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ETFs vs. Mutual Funds

An exchange-traded fund (ETF) is an investment fund that is passively managed to track an index. ETFs do not attempt to outperform the market or take defensive positions. Similarly, index mutual funds are passively managed and seek to earn the returns of a benchmark index as well. However, several key differences exist among these types of funds including trading and redemption, fee exposure, and tax consequences, which may impact an investor's overall investment goals.

Trading and Redemption

ETFs are traded throughout the day at market price like a stock. In comparison, index mutual funds shares are purchased directly from the fund company or through a broker. For mutual funds, there is typically a minimum investment requirement, while there are no minimum trades for ETFs. As a result, ETFs are more accessible to individual investors. Moreover, mutual fund shares are daily valued and sold by share redemption at the end-of-day net asset value, while ETFs are sold at market price intraday like stocks.

Because ETFs are traded on the open market, market orders create price discrepancies between the bid and ask prices. The bid-ask spread, or difference in market price between buying and selling at any point in time, can be small for largely traded ETFs. However, the spread can equate to large transaction costs for new or thinly-traded ETFs. In contrast, there is no bid-ask spread for conventional no-load mutual funds.

Furthermore, ETF returns may not match an index as well as index mutual funds.[1] Because ETFs are valued by the market, the market price can be above or below the value of the underlying securities at any given time, even when the holdings match an index exactly. On the other hand, a mutual fund's share price equals the fund's per share net asset value, or the weighted average current market value of the fund's holdings. Therefore, mutual fund shares always equal the value of the underlying securities.

Fee Exposure

Many people erroneously believe that ETFs have lower costs than mutual funds. This general misconception occurs because of an apple-to-oranges comparison made between ETFs and actively managed mutual funds. More appropriately, indexed ETFs' fees should be compared to passively managed indexed mutual funds. Exhibit 1 shows the Vanguard Index Mutual Funds Signal Shares generally cost the same or less than their ETF counterpart.

[1] "ETFs vs. Index Mutual Funds," Altruist Financial Advisors LLC, 2013

Exhibit 1

Vanguard Expense Ratios

Asset Class	Index Mutual Fund*	Index ETF
Stock - Large Cap Blend	0.06%	0.12%
Stock – Mid Cap Blend	0.12%	0.12%
Stock – Small Cap Blend	0.12%	0.17%
Bond – Intermediate-Term Corporate Bond	0.11%	0.11%

Source: Vanguard
*Signal Shares

Although ETFs are very popular, they haven't been widely used in 401(k) plans, because these retirement plans take advantage of the lower cost mutual fund shares. Additionally, most 401(k) plans use mutual fund shares rather than ETFs because the mutual funds are priced once at the end of the business day based on their holdings. Daily valued mutual funds are well-suited to manage the massive volume of transactions inherent in 401(k) plans.

Tax Consequences

Greycourt & Co., Inc., an independent and objective investment advisor, writes, "Index based ETFs and mutual funds share inherent tax efficiencies."[2] While it is frequently stated that ETFs have fewer tax consequences than mutual funds, both ETFs and index mutual funds are in actuality similarly tax efficient. With ETFs, investors are taxed on capital gains in each transaction when they sell shares, whereas mutual funds are taxed when shareholders redeem fund shares and when the fund holdings are internally rebalanced. Furthermore, if the funds are invested within an employer-sponsored retirement plan, the annual gains for both ETFs and mutual funds are tax deferred until distribution.

Conclusion

The common misconception with ETFs is that they are cheaper than mutual funds. However, when accurately compared, index mutual funds generally have lower expense ratios than ETFs. With regards to trading, the bid-ask spread inherent in buying and selling ETFs may create additional transaction costs. Additionally, ETFs may not track an index as well as mutual funds because ETFs are valued by the market rather than net asset value. Moreover, the tax implications are similar for both funds. CNBC writes, "Fund experts here predict that the amount of ETFs actually could decrease in the coming years even as assets increase. The field has seen an explosion in quantity that could be

[2] "Exchange-Traded Funds: Are They the Right Choice?" Greycourt & Co., Inc., 2001

unsustainable as investors parse their way through which funds are more efficient."[3] Therefore, ETFs may just be a buzzword and not the best investment alternative for the long term investor.

[3] "ETFs vs Mutual Funds: The Debate Heats Up," CNBC, 2013