Mutual Funds vs. ETFs: Which Is Right For You?

IF YOU KNOW A THING OR TWO ABOUT GOURMET COOKING, YOU KNOW THAT JELLY AND MARMALADE HAVE THEIR OWN DISTINCT FLAVORS, TEXTURES, AND RECIPES. Kind of like the differences between mutual funds and exchange-traded funds (ETFs), you could argue.

But, as might be the case when comparing, say, bananas and plantains—which are identical in shape and size—you may also be tempted to see only the surface similarities and conclude that there are no meaningful distinctions to be made.

After all, mutual funds and ETFs each pool your money into a basket of shares, and both offer the promise of broad diversification, professional money management, and the potential for less overall risk versus individual stocks and bonds.

That said, mutual funds and ETFs are not quite the same. While the word "fund" does appear in both descriptions. ETFs are also called "exchange-traded" due to the ability to buy and sell shares any time of day. As for which investment vehicle is best for your portfolio, well, it depends.

What Type of Investor Are You?

There are important distinctions you'll want to understand as you contemplate each product type. Trading preferences, access to asset classes, costs, transparency of underlying holdings, and your tax situation are among the areas you will need to understand to uncover your ideal investment type.

Here are some questions you'll want to ask yourself:

- Am I the type of investor who prefers to buy and sell shares at any hour of the trading day? *If that's a "yes," we think you sound like an ETF candidate.*
- Do I need access to certain actively managed asset classes that might be hard to find among ETFs? *Now you sound more like a mutual fund candidate.*
- Are low trading costs a major goal? *Close call, but let's go with ETFs, unless you like to trade a lot and have to pay a commission for each trade.*
- Am I hoping to potentially minimize the tax impact of year-end capital-gains distributions? *ETFs, generally!*
- What if I want to set up automated deposits to implement my systematic-investing strategy, or I'm just looking to fund my 401(k) plan at work? *Generally, stick to mutual funds.*

The table shown in **FIGURE 1** can help you determine whether mutual funds, ETFs, or a combination of both, are best for you.

Key Points

- Mutual funds and ETFs both offer the promise of diversification, professional management, and the potential for less overall risk versus stocks and bonds.
- Unlike mutual funds, ETFs can be bought and sold during the trading day, like individual stocks and bonds.
- Your professional can help you decide if either mutual funds, ETFs, or some combination of the two is right for you.

FIGURE 1
Comparing Mutual Funds and ETFs

Consider mutual funds if you value...	Consider ETFs if you value...
Variety: More than 9,500 mutual funds[4] offer virtually unlimited options for different investment strategies, risk tolerance levels, and asset classes. No brokerage account is required.	**Intraday trading flexibility:** The biggest ETF advantage comes from your ability to buy and sell ETF shares any time of the day. A brokerage account is required.
Active management: Most ETFs are passively managed, meaning they mirror a market index, while the mutual fund market offers a wider assortment of actively managed funds that generally seek to beat the market.	**Transparency:** Most ETFs are required to disclose their holdings on a daily basis, although a new category of "nontransparent ETFs" won't be required to do this; mutual funds only disclose their full holdings on a quarterly basis.
Service quality: Mutual fund issuers often provide a wealth of services, such as phone support, commission-free exchanges within the fund family, and check-writing privileges.	**Pricing control:** Share prices fluctuate all day. ETF investors can trade on minute-by-minute price changes, while mutual funds are priced only at the end of the trading day.
Automatic investment options: Regular investment contributions are easy to set up, so you can add to your portfolio with minimal effort.	**Lower trading costs:** ETFs, traded solely through brokerage accounts, generally have lower recordkeeping costs and licensing fees, but frequent trades could result in high trading costs through commissions.
Fractional share ownership: Say you've got $1,000 to invest and after the closing bell you learn that your favorite mutual fund is priced at $51 per share. How many shares can you buy? Exactly 19.6 shares. Over time, fractional ownership—generally not available with ETFs—could help build your wealth faster.	**Sophisticated trading moves:** Because ETFs trade like stocks, you can use limit or stop-loss orders, write options against them, short them, buy them on margin, or employ arbitrage.*
Retirement-plan options: Choose from an ever-expanding menu of mutual funds typically offered by employer-based 401(k) plans or your self-managed IRA.	**Tax efficiency:** ETFs are created and redeemed through an innovative process that helps them trade efficiently on exchanges. This process helps to minimize taxable distributions.

*A **stop-loss order** is an order placed with a broker to buy or sell once the stock reaches a certain price and is designed to limit an investor's loss on a security position. An **option** is a security that represents the right to buy or sell a specified amount of an underlying security at a specified price within a specified time. A **limit order** instructs the floor broker to buy a specified security below a certain price or to sell a specified security above a certain price. Buying securities on **margin** occurs when a brokerage firm lends the customer part of the purchase price of securities. **Arbitrage** involves the simultaneous buying and selling of securities, currency, or commodities in different markets in order to take advantage of differing prices for the same asset. **Short selling** involves the selling of a security that the seller obtained with borrowed funds.

Modern mutual funds have been around since the Roaring '20s.[1] In the decades that followed, mutual funds exploded in popularity. By 2019, worldwide mutual fund assets under management had grown to $51.6 trillion—$20.9 trillion in the US alone.[2]

While mutual funds have become an investor mainstay over the years, as well as the primary tool for funding 401(k) retirement accounts and IRAs, they've been burdened by an inconvenient limitation: Investors can only buy them at a price set at the end of each trading day.

But in the early 1990s, exchange-traded funds came into existence, offering investors a way to combine the advantages of mutual funds with the ability to trade ETFs in the same manner as stocks and bonds.

More Flexibility—Any Time of Day

ETFs were designed to give investors greater discretion over the timing of trades and to help lower expense ratios by focusing, at least initially, on passive strategies that are tied to an industry benchmark, such as the S&P 500 Index.[3] While mutual funds are distributed by fund issuers, who often seek to promote their shareholder services (telephone support, commission-free fund transfers, check-writing, etc.), ETFs are purchased through brokerage firms and online brokers, and can be traded throughout the day on local stock exchanges. Investors can even use limit orders, margin purchases, short-sale strategies, or sophisticated arbitrage techniques.

In 2008, actively managed ETFs came on the scene. From an investor's perspective, an actively managed ETF combines the benefits of active management with the trading flexibility of exchange-traded products.

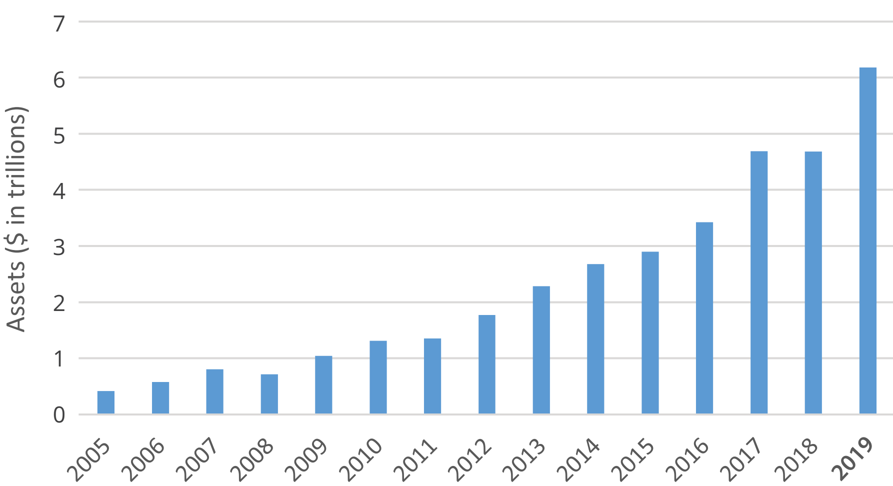
These days, ETF investors can also put their money into a growing number of exotic specialties ranging from artificial intelligence to cryptocurrencies. But you can just as easily find plain-vanilla ETFs in a wide variety of asset classes and investment strategies.

Lower Investment Minimums

If you prefer lower investment minimums, you can start investing in an ETF for the price of one share, which could be as low as $10 or as much as a few hundred dollars, depending upon the ETF. By contrast, some mutual funds impose minimum initial investment requirements unrelated to the share price, with minimums typically ranging from $1,000–$3,000.

ETFs are also considered by many investment experts to be more tax efficient. The reasons for this are somewhat technical, as they involve the mechanics of the ETF creation and redemption process.

FIGURE 2
Global ETF Asset Growth (2005-2019)



Source: ETFGI.com, 1/16/20

The Workhorse Still Pulls its Weight

But let's remember why mutual funds continue to shine as the workhorse of the investment world.

For starters, there are more than 9,500 mutual funds[4] to choose from that cover hundreds of investment strategies, risk tolerance levels, and asset classes. In 2018, an estimated 99.5 million individual Americans in 56 million households owned mutual funds.[5]

One reason for their enduring popularity is that they can help investors build good savings habits. By taking advantage of automatic investment options, a mutual fund investor can easily buy shares on a recurring basis (i.e., dollar-cost averaging)[6] to help systematically build wealth over time.

And, for some investors, there may be comfort in knowing that a mutual fund trade will be based on an end-of-the-day share price that is the same for all investors, and that there will be no mystery as to the price at which their trade will be executed. For ETF investors, trade execution price always depends on a number of variables, including the type of order you place (market orders, limit orders, etc.), and the level of participation among buyers and sellers at any given moment.

Mutual Funds or ETFs: Why Not Both?

So which type of investment is best for you? Let's get back to asking those questions, the most important of which are these: What are my short-, medium-, and long-term investment goals? What is my tolerance for risk? What about my time horizon or need for investment flexibility? What about tax efficiency?

Consider mutual funds for:

- Sheer variety of asset classes, strategies, and risk levels
- Automatic investment plans and systematic withdrawal plans
- Phone support, check-writing, and other fund-provider services

Consider ETFs for:

- Access to intraday trading
- Generally lower fees
- Tax efficiency

Your financial professional can help you work through the questions and the myriad of options and flavors—a process not much different than deciding between jelly and marmalade for that upcoming dinner you're hosting.

To learn more about investing in mutual funds and ETFs, please talk to your financial professional.

[1] Source: MutualFunds.com, A Brief History of Mutual Funds, 9/2/14

[2] Source: Investment Company Institute, 12/30/19

[3] S&P 500 Index is a market capitalization-weighted price index composed of 500 widely held common stocks. The index is unmanaged and not available for direct investment. Past performance does not guarantee future results.

[4] Source: Statista, 8/9/19, as of year-end 2018

[5] Source: Investment Company Institute, 12/30/19

[6] A dollar-cost averaging strategy involves regular, systematic share purchases made over time, regardless of the rise or fall of prices. Investors can build wealth by accumulating a relatively greater number of shares for a fixed amount when prices decline, and fewer shares for the same fixed amount when prices are rising. Dollar-cost averaging does not guarantee that your investments will make a profit nor does it protect you against losses when stock or bond prices are falling. You should consider whether you would be willing to continue investing during a long downturn in the market, because dollar-cost averaging involves making continuous investments regardless of fluctuating price levels.

Important Risks: Investing involves risk, including the possible loss of principal. Diversification does not ensure a profit or protect against a loss in declining markets. Option-writing, margin, arbitrage trading aren't suitable for every investor. These strategies involve risk, including the possibility that you could lose more money than you invest. A Fund's or ETF's focus on investments in particular sectors may increase its volatility and risk of loss if adverse developments occur.

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