

A guide to investing in exchange-traded funds

What you should know before you buy

Before you make an investment decision, it is important to review your financial situation, investment objectives, risk tolerance, time horizon, diversification needs and liquidity objectives with your Financial Advisor. This guide will help you better understand the features and costs associated with exchange-traded funds, as well as how your Financial Advisor and Wells Fargo Advisors are compensated when you invest in these products.

What are exchange-traded funds?

Exchange-traded funds (ETFs) at their core are entire portfolios of securities, sometimes referred to as baskets of securities, which are traded like individual stocks on an exchange. When you purchase an ETF, you are purchasing shares of the overall portfolio, not the actual shares of the underlying investments. ETFs are generally categorized in this guide as “traditional” ETFs or as the more complex “non-traditional” ETFs. This guide also describes complex “commodity futures-linked” ETFs. As further described below, these and other exchange-traded products may seem similar, but their functional risks and characteristics are quite different.

ETFs are sold by prospectus. Please consider the investment objectives, risks, charges and expenses carefully before investing. The prospectus, which contains this and other information, can be obtained from your Financial Advisor. Read it carefully before you invest.

Traditional ETFs

ETFs are typically structured as registered unit investment trusts (UITs) or open-end investment companies whose shares represent an interest in a portfolio of securities that track an underlying benchmark or index. However, some ETFs that invest in commodities, currencies, or commodity- or currency-based instruments are not registered as investment companies and are generally established as grantor trusts. Unlike traditional UITs or mutual funds, shares typically trade throughout the day on an exchange at prices established by the market.

Like individual stocks, ETFs can be bought and sold throughout the trading day at the current market value, which continuously fluctuates and reflects the value of each share at any particular time. Shares of the ETF are bought and sold on various stock exchanges.

ETFs can track a wide variety of sector-specific, country-specific and broad-market indexes. ETFs may provide diversification to your overall portfolio because one share or one unit may represent multiple underlying stocks, bonds and/or other asset classes. Each ETF seeks to replicate the market performance of the underlying index that makes up its basket of securities. Although ETFs seek to mirror the performance of a particular index, the relationship between performance of the index or sector and the ETF is not exact because of the fees and trading costs associated with the ETF, as well as the difficulties in exactly mimicking an index.

Non-traditional ETFs

Non-traditional ETFs may be “leveraged” or “inverse,” and function like traditional ETFs, but offer leverage, and are designed to perform inversely to the index or benchmark they track, or do both. These ETFs, which are sometimes referred to as “geared,” “responsive” or “exotic,” generally rebalance daily, although some rebalance monthly. They are complex financial instruments designed to meet a stated investment objective although their performance can change significantly from their stated objective on a daily or monthly basis, depending upon the trading session.

Leveraged ETF – Leveraged ETFs attempt to track a multiple of the daily (or monthly) returns of an index usually by using total return swaps. A leveraged ETF may be two times (2x) or three times (3x) leveraged, which means it attempts to provide two or three times the daily index return or loss, respectively. For instance, the double leveraged ETF seeks to provide a 2% gain on that daily return for each 1% increase in the market index return. Conversely, if the index drops 1%, your loss, in theory, would be 2% for that given day, assuming the ETF is rebalanced daily.

Inverse ETF – Some leveraged ETFs are inverse or “short” funds, meaning that they seek to deliver the opposite of the performance of the index or benchmark they track. An inverse ETF generally engages in trading strategies, such as short selling, or enters into total return swap agreements and futures contracts. An inverse ETF seeks to deliver the inverse (-1x) of the index’s performance, while a two times (-2x) or three times (-3x) leveraged inverse ETF seeks to deliver two or three times the opposite of the index’s performance, respectively.

These non-traditional ETFs seek to deliver multiples of the performance of the index or benchmark they track. To accomplish their objectives, non-traditional ETFs involve investment strategies that utilize swaps, futures contracts and other derivative instruments. Both leveraged and inverse non-traditional ETFs are trading vehicles and are not suitable for investors who are interested in a buy-and-hold strategy, particularly in volatile markets.

Non-traditional ETFs are not suitable for most investors. The effects of mathematical compounding can grow significantly over time, leading to scenarios whereby performance over the long run can differ significantly from the performance (or inverse performance) of their underlying index or benchmark during the same period of time.

Leveraged, inverse, and leveraged inverse ETFs may be more volatile and risky than traditional ETFs due to their exposure to leverage and derivatives, particularly total return swaps and futures. In addition, these instruments are typically designed to achieve their desired exposure on a daily (in a few cases, monthly) basis. Holding leveraged, inverse, and leveraged inverse ETFs for longer periods of time potentially increases their risk due to the effects of compounding and the inherent difficulty in market timing.

Commodity Futures-Linked ETFs

Many commodity ETFs attempt to track a futures-based commodity index. Typically these ETFs invest all their assets in a master fund commodity pool which may hold futures contracts, swaps, and/or forward contracts. They are not the equivalent of investing directly in the actual physical commodity.

Commodity futures-linked ETFs are complex investment vehicles and, as a result of the use of futures contracts and swaps are subject to unique risks and characteristics.

Commodity futures-linked ETFs are generally passively managed. These products may be volatile and may use leverage, similar to a non-traditional ETFs.

Due to a number of factors associated with ETFs in general, the performance of commodity futures-linked ETFs may be misunderstood by investors. Their performance may not necessarily correspond to the underlying spot price performance (the spot price is the price of goods, currencies, or securities that are offered for immediate delivery and payment). In fact, when there are significant differences between the spot price and the commodity or futures price, the performance of the commodity futures-linked ETF may be very dissimilar to the spot price performance and may adversely impact your return. This deviation could be positive or negative depending on market conditions and investment strategy.

The difference between the performance of commodity futures-linked ETFs and the underlying spot price may also be affected by the “rolling” of contracts by the fund manager. For instance, the manager wants to have ongoing, continual exposure to the particular commodity (or commodities) by using futures contracts or swap contracts. Therefore, if the manager is long (or holds) the contract, the manager must liquidate the contract that is currently held, sometime before expiration, and then gain exposure to another contract with a later expiration. The manager must continually liquidate and buy in contracts as the contracts’ expiration date approaches. When commodity futures-linked securities are rolled, the difference between the price of the contract it sells and the price of the new contract it buys is called the “roll yield”.

The effect of rolling contracts will vary depending on whether a particular commodity of futures market is in contango or backwardation. Contango and backwardation are unique risks associated with futures.

Contango – When a market is in contango, contracts for more distant future delivery are more expensive than near-term contracts for the same commodity. Accordingly, if contracts are rolled in an attempt to maintain a long position while in contango, then the result is a loss or a negative roll yield.

Backwardation – Backwardation is the opposite of contango. Backwardation is when more distant futures contracts are less expensive than the near-term contracts, possibly resulting in a gain when rolling. Thus, backwardation generally results in a positive roll yield for an investor who is long futures contracts and rolls into contracts with a later expiration.

It is important that you understand how commodity futures-linked ETFs are structured, in addition to understanding the risks and characteristics of purchasing investments that focus on commodity and futures trading.

Commodity futures-linked ETFs are not suitable for all investors. The performance of the commodity futures-linked ETFs does not necessarily replicate the spot price and can deviate significantly from the performance of the spot price of the referenced commodity.

How do ETFs differ from other products?

The chart below summarizes the main differences among ETFs, closed-end funds and mutual funds, followed by additional discussion.

	Traditional ETF	Non-Traditional ETF (Leveraged and Inverse)	Closed-End Fund	Mutual Fund or Open-End Fund
Management Style	Generally Passive	Generally Passive, and Actively Rebalanced	Active	Active and Passive (index funds)
Exchange Traded	Yes	Yes	Yes	No
Purchase/Sell At	Price on Exchange	Price on Exchange	Price on Exchange	NAV
Premium/Discount to NAV ¹	Yes	Yes	Yes	No
Leverage Used	Yes	Yes	Yes	Sometimes
Share Classes	Common Shares	Common Shares	Common (and Preferred, if leveraged)	Several (by cost structure)
Execution Cost	Standard Commission Rates	Standard Commission Rates	Standard Commission Rates	Sales Charge (typically 0-5.75%)
NAV Pricing ¹	Intraday	Intraday	Daily (some weekly)	Daily
Expense Ratios	Typically 0.15-0.99% (depending on the asset class and intensity of management activity)	Typically .70-.95% (depending on the asset class and intensity of management activity)	Typically 0.5-2% (depending on the asset class and leverage)	Typically 0.25-3% (depending on the asset class and intensity of management activity)
Maturity Date	Perpetual ²	Perpetual	Perpetual, except for term trusts	Perpetual, except for target date funds

¹Net asset value (NAV) – The current value of a collective investment fund share which is calculated by dividing the total value of all securities in its portfolio, less any liabilities by the number of fund shares outstanding. Because ETFs and closed-end funds trade like stocks, their shares trade at market value which price can be at a premium or discount to NAV.

²Exchange-traded notes (ETNs) have a maturity date; however, they are not discussed in this guide. Consult with your Financial Advisor for more details.

ETFs versus open-end mutual funds

ETFs and open-end mutual funds share many similar characteristics, but it is important to note that the two products are quite different in a number of aspects, including pricing and overall fund management. As noted above, prices of ETFs change throughout the trading day as investors buy and sell shares in the marketplace. Mutual funds, on the other hand, are priced at net asset value (NAV) only once a day, at the close of trading. The availability of continuous market value pricing allows ETF investors the capability to potentially take advantage of market fluctuations throughout the day, rather than just once a day like they would with open-end mutual funds.

ETFs may also offer increased tax efficiency compared to open-end mutual funds due to their in-kind creation and redemption process. Conversely, with a mutual fund, this process takes place in cash. Some ETFs that invest in commodities may issue a Schedule K-1 to be used for individual tax reporting purposes. Some non-traditional ETFs may not be tax efficient during certain market environments.

ETFs versus closed-end mutual funds

ETFs can appear fairly similar to closed-end funds with the exception of the overall management style and intraday price fluctuations. However, they are very different.

Closed-end funds are typically actively managed by a professional money manager, whereas ETFs are generally passively managed. This allows closed-end fund managers the capability to react to market conditions by adjusting the composition of their portfolio.

Closed-end funds and ETFs can generally be traded throughout normal market hours as investors buy and sell shares at the current market value in the marketplace, which may be higher (premium) or lower (discount) than its NAV.

ETFs versus exchange traded notes (ETNs)

An ETF is similar to an ETN in that they are listed on an Exchange and can be sold throughout the day.

An ETN is a common name for a senior unsecured debt obligation designed to track the total return of an underlying index or benchmark, minus investor fees.

ETNs are not funds and are not registered under the Investment Company Act of 1940. Some non-traditional ETNs seek to track the leveraged or inverse performance of an index. Similarly, commodity futures-linked ETNs seek to track a commodity or currency index. These unique non-traditional and commodity futures-linked ETN products share many of the same risks and characteristics as non-traditional ETFs.

Features and characteristics

Some key features and characteristics associated with ETFs include:

Tax Efficiency – Traditional ETFs are generally not actively managed and, as a result, typically generate fewer capital gains due to the low turnover of the securities within their portfolio. Taxes must be paid on all distributions made by the underlying securities and any capital gains associated with transactions made by the fund. However, because ETFs offer in-kind redemptions to qualified entities, they can avoid realizing capital gains for the fund although shareholders must still pay any taxes on realized gains. Non-traditional ETFs may not be tax efficient due to the increased amount of portfolio turnover due to periodic rebalancing as well as the use of leverage. If you have questions about the possible tax consequences associated with these funds, you should consult your tax advisor before making any investment decision.

Expense Ratios – In general, underlying fees and expenses are considerably less for traditional ETFs than those of mutual funds. Non-traditional ETFs will generally have higher fees than traditional ETFs. Associated charges may include management, interest and transaction fees. The management fees are charged by the fund management company, which cover both marketing and fund administration costs. Interest and transaction fees are costs related to holding and transacting derivatives and are generally built into the pricing. Purchases and sales of ETFs are subject to brokerage commissions. All fees and expenses are described in detail in the prospectus.

Transparency – The securities in the underlying ETF portfolio are made public every day. Since these securities generally trade within an index or sector that the ETF follows, you may be able to determine the positions within the portfolio at any time. You may find this beneficial because the transparency could allow you to have more control over your overall investment portfolio allocation and weightings.

Portfolio Diversification (access to wide range of sectors) – ETF portfolios can be diversified across many different securities, offering a set of portfolios for almost every asset allocation need. This diversification can help reduce an investor's risk by potentially offsetting losses from some securities with gains in others. Of course, individual securities in the ETF portfolios and the net asset value of the portfolios will fluctuate in price. Also, keep in mind that asset allocation and/or diversification cannot eliminate the risk of fluctuating prices and uncertain returns.

Buying and Selling Flexibility – Unlike traditional mutual funds, which are only priced at the end of each day, ETFs are priced and can be purchased and sold throughout the trading day. Furthermore, you can buy or sell ETF shares on a stock exchange much like the purchase or sale of any other listed stock.

Risks

Traditional ETFs are generally not actively managed. This means that securities in the portfolio will not be purchased or sold in attempt to take advantage of changing market conditions.

A traditional ETF may continue to hold securities even though their market value and dividend yields may have changed. An ETF generally carries the same investment risk as the portfolio of securities within the ETF. Securities in a portfolio may depreciate, and the ETF may not achieve its intended objective. In addition, each ETF is subject to specific risks that vary depending on each ETF's investment objectives and portfolio composition.

Non-traditional ETFs and commodity futures-linked ETFs are complex products and should only be purchased by sophisticated investors who understand the speculative nature of these products. As a result, these products are subject to a number of risks that transcend those of traditional ETFs. These risks include, but are not limited to, the following:

Speculative in Nature – Non-traditional ETFs are trading vehicles in which daily rebalancing and market volatility have a significant impact on the realized return. You can lose a significant amount of your principal in these securities rapidly.

Leverage – The use of leverage in an investment portfolio can magnify any price movements, resulting in high volatility and potentially significant loss of principal.

Tracking Risk – Non-traditional ETFs may not track the underlying index. As a result of periodic rebalancing and volatility, the return of each non-traditional ETF should not be held as long-term investments. In addition, the performance of a commodity futures-linked ETF may not correspond to the spot price performance, and dissimilar performance may adversely impact your returns. Refer to the specific non-traditional ETF and commodity futures-linked ETF sections above for more information about unique tracking risks.

Volatility – Non-traditional ETFs are volatile and not suitable for all investors. Commodity futures-linked ETFs may also respond to volatility in the commodities and futures markets. Due to their volatile nature, you should consider your financial ability to purchase these products in volatile markets.

Talk to your Financial Advisor

Determining whether ETFs are an appropriate investment strategy for you requires an in-depth evaluation of your individual financial situation and the objectives you want to achieve. Talk with your Financial Advisor today about how ETFs may help you work toward your investment goals.

Holding Period – Positions in non-traditional ETFs should be monitored closely due to their volatile nature and inability to track the underlying index over an extended period of time. Non-traditional ETFs are not intended to be held long term.

Liquidity – Some ETFs may be thinly traded which could impact your ability to sell your shares quickly.

Counterparty Risk – Non-traditional ETFs and commodity futures-linked ETFs may enter into total return swaps with a counterparty. If the counterparty becomes unable to deliver its share of the contract, it will default on the swap, therefore negatively affecting the value of the non-traditional ETF.

Each type of ETF offers unique risks and characteristics. Please refer to the prospectus for additional details.

Tax treatment

Generally ETF shareholders are subject to income taxes on the interest, dividends and/or capital gains distributed to them from the portfolio. However, in retirement accounts such as individual retirement accounts (IRAs), taxes are deferred until distributions are taken from the account. Also, when an investor sells the ETF position, he or she will generally realize a taxable gain or loss that should be reported on their income tax returns. Nonresident aliens may be subject to special tax withholding and reporting requirements as a result of an ETF sale. Certain ETFs may be subject to the alternative minimum tax (AMT). Shareholders should review the prospectus for further details.

Neither Wells Fargo Advisors nor your Financial Advisor can offer tax, legal, or accounting advice. As a result of complex tax-reporting requirements, investors should consult with their tax advisor or attorney before investing in ETFs.

Costs of investing in ETFs

An ETF's prospectus includes a fee table that lists the charges you pay. Although ETFs are not subject to sales loads, ordinary brokerage commissions for purchases and sales will apply. Upon purchase and sale of an ETF, you will incur a commission as a cost of processing each transaction. There is an embedded expense ratio for ETFs that is similar to open-end index funds.

Advisory accounts are fee-based accounts in which clients may be charged a fee on the underlying assets. It is also possible to own ETFs through discretionary and nondiscretionary investment advisory programs. Instead of paying a sales charge or commission on each transaction, you may pay an annual fee, billed quarterly in advance, that is based on a percentage of the account's value. Annual ETF operating expenses apply.

Investor characteristics

Suitability – ETFs are not suitable for all investors. Selecting an ETF for your investment objectives involves a number of factors: fund strategies, fund performance history, risks, investment time horizon, etc. You should review any ETF's disclosure document, as well as the fund prospectus, to fully evaluate your options. You should also talk with your Financial Advisor so that, together, you can make the choices suitable for you.

Non-traditional ETFs and commodity futures-linked ETFs are suitable only for sophisticated and speculative investors as well as institutional clients who fully understand the complexities of these products and the significant risks that exist in purchasing or trading in them. Non-traditional ETFs and commodity futures-linked ETFs are for individuals who have a high tolerance for risk as well as the ability and willingness to absorb potentially significant losses. An increase in market volatility relative to the level of expected return in the underlying index, commodity, or other related products may negatively impact your expected return.

Non-traditional ETFs are not designed to be used as long-term investment vehicles. Most non-traditional ETFs rebalance on a daily or monthly basis. Due to the compounding of daily or monthly returns, the actual return of a non-traditional ETF may differ greatly from the return of a traditional ETF. The use of +2x or +3x leveraged ETFs does not guarantee double or triple the return, respectively, during any single or multi-day holding period.

Diversification – Wells Fargo Advisors believes that investors should diversify their investment portfolios. It is recommended that investors observe an asset allocation strategy and not overweigh their overall portfolio in any one class or sector of securities, including the underlying portfolio within an ETF. Although asset allocation can be an effective investment strategy, it cannot eliminate the risk of fluctuating market prices and uncertain returns.

How your Financial Advisor and Wells Fargo Advisors are compensated on ETFs

For helping you invest in an ETF, Wells Fargo Advisors and your Financial Advisor are compensated in ways that vary depending on the selected investment. Your Financial Advisor will receive compensation in the form of a commission from most transactions.

For most purchases, a Financial Advisor's compensation is based on the dollar amount purchased or sold in the ETF transaction. In certain fee-based accounts, a Financial Advisor's compensation is based on a percentage of assets in the account rather than on the concession as mentioned above. The compensation formula that determines the amount of payment to your Financial Advisor is generally the same for all ETFs.

Wells Fargo Securities (WFS) may receive compensation for making a market and keeping an inventory on select ETF offerings. WFS may have an investment banking relationship with ETF issuers. Wells Fargo Advisors and Wells Fargo Securities, LLC, are registered broker-dealers and separate, non-bank affiliates of Wells Fargo & Company.

Additional compensation received by Wells Fargo Advisors from ETF product sponsors

At Wells Fargo Advisors, we receive payments from many of the companies whose ETFs we sell. These contributions may be used to pay for a number of purposes, including training, educational conferences and meetings for our Financial Advisors, as well as for conducting due diligence on the ETFs. Marketing support compensation may be paid to Wells Fargo Advisors by an ETF product sponsor to provide for ongoing day-to-day marketing and sales support to our Financial Advisors with respect to ETFs.

Marketing support compensation

Marketing support compensation is generally paid by the ETF product sponsor, or an affiliate of the sponsor, as a percentage of Wells Fargo Advisors' aggregated value of client assets invested in the ETFs. In certain instances marketing support compensation may be paid as a percentage of annual new sales to clients, or as a combination of a percentage of new sales and percentage of aggregate client assets. The percentage amounts are typically established in terms of basis points. One basis point is equal to one one-hundredth of one percent.

Wells Fargo Advisors may receive different marketing support rates from ETF product sponsors, and may receive different marketing support rates from certain types of ETFs within a particular ETF product sponsor's offerings. The marketing support paid from ETF sponsors to Wells Fargo Advisors can be as high as 5 basis points or .05% annually on aggregate client assets. (On a \$10,000 holding, that would be \$5 per year). However, certain ETF product sponsors may pay Wells Fargo Advisors a negotiated, fixed annual amount, regardless of the amount of assets held in client accounts or in new sales to clients.

Training and education compensation

Training and education compensation is paid by companies who offer ETFs to offset or reimburse Wells Fargo Advisors for costs incurred in conducting comprehensive training and education meetings for its Financial Advisors. These meetings or events are designed to provide comprehensive Financial Advisor training and education with respect to product characteristics, sales materials, customer support services and successful sales techniques. Likewise, from time to time, ETF product sponsors will reimburse Wells Fargo Advisors for expenses of individual branch offices incurred in connection with conducting training and educational meetings, conferences or seminars for Financial Advisors and customers. Also, Financial Advisors may receive promotional items, meals or entertainment or other “non-cash” compensation from product sponsors.

Although training and education compensation is not related to individual transactions or assets held in client accounts, it is important to understand that, due to the total number of companies whose products are offered by Wells Fargo Advisors, it is not possible for all the product sponsors affiliated with each company to participate in a single meeting or event. Consequently, those product sponsors who participate in training, an educational meeting, seminar or other event gain an opportunity to build relationships with Financial Advisors that could lead to additional sales of the sponsor’s ETF products.

ETF sponsor policies can be found in an ETF’s prospectus, which is available on request from the ETF product sponsor. If you have any questions about these practices, please contact your Financial Advisor.

While Wells Fargo Advisors offers a wide variety of ETFs for our Financial Advisors to sell or recommend, we reserve the right in the future to limit branch access to ETF sponsors who do not provide marketing support or meet other criteria. These amounts are not part of the compensation formula for your Financial Advisor in his or her role as a Financial Advisor. We believe that these financial arrangements do not compromise the advice your Financial Advisor offers you. Additionally, these arrangements do not affect your sales charge.

The following ETF sponsors made marketing support and/or training and education compensation payments to Wells Fargo Advisors in 2009: Barclays Global Investors, First Trust Advisors LP, Power Shares, State Street Global Advisors and Wisdom Tree.

Additional information

You'll find more information about ETFs, by visiting the following web sites.

Wells Fargo Advisors
wellsfargoadvisors.com

Financial Industry Regulatory
Authority (FINRA)
finra.org

U.S. Securities and Exchange
Commission
sec.gov

Securities Industry and Financial
Markets Association (SIFMA)
sifma.org

American Stock Exchange
amex.com

Investment and Insurance Products: ► NOT FDIC Insured ► NO Bank Guarantee ► MAY Lose Value

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This guide is not an offer to sell or a solicitation. This guide was developed with the assistance of Mariana F. Bush, CFA, Senior Analyst with Wells Fargo Advisors. Ms. Bush has written several articles about exchange-traded funds, which are available by request from your Financial Advisor.