Client Education Resources

How ETFs Are Created and Redeemed

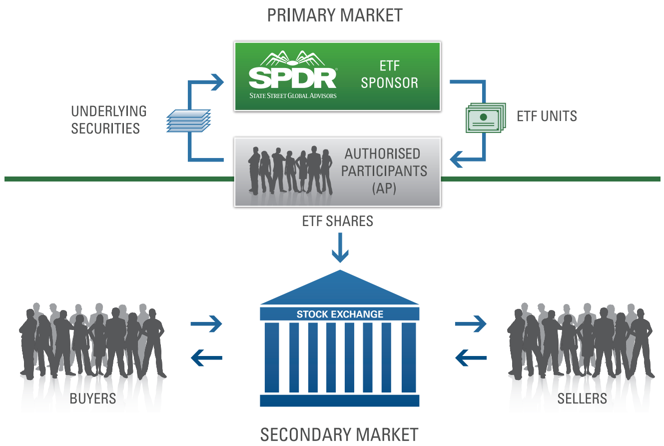
Exchange traded funds (ETFs) in the market place today cover a wide variety of asset classes. There are ETFs that track broad market indexes, specific sectors, as well as fixed income, commodity, currency and leveraged products. In the simplest terms, ETFs are a collection or "basket" of securities that typically track a specific market index. ETFs have characteristics of both stocks and mutual funds. Similar to a stock, they are priced intraday and trade on the exchange. Like indexed mutual funds, ETFs are transparent[1] with their expenses and holdings. While there are some similarities, the main difference between ETFs and other investment vehicles like traditional mutual funds or stocks is the process through which fund shares are created and redeemed. This is called the creation/redemption process and takes place in the primary market between the fund and authorized participants (APs). APs are US registered, self-clearing broker dealers who meet certain criteria and sign a participant agreement with a particular ETF sponsor or distributor to become authorized participants of the fund. APs are highly scrutinized for their integrity and operational competence; they are the only parties who transact directly with the fund.

Authorized participants create fund shares in large increments—known as creation units—by assembling the underlying securities of the fund in their appropriate weightings to reach creation unit size (typically 50,000 fund shares) and then delivering those securities to the fund in-kind. In return, the AP receives fund shares which are then introduced to the secondary market where they are traded between buyers and sellers through the exchange. As a result of the creation/redemption process, the ETF's portfolio manager typically does not have to buy or sell securities except for rebalancing purposes.

APs also have the ability to redeem fund shares through the same process in reverse. Large increments of fund shares—known as redemption units—are collected in the secondary market and then delivered to the fund in-kind in exchange for the underlying securities in the appropriate weighting equaling that redemption unit (again, typically 50,000 shares).

To help illustrate this process, let's walk through a specific example (Figure 1). Suppose an authorized participant wants to create shares of the SPDR® S&P 500® ETF [SPY]. First, the AP would reference a list of the exact securities and their weightings within the fund. The list is provided daily by the ETF fund sponsor. The AP would gather those same securities in their appropriate weightings into a creation unit. Next, the AP would transfer the creation unit in-kind to State Street in exchange for shares of SPY. To complete the creation process, the AP would introduce these newly created SPDR S&P 500 ETF shares into the secondary market where they would be traded between buyers and sellers through the exchange.

FIGURE 1: ETF CREATION/REDEMPTION



When the authorized participant wants to redeem fund shares of SPY, they would follow the same process in reverse. In the secondary market, the AP would gather large increments of fund shares into a redemption unit. Then in the primary market, the AP would deliver the redemption units to State Street in-kind in exchange for the underlying securities in the appropriate weightings equaling that redemption unit. Only authorized participants are able to create or redeem ETF shares in the primary market.

Understanding the creation/redemption process is key to understanding the unique structure of ETFs, allowing investors to more efficiently buy and sell ETFs. It is this process that sets ETFs apart from other investment vehicles like traditional mutual funds or stocks.

TALK TO YOUR FINANCIAL ADVISOR
If exchange traded funds interest you, speak to your financial advisor to determine if you could benefit from incorporating ETFs in your investment plans.

INDEX DEFINITIONS

S&P 500 INDEX

The S&P 500 Index is composed of 500 selected stocks, all of which are listed on the Exchange, the NYSE or NASDAQ, and spans over 24 separate industry groups. Since 1968, the S&P 500 Index has been a component of the US Commerce Department's list of Leading Indicators that track key sectors of the US economy. Current information regarding the market value of the S&P 500 Index is available from market information services. The S&P 500 Index is determined, comprised and calculated without regard to the Trust.

ABOUT SPDR® ETFs

SPDR ETFs are a comprehensive fund family of over 100 ETFs, spanning an array of international and domestic asset classes. Offered by State Street Global Advisors, SPDR ETFs provide investors with the flexibility to select investments that are precisely aligned to their investment strategy. Recognized as the industry pioneer, State Street Global Advisors created the first ETF in 1993 (SPDR S&P 500®—Ticker SPY). Since then, we've sustained our place as an industry innovator through the introduction of many ground-breaking products, including first-to-market launches with gold, international real estate, international fixed income and sector ETFs.

For information about our ETF family, visit spdrs.com.

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[1] Transparency is defined as the accessibility of information on the order flow for a particular stock, allowing knowledge of the quantities of stock being offered and the bids at the various price levels.

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IMPORTANT RISK INFORMATION

ETFs trade like stocks, fluctuate in market value and may trade at prices above or below the ETFs' net asset value. Brokerage commissions and ETF expenses will reduce returns.

Diversification does not ensure a profit or guarantee against loss.

The shares issued by SPDR ETFs are not individually redeemable from the ETF and may only be purchased or sold individually at market prices, which may deviate from the ETF's net asset value. Ordinary brokerage commissions apply to secondary market transactions. Certain large investors who have entered into agreements with the SPDR ETFs may transact directly with the ETF at net asset value, but only in large aggregations of shares known as creation units.

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