ETF's vs. Mutual Finds- Not One in the Same – April 2014

The market for Exchange Traded Funds (ETF) may eventually rival that of mutual funds. There are fundamental differences between ETFs and mutual funds which are not adequately understood by investors. Issues related to the distinction between ETFs and mutual funds include: diversification – by both portfolio and sector, liquidity, fees, minimum investment thresholds and tax treatment. These issues will impact both the investment process and portfolio returns.

According to WisdomTree.com, "ETFs took in nearly $180 billion in 2013, which represented a 14% organic growth rate for the U.S. ETF industry….Many experts, including top-rated financial advisors, believe that ETFs may displace mutual funds within the next 10–15 years. As of the most recent quarter, (ending Dec 31, 2013) there are more than 1,300 ETFs trading in the U.S. marketplace (which) target a wide array of regions, sectors, commodities, bonds, futures and other asset classes."

Trading ETF's Vs. Mutual Funds

A mutual fund is an investment in a pool of different shares of individual stocks and or bonds, which are specifically chosen by a fund manager. An investor buys or sells shares of a mutual fund at the end of the day after the price for that day has been set, based on the value of the aggregate underlying investments in the fund. Thus mutual fund share price is fixed at the end of the trading day.

Like a mutual fund, an ETF is a pool or basket of investments that is usually thematically structured to replicate a market index, industry sector or market sector. For example, an investor could invest in an ETF which attempts to replicate the performance of one of the larger market indexes like the S&P 500 index. ETF's trade much the same as stocks, and are bought and sold on an inter day basis. For the average client, this means an ETF can be bought and sold at any point during the day. Just like a stock, the price of the ETF is determined by investor demand at any given point in time during trading hours.

Structure: Historically Active Management Methods of Mutual Funds vs. Passive Management of ETF's

Active management means that investment teams scour the market and make purchase and sale decisions based on the judgment of an experienced fund manager or investment team and readjust their underlying portfolios frequently attempting to capture additional investment returns.

Passive investment management is a mechanical approach to investment management where investment decisions are made automatically within predetermined selection criteria. For example, in a passive investment S&P 500 fund (e.g. SPY), the ETF will purchase only the proportionally representative holdings of the S&P 500 index and change holding positions and weighting as the S&P 500 index is redefined. Those trading adjustments to the fund and the underlying index tend to occur less frequently.

Mutual fund managers are generally active managers who make frequent changes in the portfolio holdings of the fund by buying and selling the underlying stocks and readjusting holdings and position size based on the performance of the individual stocks in the portfolio and the skill and aptitude of their

investment team. The fund managers are afforded substantial latitude (discretion) in their investment selection process in an effort to improve the underlying performance of their funds. By investing in an active mutual fund the investor is relying on the acumen of the fund manager to select the funds underlying investments.

ETF funds are generally passively managed. ETF's will typically purchase a basket of securities which mimic, as closely as possible, the underlying index and any adjustments made in the portfolio are for the purpose of maintaining the congruity with the index, not necessarily capturing additional return. ETF managers typically do not need the extensive research staff required by mutual fund managers, and thus pass through their cost savings to investors in the form of lower management fees charged to investors in their funds. With ETF's, the investor has made a decision to be in a defined, relatively fixed basket of stocks. With and ETF the investor is driving the investment decision process whereas with a mutual fund the investor is generally relying on the fund managers portfolio decisions.

Issues/Characteristics

Diversification

Both ETF's and mutual funds provide less risk through more diversification. While there is a broad array of mutual fund products, generally, ETFs may serve as better vehicles for portfolio diversification where the investor is taking a more active role in the investment process. Despite there being many industry specific mutual funds, there are a greater offering of highly focused ETF products which offer the ability to invest in sub-sectors of an industry (e.g. healthcare services sector within the healthcare industry). This approach is particularly valuable if the investor believes one sector will dramatically outperform another but does not want to concentrate the portfolio by selecting individual companies in that sector.

Liquidity

ETF's trade like individual shares of stock. ETF shares are traded on the major stock exchanges and have both high levels of liquidity and intra-day pricing advantages. With an ETF product it is possible to buy and sell at any time within the market day allowing the investors to react much more quickly to real time news events. ETFs are generally more suitable as broad market trading vehicles and can be sold short while mutual funds cannot. With most mutual funds, pricing and purchases and/or sales occur at the end of the trading day. Thus investors in mutual funds lack the ability to react quickly to news and events.

Fees

Fees for mutual funds are generally much greater and more complex than ETF's. Mutual funds have higher operational and management costs. The expense ratio for mutual funds can typically run from 1%-2% and includes management fees, transaction fees, distribution fees, marketing costs and other expenses. These regular fees are not always readily apparent to investors. Maintenance fees for ETF funds are typically much lower than traditional mutual funds.

Mutual funds may also contain varying commission fees schedules (or loads) sold as different classes of mutual fund shares for the same fund. An A share for example could have a typical fee of 5.75% up front sales commission while the I class shares have no sales commission charge yet both shares have the same Net Asset Value (NAV) and are reported as one in the newspaper at the end of the day. Both classes of shares represent the same proportional ownership in the mutual fund with the

main difference being the fee sharing and sales charges. Mutual fund sales and management load rates are generally much larger and more complicated and often seem designed to be confusing to investors. Oftentimes sales loads are waived if the fund is purchased through qualified advisors.

ETF shares are sold as stock shares, with commission rates negotiated with the transaction broker. Those rates are generally nominal with respect to the commissions charged by most mutual funds and are very straight forward and easy to understand.

Dividend Reinvestment

Generally dividends in open ended ETFs are immediately reinvested. Dividends are not automatically reinvested with most mutual funds and require the investor to proactively choose to reinvest the proceeds in the fund. There also may be a fee charged when reinvesting mutual fund dividends.

Minimal Investments

As with shares of stock, ETF's are priced per share and can be purchased in smaller amounts (even a single share) than mutual funds which, generally, require a minimum investment typically $1000 or more.

Taxes

With mutual funds, the fund manager can sell securities at any time to rebalance the fund. In theory, investors could incur a tax liability without incurring the appreciation in share value or while not benefiting from the appreciation in share value if the underlying security continues to rise

From a tax perspective, not all ETF's are created equal. Though equity and fixed income ETF's are generally treated similarly regardless of structure, commodity ETF's for example can be taxed at a much higher rate than mutual fund holdings. Before investing in an ETF or mutual fund, it is important to understand the tax implications specific to that fund. Please consult with your financial adviser before making an investment.

Conclusions

The strong in-flows into ETF products demonstrate the increasing attractiveness of those products. There is a place for both of these products in an investment portfolio. However the investor must understand the difference between the products to fully understand their benefits before making an investment in either. Please consult with your financial advisor before making any investment.

Note:

Investors could lose money when investing in the stock and bond markets. Investment market exposure should be in-line with the investor's risk tolerance and long term goals. Invest with care and appropriate advice.