder") is then free to either keep the ETF shares or to sell all or part of them on the open market. ETF shares are listed on a number of stock exchanges (NYSE, NASDAQ, Amex, etc.) where investors can purchase them through a broker-dealer. Like other exchange-listed securities, a retail investor who purchases an ETF can liquidate its investment by selling its ETF shares at the then-current price. By contrast, a creation unit is liquidated when an institutional investor returns to the ETF the specified number of shares in the creation unit; in return, the institutional investor receives a basket of securities reflecting the current composition of the ETF.

The basket of securities deposited by the institutional investor with the fund sponsor has been predetermined by the sponsor to track a particular index. When changes are made to the index (a stock is added to or dropped from the index), the fund sponsor notifies the creation unit holders that changes need to be made to the basket of securities originally deposited with the fund to ensure that the basket continues to track the composition of the index.

How an ETF Comes to Market

Retail investors who purchase an interest in an ETF do not directly own a pro-rata interest in the ETF's portfolio. Rather, the investor owns a share in a "creation unit," which is issued by the ETF sponsor to a creation unit holder in return for a basket of securities. In other words, there is a person—typically an institutional investor—interposed between the retail ETF owner and the ETF sponsor.

HOW AN ETF COMES TO MARKET

Step One:
A fund sponsor sets an investment objective (e.g., create an ETF that tracks the S&P500 Index) and develops the list of the basket securities that can be exchanged for ETF shares.

Step Two:
The fund sponsor forms participation agreements with entities that want to become creation unit holders (e.g., securities firm or institutional adviser).

Step Three:
The participating companies assemble a basket of securities that contains shares of every company listed on the S&P 500 based on their relative weighting and deposit the basket of securities with the fund sponsor.

Step Four:
In return for the basket of securities, the fund sponsor provides the participating entities with a "creation unit," which can contain thousands of individual ETF shares.

Step Five:
The creation unit holder can either hold the ETF shares or sell all or part of them.

Step Six:
Retail investors can purchase the individual ETF shares through a broker-dealer.

How Do ETFs Generate Returns for Investors?

The price of an ETF share depends on the forces of supply and demand in the market and on the performance of the underlying index. Of course, the performance of the index is determined by the performance of each component stock.

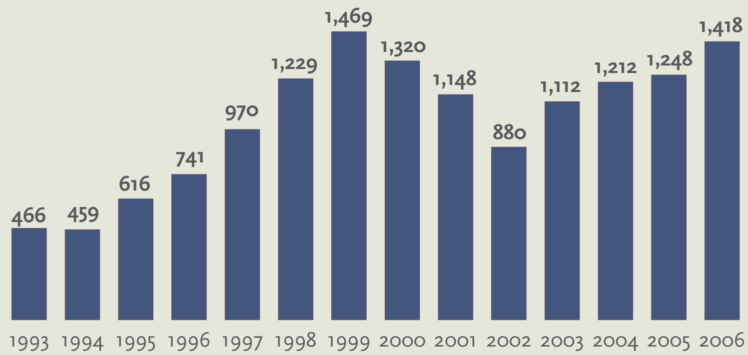
In some ways, holding a share in an ETF is like holding a share of any company's stock. If an investor buys a share of XYZ Company's stock for $10 on Monday and sells when the share price rises to $20 on Wednesday, he or she has made a $10 profit. But if that investor sells on Friday, when the price of the stock has fallen to $8, he or she will experience a $2 loss. The same holds true for ETFs.

Pricing, however, differs between mutual funds and ETFs. For a mutual fund, the price at which investors buy and sell shares is equal to the fund's net asset value (NAV), less any commissions. The NAVs of both mutual funds and ETFs are calculated daily at the close of the markets. While investors can buy and sell mutual fund shares are any time throughout the day, all investors will receive the same transaction price (the NAV). In contrast, the price of an ETF share is continuously determined on a stock exchange. Consequently, the price at which investors buy and sell ETF shares may not necessarily equal the NAV of the portfolio of securities in the ETF. In addition, two investors selling the same ETF shares at different times on the same day may receive different prices for their shares, both of which may differ from the ETF's new asset value.

The price of an ETF share on a stock exchange is influenced by the forces of supply and demand. For example, when investor demand for an ETF increases, the ETF's share price will rise, perhaps exceeding the ETF's net asset value. ETFs are structured, however, so that large differences between their share prices and their NAVs are unlikely to persist. Third parties calculate and disseminate every 15 seconds a measure often called the Interday Indicative Value (IIV), which is a real-time estimate of a fund's NAV. When an ETF's share price is substantially above this indicative value, institutional investors may find it profitable to deliver the appropriate basket of securities to the ETF in exchange for ETF shares. Retail investors may find it profitable to take a short position in the ETF's shares. When an ETF's share price is substantially below its indicative value, institutional investors may find it profitable to return ETF shares to the fund in exchange for the ETF's basket of securities. Retail investors may find it profitable to take a long position in the ETF's shares. These actions by investors help keep the market-determined price of an ETF's shares close to the NAV of its underlying portfolio.

ETFs have been offered to investors since 1993. As indicated by the graph below, an investor who bought shares of an ETF that tracked the S&P 500 Index in 1993 would have seen the value of their ETF shares rise or fall to varying degrees over the past 11 years.

HISTORICAL S&P 500 INDEX PERFORMANCE
(year-end)



Dividends and Capital Gains. Dividends are paid on a quarterly or annual basis. Some ETFs allow their shareholders to reinvest their dividends in the purchase of additional ETF shares. Any profit realized in conjunction with the sale of any investment is called a "capital gain." Because ETF investors can see the value of their investment change throughout the day, they can sell their ETF shares when the price is higher, earning an investment return. However, when an ETF investor sells their ETF shares for a profit and realizes capital gains, the investor incurs a capital gains tax liability.

Are ETFs Similar to Index Mutual Funds?

ETFs and index mutual funds are similar in that they typically seek to match the return of a market index and both are good choices for investors with a long-term investment strategy. There are important differences between the two investment options, however.

ETFs & INDEX FUNDS

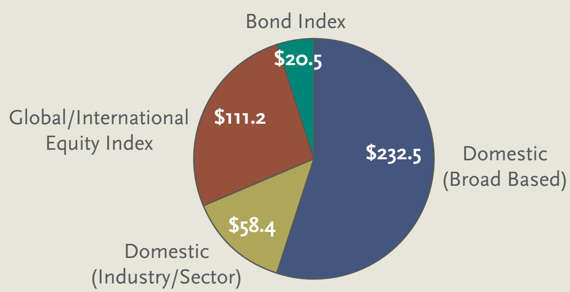
Ownership	ETF investors own a share in a "creation unit."	Index fund investors purchase a pro-rata interest in the securities that make up the fund's portfolio.
Method of Purchase	Investors can buy ETF shares only through a broker-dealer.	Index funds can be purchased through a variety of distribution channels, including through a broker-dealer or directly from a fund company.
Pricing	ETFs are priced continuously and investors can buy and sell their ETF shares throughout the day at the current offering price. As a result, two investors selling ETF shares at different times on the same day may receive different prices for their shares.	Traditional mutual funds are priced at the close of the markets each day. While an investor may purchase or sell traditional mutual fund shares at any time on a trading day, the price the investor receives will be the price determined at the end of that trading date, which will be the same for all shareholders in the fund.
Management Style	Passive. ETF managers only make changes to the ETF portfolio when there is a change in the underlying index.	Passive. Fund managers only make changes to the fund portfolio when there is a change in the underlying index.
Transaction Costs	Because ETFs are purchased through a broker-dealer, an ETF investor pays a brokerage commission when buying or selling ETF shares. In addition to any commissions charged, ETF investors also may pay a management fee, which is deducted from the ETF's assets.	Depending upon the distribution channel, an investor in a traditional mutual fund may be required to pay a commission when buying or selling shares. In addition to any commissions charged, mutual fund shareholders also pay an ongoing management fee, which is deducted from the fund's assets.

What Kinds of ETFs Are Available for Purchase?

There are ETFs that track almost every U.S. stock market index, as well as ETFs that track individual U.S. stock market sectors, international indices, and bond indices. The main categories of ETFs are:

- » **Broad-Based Equity Index Shares.** These ETFs track indices like the S&P 500 Index, the NASDAQ Composite Index, as well as large-, mid-, and small-cap indices.
- » **Sector/Industry Equity Index Shares.** These ETFs track indices that focus on specific sectors such as energy, financial services, healthcare, real estate, technology, industrial, transportation, and consumer goods, to name a few.
- » **Global/International Equity Index Shares.** These ETFs track indices focusing on a specific country or region.
- » **Bond Index Shares.** These ETFs track U.S. Treasury bond and corporate bond indices.

ASSETS OF EXCHANGE-TRADED FUNDS BY TYPE
(billions of dollars)



Source: Investment Company Institute, December 2006

What Are the Risks of Investing in ETFs?

All investments, including ETFs, involve varying degrees and types of risk, including the potential loss of money. While investment diversification mitigates the effect of a decline in the value of any one security in an ETF portfolio, an ETF's value could decline due to larger economic events or policy changes affecting the underlying index (e.g., a recession). This is known as market risk. ETFs tracking a bond index are also subject to interest rate risk, which is the possibility that changes in interest rates will lower the price of bonds and reduce the value of an ETF's portfolio.

Who Regulates ETFs?

The vast majority of exchange-traded funds are registered with the Securities and Exchange Commission (SEC) and must comply with the applicable provisions of the Investment Company Act, except to the extent the fund or trust has received exemptive relief from the Act. Exchange-traded funds have obtained exemptive relief to (1) allow them to register as mutual funds under the Act even though their shares are not individually redeemable (ETFs are, however, prohibited from referring to themselves as mutual funds.); (2) permit affiliated entities to purchase and redeem shares in kind rather than in cash; and (3) enable their shares to trade at negotiated prices on an exchange rather than at a current offering price described in the prospectus or at a price based on net asset value (NAV).

As of 2006, about 3 percent of ETF assets were not registered with or regulated by the SEC under the Investment Company Act. These ETFs are commodity-based. Those ETFs that invest in commodity futures are regulated by the Commodity Futures Trading Commission (CFTC), while the ETFs that invest solely in physical commodities are not regulated by the CFTC.

Where Can I Get More Information on ETFs?

- U.S. Securities and Exchange Commission, Exchange Traded Funds
  www.sec.gov/answers/etf.htm
- The American Stock Exchange, Exchange Traded Funds
  www.amex.com/?href=/etf/EtMain.jsp
- The NASDAQ Stock Market, Exchange Traded Funds
  www.nasdaq.com/indexshares/about_funds.stm
- ETFConnect, Know Your Funds
  www.etfconnect.com/education/fundamentals_etf.asp

In addition, the Institute provides answers to a series of frequently asked questions about exchange traded funds on their website at www.ici.org/funds/abt/faqs_etfs.html.

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