CAMBRIA

The ETF Edge

Creation / Redemption Process: An Efficient and Fair Way for ETFs to Acquire New Securities

The key to understanding how ETFs work is the 'creation / redemption' process. It's how ETFs gain exposure to the market, and is the secret sauce that allows ETFs to be less expensive, more liquid and more tax efficient than traditional mutual funds. It's complicated, but worth understanding.

The Important Parties:

Individual Investor / Shareholder

ETF Sponsor / Provider / Trust

The ETF company

Authorized Participant (AP)

A large institutional investor, such as a broker-dealer, that enters into a contract with an ETF sponsor to create or redeem shares directly with the fund

The Key Terms:

Creation / Redemption Unit

A large block of ETF shares, usually 50,000 shares

Primary Market

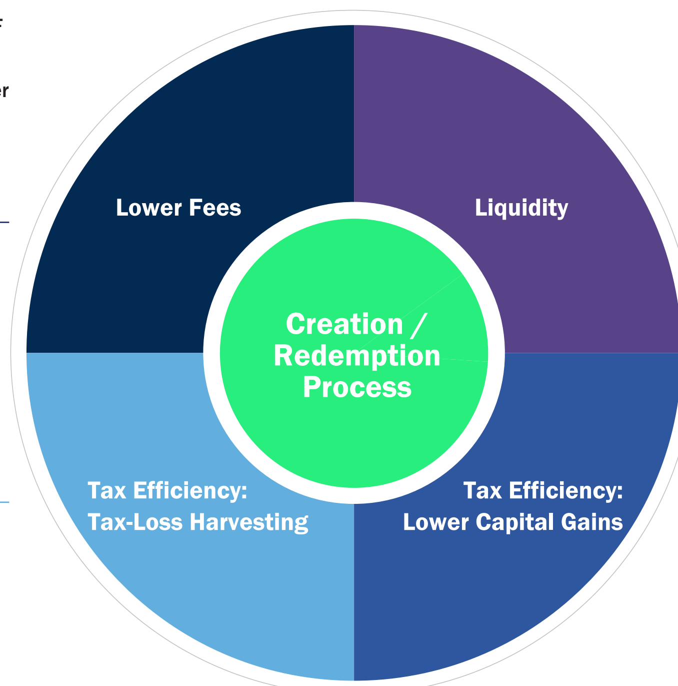
The part of the market that deals with the issuance of new securities

Secondary Market

The part of the market where investors purchase securities/ETFs from other investors

With their administrative efficiencies and frequently passive structure, ETF fees and expenses (measured in a fund's expense ratio) tend to be lower than comparable products such as mutual funds.

ETFs are traded throughout the day on various exchanges. When supply and demand get out of balance, the creation/redemption process allows the AP (Authorized Participant) to create and redeem fund shares.



Tax-loss harvesting involves the sale of one or more tax lots of a security in order to show a loss that offsets previously recognized gains.

ETFs are designed to allow the deferral of capital gains taxes – typically at lower long-term rates – until the ETF is redeemed. Deferring capital gains may be a benefit to shareholders.

WHY CREATE

- Create Inventory
- Fill Orders
- Take Advantage of Arbitrage Opportunities

WHY REDEEM

- Reduce Inventory
- Fill Orders
- Take Advantage of Arbitrage Opportunities

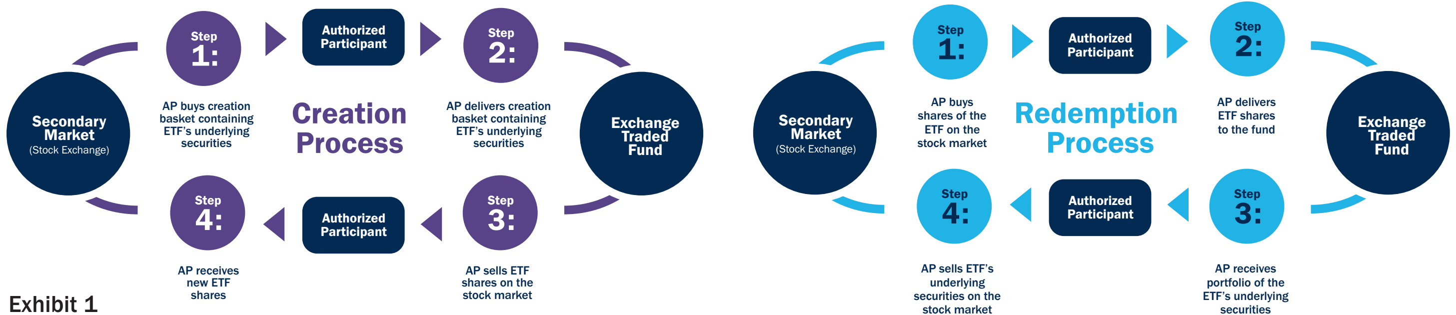


Exhibit 1

When an ETF company wants to create new shares of its fund, whether to launch a new product or meet increasing market demand, it turns to an Authorized Participant. An AP may be a market maker, a specialist or any other large financial institution. Essentially it's someone with a lot of buying power. It is the AP's job to acquire the securities that the ETF wants to hold. For instance, if an ETF is designed to track the S&P 500 Index, the AP will buy shares in all the S&P 500 constituents in the exact same weights as the index, then deliver those shares to the ETF provider. In exchange, the provider gives the AP a block of equally valued ETF shares, called a creation unit.

With ETFs, APs do most of the buying and selling. When APs sense demand for additional shares of an ETF—which manifests itself when the ETF share price trades at a premium to its NAV—they go into the market and create new shares. When the APs sense demand from investors looking to redeem—which manifests itself when the ETF share price trades at a discount—they process redemptions. See Exhibit 1 for the full creation/redemption process.

The AP pays all the trading costs and fees, and even pays an additional fee to the ETF provider to cover the paperwork involved in processing all the creation/redemption activity.

The system is inherently more fair than the way mutual funds operate. In mutual funds, existing shareholders pay the price when new investors put money to work in a fund, because the fund bears the trading expense. In ETFs, those costs are borne by the AP.

LOWER FEES

With their administrative efficiencies and frequently passive structure, ETF fees and expenses (measured in a fund's expense ratio) tend to be lower than comparable products such as mutual funds. Understanding how fees work is an important aspect of investing success.

Expenses are incurred by all investment vehicles regardless of structure. Those costs include, but are not limited to: portfolio management fees, custody costs, administrative expenses, marketing expenses and distribution. These costs are passed on to the shareholders, expressed as a percentage called an expense ratio.

Why are ETFs, in general, cheaper than mutual funds? Again, it involves the unique creation and redemption process of ETFs. ETFs are made up of creation units, whereas mutual funds are portfolios made up of investment security holdings.

For ETFs, the exchange of shares takes place on a one-for-one, fair-value basis. The AP delivers a certain amount of underlying securities and receives the exact same value in ETF shares, priced based on their net asset value (NAV), not the market value at which the ETF happens to be trading. This whole process enables ETFs to trade like stocks on an exchange, which means investors can buy and sell shares of ETFs with each other in the secondary market, rather than using an intermediary like a mutual fund to buy and sell securities in a portfolio.

Put simply, when investors want to buy shares in an ETF, they enter an order with their brokerage and that's it. But when investors add new money to a mutual fund, the fund company must take that money and go into the market to buy securities. ETFs are cheaper than

mutual funds because they trade seamlessly on an exchange, whereas mutual funds involve third-party interaction that adds to the cost of management. Less work equals lower cost for ETFs.

Source: Cambria; ETF.com '*How Do ETF Fees Work?*' by Kent Thune.

LIQUIDITY

Liquidity refers to the ability to buy or sell a security quickly, and at a reasonable cost. Liquidity might be the most important benefit, but it is also one of the most widely misunderstood. Loosely translated, liquidity refers to the ability to buy or sell a security quickly, easily, and at a reasonable transaction cost. Thanks to the unique features of ETFs and the ecosystem in which they operate, ETF liquidity is often far greater than most investors assume. In this section, we dispel a few common myths, including:

- **Myth #1:** ETF asset levels or trading volumes are good proxies for ETF liquidity.
- **Myth #2:** Secondary market ETF liquidity is limited to what you see "on screen."
- **Myth #3:** It doesn't matter when you trade an ETF.

Myth #1

Don't use trading volumes or fund size as a guide. Perhaps the most common ETF misconception is that funds with low daily trading volumes or with small amounts of assets under management will be difficult or expensive to trade. This is not the case. Thanks to the ETF creation and redemption mechanism, small- or low-trading-volume ETFs are usually able to absorb large buy or sell order while continuing to trade at prices that are typically close to the net asset value.

To illustrate to investors who may be skeptical that small- or low-trading volume ETFs can be highly liquid, let's use Cambria Global Real Estate ETF (BLDG) as an example.

BLDG was a relatively new ETF to the Cambria ETF line-up, which like most new product launches shortly after launch had a low trading volume history. BLDG invests in broad, highly-liquid real estate securities around the globe. While the underlying securities were highly liquid, BLDG did not trade much and trades that did occur were generally modest in size.

Nevertheless, one-large trade for 158,691 shares (~$4.58m), which doubled BLDG's assets, was successfully executed at $28.86 per share on 1/5/21 (See Exhibit 2). The trade didn't affect BLDG's ETF price. In fact, Cambria's product team worked with the financial advisor's (FA's) trade desk. The FA's trade desk sent out an RFQ (Request for Quote) to various Market Makers to find the best price. One was found, and the trade was executed 11 cents below the on-screen price.

On a 158,691 share trade, that was a savings of ~$17,500 for the advisor's clients.

Exhibit 2

Cambria Global Real Estate ETF (BLDG) large trade on January 5th, 2021 can be seen on this chart (Exhibit 2).

SOURCE: Bloomberg. Data from 9/24/20 to 1/26/21

Myth #2

Look at total ETF liquidity in the secondary and primary markets. Because market makers - who maintain continuous two-way ETF orders and are a key input to exchange order books - typically display only a small fraction of the volume they are willing to trade, investors may find that secondary market liquidity is actually much higher than on-screen indicators suggest. Investors with large ETF trades can also tap into primary market liquidity by working with an AP to create or redeem ETF shares directly with the fund company.

Myth #3

Consider the time of day when placing ETF trades. As a general rule, trading at times when it is difficult for market makers and other institutional investors to hedge underlying securities in an ETF will likely result in wider spreads and less efficient trades. This is typically the case just after U.S. markets open and just before they close. U.S.-domiciled ETFs that invest beyond U.S. markets are subject to additional liquidity considerations, due to the fact that the stock exchanges on which the underlying securities trade may be closed while U.S. exchanges are still trading. In that interval, the underlying securities are less liquid, which can again result in wider bid-ask spreads.

In addition to the three myths above, please:

- ***Use limit orders as the default order type when trading ETFs.*** A limit order - an order to buy or sell a set number of shares at a specified price or better—gives investors some control over the price at which the ETF trade is executed. By contrast, a market order—an order to buy or sell immediately at the best available current price—may end up being executed at a price that is far higher (or lower) than expected as the order sweeps through standing orders on the order book.

- ***Work with your Cambria Regional Investment Consultant, especially when placing large trades.*** Don't do it alone. Most providers have capital markets desks whose role is to work with portfolio managers, APs, market makers and stock exchanges to help assess true ETF liquidity and assist investors with efficient trade execution.

Source: Cambria; JP Morgan

TAX EFFICIENCY: LOWER CAPITAL GAINS

If a mutual fund or ETF holds securities that have appreciated in value, and sells them for any reason, they will create a capital gain. These sales can result either from the fund selling securities for a tactical move, due to a rebalancing effort, or to meet redemptions from shareholders. By law, if funds accrue capital gains, they must pay them out to shareholders at the end of each year.

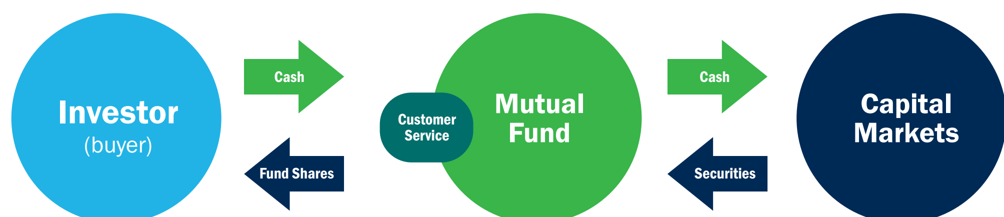
ETFs however, offer investors a powerful tool for tax efficiency, as they are designed to allow the deferral of capital gains taxes – typically at lower long-term rates – until the ETF is redeemed. Deferring capital gains may be a benefit to shareholders. Again, this is due to the creation/ redemption process. Mutual funds must sell securities to raise cash to meet redemption. ETFs simply sell the securities to another investor like a stock. Therefore, in summary, the benefit for ETFs are:

- Deferral of capital gains for shareholders
- Costs of adding and deleting securities from the portfolio are not borne by long-term shareholders. Instead, costs are incurred by buyers and sellers of ETF shares in the secondary market.
- There is no cash drag: The ETF will be fully invested at all times.
- The creation and redemption process allows ETF portfolio managers to purge low-cost-basis positions from their portfolios without unlocking capital gains. This makes ETFs, in general, a far more tax-efficient wrapper than mutual funds.

Mutual fund managers must constantly re-balance the fund by selling securities to accommodate shareholder redemptions or re-allocate assets. The sale of securities within a mutual fund creates capital gains for the shareholders, even for shareholders who may have an unrealized loss on the overall mutual fund investment.

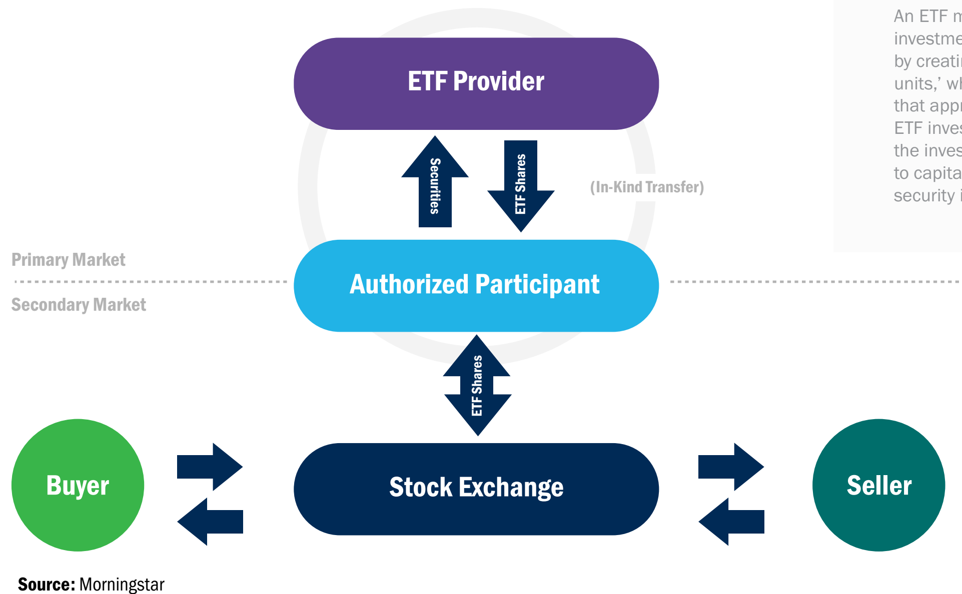
Can that really happen? Yes
Does that seem unfair? Yes

Mutual Fund Investors Transact Directly With Mutual Fund Companies



Source: Morningstar

ETF Investors Typically Buy Shares on the Secondary Market



Source: Morningstar

An ETF manager accommodates investment inflows and outflows by creating or redeeming 'creation units,' which are baskets of assets that approximate the entirety of the ETF investment exposure. As a result, the investor is not usually exposed to capital gains on any individual security in the underlying structure.

TAX EFFICIENCY: TAX-LOSS HARVESTING

Specifically, tax-loss harvesting is the selling of securities at a loss to offset a capital gains tax liability in a very similar security. Using ETFs has made tax-loss harvesting easier since several ETF providers now offer similar funds that track the same index but are constructed slightly differently. Tax-loss harvesting can be a great strategy to lower tax exposure, but investors must be sure to avoid wash-sale trades.

The wash sale rule is very important to pay attention to. Since harvesting a loss involves selling off an asset that's underperforming, investors must wait past 30 days of sell date to repurchase the asset, or an asset that's substantially identical. If you attempt to include the loss on your tax filing, the IRS (Internal Revenue Service) will disallow it. Investors won't receive any benefit from the sale. The tricky part is that the IRS does not provide a precise definition of what constitutes a 'substantially identical' security so navigating this rule can be tricky.

Simple strategies that an investor could implement for tax-loss harvesting:

Strategy 1: Sell security B to offset gains in security A. Buy an ETF with exposure to the sector or industry that security B is in. On day 31, you can sell the ETF and reinvest in security B, or you can keep holding the ETF for the long term.

Strategy 2: Sell mutual fund D to offset gains in mutual fund C. Buy an ETF with a similar objective to mutual fund D. On day 31, you can sell the ETF and reinvest in mutual fund D, or you can keep holding the ETF for the long term.

Strategy 3: Find ETF alternatives for all your mutual fund holdings. As ETFs tend to be more tax efficient, as detailed above, they may be a wise move for the long-term health of your portfolio.

Tax-Loss Harvesting

1. Tax-loss harvesting involves the sale of one or more tax lots of a security in order to show a loss that offsets previously recognized gains

2. When a security is sold at a loss, **it is important to avoidd repurchasing that security - or a substantially equivalent security - for at least 30 days**. If a repurchase takes place during that period, the IRS treats the sale and purchase as a "wash sale," eliminating the transaction's benefit for tax purposes

3. For investors in this situation, ETFs can be a tax efficient way to invest cash received from tax-loss harvesting while waiting for the 30-day "wash sale" period to expire

For example, if you want to sell 500 shares of an underperforming value stock at a loss, but you want to maintain the same level of exposure to that particular asset class in your portfolio, you could use the proceeds from the sale of that stock and invest in an ETF that tracks the broader value category. This way, it's possible to preserve asset diversity without violating the wash-sale rule.

If you're selling a mutual fund, instead of a stock as mentioned above, then make sure that the mutual fund and the ETF have different holdings and/or track a different benchmark or index. Make sure that the mutual fund and ETF aren't substantially identical.

To summarize, tax-loss harvesting with ETFs can be an effective way to minimize or defer tax liability on capital gains. Simply be mindful of the wash-sale rule, as well as choosing a suitable investment to move into to take advantage of this benefit.

Cambria's priority is acting as a fiduciary to its clients, investors and shareholders.

Speak with your financial advisor or Cambria to learn more about The ETF Edge.
For more information, visit www.cambriafunds.com

To determine if Cambria Global Real Estate ETF (BLDG) is an appropriate investment for you, carefully consider the Fund's investment objectives, risk factors, charges and expense before investing. This and other information can be found in the Fund's prospectus which may be obtained by calling 855-383-4636 (ETF INFO) or visiting www.cambriafunds.com. Read the prospectus carefully before investing or sending money.

Cambria Global Real Estate ETF (BLDG), the Fund's investments are concentrated in real estate-related industries, and the Fund may be susceptible to loss due to adverse occurrences affecting these industries including declines in the real estate market, decreases in property revenues, increases in interest rates, increases in property taxes and operating expenses, legal and regulatory changes, a lack of credit or capital, defaults by borrowers or tenants, environmental problems and natural disasters. The availability or mortgages and changes in interest rates may also affect real estate values.

Cambria Global Real Estate ETF is actively managed.

Authorized Participant: An Authorized Participant (or, AP) is an organization that has the right to create and redeem shares of an ETF. APS are a large portion of the liquidity in the ETF market by obtaining the underlying assets required to create the shares of an ETF.

Bid-Ask Spread: The amount by which the ask price (sell order) exceeds the bid price (buy order) for a security.

Market Maker: Market Makers maintain continuous two-way ETF orders (bid and ask), and are a key input to exchange order books.

Market Orders: An order to buy or sell a security immediately at the best available current price.

Net Asset Value (NAV): Represents the value of each share's portion of the fund's underlying assets and cash at the end of the trading day.

Order Book: Order Books (aka, Exchange Order Books) provide an inventory of open bid and ask orders (including both price and size) for a given security.

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Cambria does not provide tax advice and investors should consult their individual tax professional for tax advice.

ETFs are subject to commission costs each time a "buy" or "sell" is executed. Depending on the amount of trading activity, the low costs of ETFs may be outweighed by commissions and related trading costs.

Shares are bought and sold at market price (closing price) not net asset value (NAV) are not individually redeemed from the Fund. Market price returns are based on the midpoint of the bid/ask spread at 4:00pm Eastern Time (when NAV is normally determined), and do not represent the return you would receive if you traded at other times. Buying and selling shares will result in brokerage commissions. Brokerage commissions will reduce returns.

Cambria Investment Management, LP

3300 Highland Ave | Manhattan Beach, CA 90266 | (310) 683-5500 | www.cambriafunds.com

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