

Choosing Between Mutual Funds and ETFs

The decision to own a mutual fund or an exchange-traded fund (ETF) is dependant on a variety factors. Both types of investments have advantages, but individual investors should not feel compelled to switch from one to another. Rather, investors should first consider the following factors and then consider the investment that is best for them.

What Are Your Portfolio Diversification Needs?

The first step when choosing among funds is to determine what your portfolio needs are. For example, do you need exposure to domestic small-cap stocks or municipal bonds? The answer to this question will be determined by what asset classes further diversify your portfolio and keep your investing risk within your tolerance limits.

Knowing what asset classes you want to target helps you in two ways. First, it narrows your search to a smaller, more targeted group of funds. Secondly, it makes comparisons between funds easier. A fund investing in emerging market debt will have different return characteristics and higher expenses than a fund that invests in U.S. blue-chip companies.

Active or Passive Management?

Once you know what your portfolio needs are, you can start to consider whether you want to use an active or passive strategy.

Active strategies rely on the ability of the fund manager to handpick the securities. Active managers attempt to beat their benchmark index (e.g., the S&P 500) or produce a portfolio that is either less volatile or less correlated with the benchmark. The inherent danger is that the fund manager fails to do so. Active management can result in higher expenses and greater turnover.

Passive strategies attempt to mimic the return characteristics of a benchmark index. Passively managed funds charge lower expense fees than their actively managed counterparts. An inherent danger is that a passively managed fund fails to accurately mimic the performance of the benchmark index and incurs tracking error. Plus, as exchange-traded funds have grown, so has the number of indexes designed for ETFs to track.

“Enhanced indexes” fall into a grey territory between active and passive approaches. Though funds that track these indexes are technically following a passive approach, the indexes themselves are designed to track an anomaly or a group of characteristics that may result in better performance than a well-known index. Again, the dangers of underperformance and higher expenses exist.

Mutual funds remain the only viable choice for low-cost exposure to active strategies, with very few ETFs following active strategies (though this could change). For

passive strategies, ETFs tend to charge lower annual expense fees than their mutual fund counterparts.

Portfolio Composition

When looking at active and passively managed portfolios, you should also consider the securities held. Similar sounding funds can have vastly different holdings. (ETFs update their holdings much more frequently than mutual funds do.)

Index funds tend to overweight the largest companies within the index. For example, as of the end of January 2012, Apple (AAPL) and Exxon Mobil (XOM) comprise approximately 7% of the SPDR S&P 500 ETF (SPY). Depending on how the index is structured, a few companies can have a very significant impact on the fund’s performance.

Actively managed funds may also overweight large companies. Alternatively, they emphasize certain sectors in an attempt to boost performance. Managers who target securities that are less liquid, such as micro-cap stocks or smaller foreign markets, may incur more volatility or have problems replicating past performance if their fund attracts too much investor dollars. (Mutual funds can close themselves off to new investors, while ETFs cannot.)

This is why, when looking at a mutual fund or an ETF, you should always read the prospectus and understand exactly what the fund invests in. Only invest in funds whose portfolio strategies you understand and are comfortable owning.

Your Personal Situation

Finally, you should consider your personal situation. Most 401(k) plans only offer mutual funds to participants. (Some do offer ETFs, however.) Individual accounts, both taxable and tax-deferred (e.g., IRAs) can be invested in mutual funds or ETFs. If your portfolio is invested directly with a mutual fund family (e.g., T. Rowe Price, Dodge & Cox, etc.), you will have to transfer money to a brokerage account in order to buy ETFs. (Unlike most mutual fund families, Fidelity and Vanguard do operate their own brokerage units.)

When choosing between a mutual fund and an ETF, go with the fund that best suits your needs. If it is a close call between a mutual fund and an ETF, the lower-cost option may be the best choice. Pay attention to any fees you may incur by making the change, such as brokerage commissions and transfer fees, since these can impact your overall cost savings.

Finally, do not feel compelled to alter your portfolio just for the sake of change. If you are happy with your current fund holdings, do not transfer your money out of them.

—Charles Rotblut, CFA