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ETFs vs. Mutual Funds: How to Choose?

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Exchange-traded funds (ETFs) and mutual funds are both baskets of individual stocks, bonds, and other securities that provide investors with an easy way to invest and create a diversified portfolio. While they are more similar than not, there are key differences that may lead investors to select one over the other. The purpose of this Brief is to explain the similarities and differences so you can decide for yourself how to choose between these two common fund structures.

Similarities

Both ETFs and mutual funds can invest in a variety of asset classes (e.g., stocks, bonds, real estate, commodities, etc.). Depending on the specific fund, both can provide either very broad-based exposure or be more targeted to specific sectors, geographies, and investment strategies. Both can provide varying degrees of risk depending on the underlying investments.

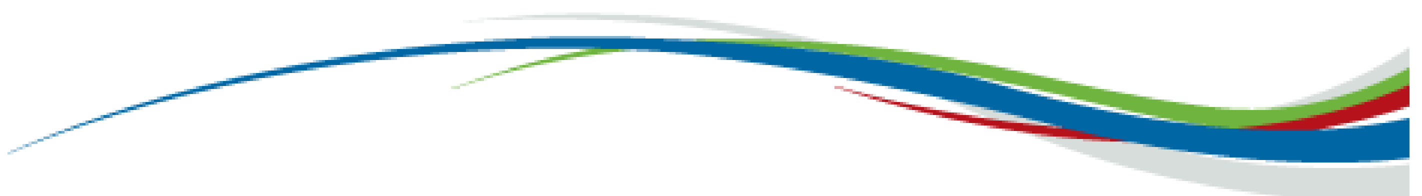
Another key similarity is that they can both be passively managed or actively managed. Passively managed funds, whether ETFs or mutual funds, do not rely on a management team to select the individual securities and try to outperform a chosen benchmark; instead, they aim to track an index and therefore match the index return—for example, the S&P 500. Although the term “index fund” is most often associated with mutual funds, it is important to recognize that ETFs and mutual funds can both be index-based (i.e., passively managed).

Whether a fund is actively or passively managed is the biggest driver of its management fee, called an “expense ratio.” Generally, passively managed funds have lower expense ratios as compared to actively managed funds. ETFs and mutual funds can also have trading fees (commissions) associated with them. You should review the fund to determine its investment approach (active vs. passive), expense ratio, and potential trading fees.

Differences

One important difference is in how you trade the two types of funds. Mutual fund orders are only executed once per day (at the end of the day), with all investors on the same day receiving the same price. ETFs are bought and sold on a stock exchange, and you can trade them throughout the day. This means that the price at which you buy an ETF will likely differ from the prices paid by other investors.

Another difference is that ETFs have an advantage in overall tax-efficiency. ETFs and mutual funds must pay out all capital gains and dividends to investors each year. These distributions are taxable when the fund is held in a taxable brokerage account. ETFs tend to generate fewer capital gains for investors, which can lead to a higher after-tax return.[1]



The final important distinction is that it may be easier to make automatically recurring investments into mutual funds than ETFs. Most of the large brokerage firms (e.g., Fidelity, Vanguard) do not allow you to create an automatic investment program with ETFs whereby you can invest a fixed dollar amount on a pre-determined schedule.[2] This is because most brokerage firms do not allow you to trade fractional shares of ETFs. In contrast, it is easy to schedule recurring investments into mutual funds, which allow for fixed dollar investments.

How to Choose?

Choosing between ETFs and mutual funds comes down to the relative importance of the three key differences—how they trade, tax efficiency, and setting up automatically recurring investments.

1. ETFs are better if you trade actively. ETFs not only offer transparent, intraday pricing, but they also allow for stop orders, limit orders, options, and short selling—none of which are possible with mutual funds. In addition, some mutual funds may charge early redemption fees or impose frequent trading restrictions. This helps to keep their turnover and costs lower but makes them ill-suited for more active investors.
2. Tax-efficiency is an important consideration if you are investing in a taxable brokerage account. If, however, your assets are all in retirement accounts, then this difference is inconsequential as you can reinvest any capital gains passed through by the fund without being taxed. Also, the incremental tax-efficiency of a passively managed ETF vs. a passively managed mutual fund is often quite small.
3. Mutual funds may be better if you want to make contributions on a regular basis (e.g., weekly, bi-weekly, or monthly). Mutual funds allow you setup an automatic investment program to invest the same dollar amount each time (called "dollar cost averaging"). For those of you in retirement, you can also do this in reverse and setup an automatically recurring distribution.

Bottom Line

Mutual funds and exchange-traded funds (ETFs) are more similar than not. They can both provide you with instant access to hundreds or even thousands of different stocks and bonds. Whether you choose ETFs or mutual funds ultimately depends on many factors, like the type of investor you are, the type of account you have, and your overall goals.

Footnotes

[1] ETFs use a unique in-kind creation/redemption process, which minimizes the need for the fund to buy or sell securities to facilitate purchases and redemptions. In contrast, whenever anyone redeems shares of a mutual fund, the fund must sell securities to generate the cash to pay them. If the fund sells the securities for a gain, the net gains are passed on to every investor in the fund.

[2] This may change in the future and there are already some smaller brokerages where you can do this with ETFs, such as M1 Finance. Additionally, you can setup recurring investments in ETFs via a robo-advisor, such as Betterment or Wealthfront.

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