



Comparing Mutual Funds and ETFs

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In recent years, more investors are selecting to invest by using Exchange Traded Funds (ETFs) over mutual funds. An ETF can offer benefits of tax efficiency, investment liquidity and transparency, and reduced holding costs.

Tax-Efficiency

If you own a mutual fund that's not in a tax-deferred account, then you have probably experienced a year-end capital gains distribution because trades made by the fund sponsor throughout the year flow to its shareholders. This can create tax liabilities at year-end, even if a fund has lost money overall. ETFs do not have capital gains distributions because ETF sponsors do not transact with their shareholders. ETFs are traded among other investors. Hence, capital gains and losses are controlled by the investor—making ETFs highly tax efficient.

Liquidity and Transparency

Mutual fund investors can only buy or sell their shares directly from the fund sponsor and only at the end of each day. ETFs can be traded throughout the day, just like stocks. Investors not only can actively trade ETFs, they can also employ the same trading strategies that apply to stocks (limit/stop loss orders, short-sales, and options). In addition, it's easier to "look under the hood" of an ETF because ETFs report their holdings daily, which gives investors up-to-date information. Mutual funds report their holdings quarterly.

Cost

Mutual funds incur significant recordkeeping expenses to keep track of all

their shareholders. ETFs do not have such expenses because they are traded among investors just like stocks. Unlike some mutual funds, ETFs do not have sales loads or require minimum investments, though investors have to pay a commission to trade ETFs. Depending on the liquidity of a particular ETF (that is, how many trades are made in it each day), those trading costs can be very low.

Which is Better?

Given the description above, investors might think that mutual funds are no longer good investment options. However, it's not that simple. Here are some rules-of-thumb to help make your decision:

- Many mutual fund companies have low minimums for starting investors (as low as \$25). In contrast, commissions to trade ETFs make small purchases cost prohibitive.
- If an investor plans to dollar-cost average (buy a fixed dollar amount every month) or reinvest dividends, then a mutual fund will likely be a lower-cost purchase, too.
- Mutual funds are effective for gaining exposure to a very specific sector of the market. For instance, a mutual fund would be more appropriate for an investor interested in seeking an international high-yield fixed income or exposure to a specific country. Many ETFs have been developed for specific market sectors, too, but there are some sectors for which they are not yet available.

Growth in ETFs has exploded in recent years. According to estimates by the Financial Research Corp. of Boston, ETF assets will most likely reach \$1.4 trillion this year. And while mutual funds still remain the dominant investment vehicles in individual retirement accounts - where the bulk of investor assets are held - it is important to determine which investment is appropriate for your unique circumstances.

If you have any questions regarding this article, please feel free to contact your advisor.