

Exchange Traded Funds (ETFs) - Meaning, Types & Benefits

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Exchange Traded Funds (ETFs) are investment instruments that provide diversification by holding a basket of securities and trade on stock exchanges like individual stocks, offering liquidity and flexibility. They typically include a range of securities such as equities, bonds or commodities and are designed to track the performance of a specific index or asset class. Since ETFs are listed on stock exchanges, they can be bought and sold during market hours at prices that change in real time based on market demand and supply.

Over the years, ETFs have emerged as a preferred investment option for investors who want broad market exposure without the complexity of managing individual stocks. Their appeal lies in their simplicity, cost efficiency, transparency and the ability to closely reflect the performance of the underlying market or sector they track.

Key Takeaways

- The full form of ETF is an Exchange-Traded Fund.
- An ETF is a market-linked basket of securities that trades on an exchange like a stock.
- It combines diversification with real-time tradability.
- ETFs are built to replicate market performance, not outperform it.
- Their value lies in simplicity, transparency and cost efficiency.
- They are most effective as long-term, structured exposure to markets rather than speculative tools.

What is an Exchange Traded Fund (ETF)?

An ETF (Exchange Traded Fund) is a fund that holds a basket of securities such as stocks, bonds or commodities and is listed on a stock exchange for buying and selling like a regular share. Its price changes throughout the trading day based on market activity.

Most ETFs are designed to track a specific index such as the Nifty 50 and typically operate with a lower [expense ratio](#) due to passive management. This structure allows investors to gain diversified exposure to a market or sector through a single transaction.

How do ETFs Work?

An ETF is built by a fund house that first chooses a benchmark index it wants to follow. Based on that index, the fund is structured to hold a collection of securities in a way that reflects the same overall composition and weightage as the benchmark.

After the portfolio is formed, the ETF units are listed on a stock exchange. Investors can then buy or sell these units through a trading account during market hours in the same way they trade shares.

The price of an ETF changes continuously during the trading day. It moves based on the value of the underlying assets as well as the demand and supply in the market. This is why the price may differ at different times within the same day.

Types of ETFs in India

There are several types of ETFs available for investors

1) Equity ETFs

- Broad Market ETFs - Track major indices such as NIFTY 500.
- Sectoral ETFs - Focus on specific sectors like banking, information technology, pharmaceuticals etc.
- Thematic ETFs - Built around investment themes such as ESG (Environmental, Social, Governance), consumption, manufacturing or digital economy.
- Smart Beta / Factor ETFs- These ETFs follow rule-based strategies rather than traditional market-cap-weighted indices.

2) Debt ETFs

Debt ETFs invest in fixed-income instruments such as government securities and corporate bonds.

3) Commodity ETFs

Commodity ETFs invest in physical commodities other than equities and bonds.

- Gold ETFs
- Silver ETFs

4) International ETFs

These ETFs provide exposure to global markets by tracking foreign indices such as the NASDAQ-100 or S&P 500. They enable Indian investors to diversify internationally without directly investing overseas.

Pros and Cons of ETFs

Pros

1) Cost efficiency

Most ETFs are passively managed, meaning they track an index rather than relying on active stock-picking. This keeps management expenses relatively low compared to traditional actively managed funds, allowing more of the returns to stay with the investor.

2) Stock like tradability

ETFs are listed and traded on exchanges, which means they can be bought or sold throughout the trading day at market determined prices.

3) Built-in diversification

A single ETF typically holds a basket of securities. Whether it tracks an index or a theme, it spreads exposure across multiple stocks or bonds, reducing the impact of any single security's performance.

4) Transparency of holdings

ETF providers generally disclose their portfolios regularly. Investors know what they own, with minimal ambiguity about underlying assets.

Cons

1) Requirement of a demat account

Unlike some traditional investment routes, ETFs require a dematerialised account, which may add an extra step for first-time investors.

2) Trading-related costs

While expense ratios are low, investors still incur brokerage charges. In addition, bid-ask spreads can slightly affect returns, especially in less liquid ETFs.

3) Market-linked volatility

ETFs do not eliminate risk. Since they mirror market indices or assets, their value fluctuates with broader market movements.

4) Liquidity variation

Not all ETFs enjoy high trading volumes. In less popular funds, low liquidity can lead to wider spreads and difficulty executing large orders efficiently.

Risks and Limitations of ETFs

ETFs carry certain risks and investors should understand their limitations before investing. While they offer diversification and cost efficiency, they are still subject to market related risks.

- **Market Risk** - ETF prices generally track the performance of the underlying market or index. A decline in the market or index will typically lead to a corresponding decline in the value of the ETF.

- Tracking Error - An ETF is designed to replicate an index, but in practice, small gaps can appear between ETF performance and the actual index due to expenses, cash holdings or replication methods.
- Liquidity Risk - While large ETFs trade actively, smaller or niche funds may see limited participation. This can lead to wider bid-ask spreads and less efficient trade execution.

Things to Consider While Investing in Exchange Traded Funds (ETF)

Choosing an ETF is less about chasing returns and more about understanding what sits beneath the product. A few core checks can make a meaningful difference to long-term outcomes.

- Expense Ratio - Even small cost differences compound over time. Lower expenses generally improve net returns, especially in long-horizon index investing.
- Tracking Error - This reflects how closely the ETF follows its benchmark index. A consistently wide gap may indicate inefficiencies in replication or portfolio management.
- Liquidity and Trading Volume - Actively traded ETFs tend to have tighter bid-ask spreads and smoother execution. Thinly traded funds can introduce hidden costs at entry and exit.
- Underlying Index or Asset - The quality of an ETF depends on what it tracks such as broad indices, specific sectors, bonds or commodities. Understanding the composition helps align it with investment goals.
- Fund Provider Credibility - The reputation and scale of the issuer matter. Established providers generally ensure better liquidity support, operational efficiency and tracking accuracy.

How to Invest in ETFs in India?

Investing in ETFs is fairly straightforward, but the process still follows a clear sequence that links account setup, selection, and execution.

1. Set up a Demat and Trading Account: ETFs are exchange-traded instruments, so ownership and trading require a demat account linked with a trading account.
2. Select a Broker or Investment Platform: Choose a SEBI-registered broker or online investment platform based on factors like brokerage charges, ease of use and research tools.
3. Identify the ETF: Search for the ETF using its name or ticker symbol.
4. Place a Buy Order During Market Hours: ETFs trade like stocks, so orders must be placed during exchange hours. You can place market orders or limit orders depending on your price preference.
5. Track and Review Periodically: Once invested, monitor performance in relation to the underlying index and review periodically to ensure it still aligns with your financial goals.

Expense Ratio and Tracking Error

Two simple measures largely determine how efficiently an ETF works in practice.

Expense Ratio - This is the yearly cost of running the fund, shown as a percentage of your investment. It is automatically adjusted within the fund. A lower expense ratio means fewer costs eating into returns.

Tracking Error - This shows how closely an ETF follows its benchmark index. If the difference is small, the fund is doing its job well. A larger gap means the ETF is drifting away from the index it is supposed to mirror.

Who Should Invest in ETFs?

Active traders - Investors who prefer flexibility, as ETFs can be bought and sold throughout the trading day unlike traditional [type of mutual fund investments](#).

Passive investing followers - Those who prefer to mirror the market rather than attempt to outperform it.

Cost-conscious investors - Individuals looking for lower expense ratios compared to many actively managed schemes.

Diversification seekers - Those who want exposure to a broad basket of securities through a single investment.

ETFs vs Index Funds

ETFs - Traded on stock exchanges like shares. Prices change throughout the trading day based on demand and supply.

Index Funds - Bought and sold directly through [mutual fund](#) companies at the end of day [NAV](#) (Net Asset Value).

Conclusion

An ETF is best understood as a market instrument that packages diversification into a single tradable unit. Instead of buying individual securities one by one, an investor holds a basket that mirrors an index, sector or asset class. This structure reduces effort in decision-making while maintaining full exposure to market movements.

Frequently Asked Questions

1) What is an ETF Fund?

An ETF (Exchange Traded Fund) is a fund that holds a basket of securities such as stocks, bonds, or commodities and trades on a stock exchange like a share.

2) What is the full form of ETF?

ETF stands for Exchange Traded Fund.

3) What is tracking error in ETFs?

Tracking error is the difference between an ETF's return and the return of its benchmark index. A lower tracking error means the ETF is closely following its index, while a higher one indicates deviation.

4) Are ETFs safe to invest in?

ETFs are not risk-free. They are as safe as the underlying assets they track. For example, equity ETFs carry market risk, while bond ETFs carry interest rate risk. They are generally considered transparent and relatively efficient, but not guaranteed investments.

5) Can I invest in ETFs with a small amount?

You can start investing in ETFs with a small amount, as they are priced per unit and do not require a large minimum investment. However, you must consider brokerage charges, which can impact very small investments.

6) How can I buy or sell an ETF?

ETFs can be bought or sold through a demat and trading account on a stock exchange during market hours. You simply place a buy or sell order through a broker, just like trading a stock.

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