Five Reasons to Consider Investing in ETFs Instead of Mutual Funds

by Donna Fuscaldo | Apr 15, 2015 | Advice |

Exchange traded funds, or ETFs, have grown almost ten-fold over the past decade, from a $228 billion market in 2004 to nearly $2 trillion at the end of 2014. Nevertheless, their popularity among investors still trails that of mutual funds. According to the Investment Company Institute, 46% of U.S. households own mutual funds and only 4% own ETFs.

There are many possible reasons for that. ETFs are still a fairly new investment vehicle. Mutual funds have been around since the 1920s, while ETFs came onto the scene in 1993. Mutual funds are the main investment vehicle available in 401(k)s, while ETFs can only be bought in brokerage accounts or IRAs. Not least, says Brad Jenkins, chief executive and chief investment Strategist at Jenkins Wealth, investment brokers have little incentive to sell ETFs, because they don't earn a commission on those sales, while they do on many actively-managed mutual funds.

For the needs of many everyday investors, however, ETFs offer notable advantages over mutual funds.

Lower costs

"ETFs generally have a lower cost structure and for retail investors, they can be a much more economical vehicle than mutual funds," says Wayne Schmidt, chief investment officer at Gradient Investments. "Anything they can do to limit the cost behind the product is important to retail investors."

According to SigFig data, investors paid on average 62 basis points for mutual funds in the 12-month period ending March 8, 2015, and an average of 17 basis points for ETFs. Actively-managed mutual funds are even more expensive, and average 125 basis points in expense ratio, according to fund research firm Morningstar.

Performance

As *the New York Times* wrote recently, research on whether it is possible to beat the stock market over time typically comes to conclusions ranging from "no" to "most probably not."

We *do* know that cheaper investments outperform expensive ones, even during a bear market — and actively managed funds (the ones *trying* to beat the market) tend to be more expensive than passive index funds. The Economist recently put the odds of a large cap mutual funds beating the market over the past 20 years at 25%:

> "But the index doesn't have costs and the fund managers do. Those costs doom the fund managers to underperform. One does not have to believe in the efficient market hypothesis to understand this outcome. But to the extent that any market is efficient, large-cap US stocks is the one; dozens of analysts cover every stock and their business models are well known and understood. The chance that any investor has a unique insight into a particular company is very small."

Tax advantages

When a mutual fund manager buys and sells throughout the year, they can trigger tax events, of which fund investors have no control (and often, no knowledge). The higher a mutual fund's turnover, the more its manager is trading in and out of positions. If they sell certain stocks at a gain, that tax hit passes onto the fund investors in the form of lower returns.

ETFs, meanwhile, have *much* lower turnover, says Jenkins. "ETFs don't have human beings doing a lot of buying and selling," he says. "An ETF may get rid of one stock in the course of a two-year period."

Liquidity

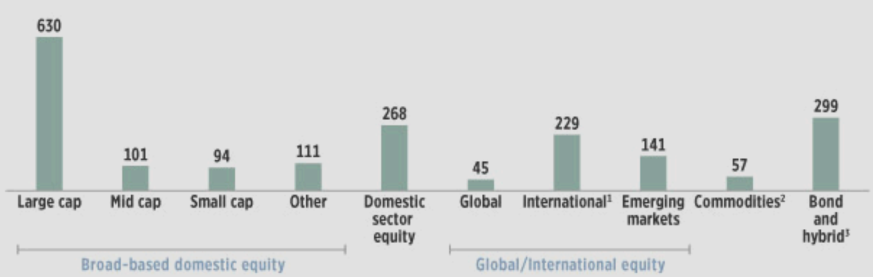
Another benefit of owning an ETF over a mutual fund is the ease of trading. Trading in a mutual fund requires placing your order during market hours and waiting until the following day for the transaction to be completed. With an ETF, you can get in and out during market hours. "If someone wants to buy an ETF at a specific price, they get that within a couple of pennies," Jenkins says.

This might be of little importance to buy-and-hold investors, and might not matter much even to more frequent traders in a non-volatile market environment. When the market starts moving multiple percentage points during a single day, however, waiting a day to actually or sell an investment may mean a sizeable difference in how much you get when you sell, or how many shares of a fund you buy.

Diversification

At the end of 2014, there were 1,411 ETFs spanning all major asset classes, so that building a diversified ETF portfolio is entirely possible. "ETFs span a lot of different asset allocations and lots of parts of the world," says Andrew Brownsword, senior vice president at Fidelity retail brokerage. All those asset and geographic allocations combined give investors a lot of flexibility.

Total Net Assets of ETFs Are Concentrated in Large-Cap Domestic Stocks
Billions of dollars, December 2014



[1] This category includes international, regional, and single country ETFs
[2] The funds in this category invest primarily in commodities, currency, and futures, and are not registered under the Investment Company Act of 1940
[3] Bond ETFs represented 99.2 percent of the assets in the bond and hybrid category.
Note: Data for ETFs that invest primarily in other ETFs are excluded from the totals.
Source: Investment Company Institute

February 2015

Image: Investment Company Institute.