Giving Thanks: Ten Reasons ETFs Are Better Than Mutual Funds

ETFdb *By Michael Johnston | ETF Database – Thu, Nov 24, 2011 7:00 AM EST*

Companies:

- PIMCO Australia Bond Index ETF
- EGShares China Infrastructure
- Russell Contrarian ETF

This year more than ever before, investors of all sizes are giving thanks for the tremendous expansion in the ETF industry in recent years. ETF assets continue to climb, even in challenging economic environments. And in many cases, the growth of this industry is thanks to an exodus of cash from traditional mutual funds to vehicles that seem like new innovations, although they are actually approaching their two decade anniversary.

For certain investors in certain circumstances, mutual funds make a lot of sense. But while these vehicles can still be useful in a limited number of scenarios, they are bleeding cash because ETFs are in many ways a better solution that can deliver a number of advantages [see 25 Things Every Financial Advisor Should Know About ETFs]. For those advisors and individual investors beginning to explore the opportunities in ETFs, we present a quick rundown of why so many have embraced these securities:

1. Lower Expenses = Higher Returns

This is, of course, the advantage that gets most of the air time; ETFs are, in general, much cheaper than mutual funds. There are a couple reasons why this is true. First, many ETFs are passively indexed whereas many mutual funds are actively managed. Because most ETFs don't employ a team of managers, analysts, and expensive research capabilities, they're able to charge a lower management fee for their services.

But the expense differential also results from the structural distinctions; ETFs are traded like stocks, which means that the issuer generally isn't required to incur administrative fees processing redemptions and other transactions with investors. Because ETFs are generally traded between investors–and not between an investor and the fund company–the administrative burden is considerably lighter [see Considering The Total Cost Of ETF Investing].

The average expense ratio for the mutual fund industry is about 1.4%. The average ETF charges about 60 basis points, with most "plain vanilla" products that make up core positions in buy-and-hold portfolios coming in at a considerably lower price. Considering that there is a boatload of evidence suggesting that active management generally fails to add value over the long term, many have embraced a reduction in fees as a way to improve performance.

It’s pretty easy to build a balanced, well-rounded all-ETF portfolio with a bottom line expense ratio of about 30 basis points–or about 110 basis points below the mutual fund average. In fact, our well-diversified, Cheapskate ETFdb Portfolio will costs investors only a mere 0.13% in expense fees. Let’s suppose that an all-ETF portfolio and an all-mutual fund portfolio each return 7% annually before fees. Over a 30 year time horizon, $1 million invested in the all-ETF portfolio would become about $7 million. The same amount invested in the mutual fund portfolio would be worth just $5.1 million.

2. Intraday Trading

It’s somewhat surprising that this benefit of the exchange-traded structure is often overlooked–especially in an environment where markets often swing by multiple percentage points in a matter of hours. The fact that ETFs are exchange-traded is a huge advantage for investors who monitor their positions regularly and enjoy the flexibility that comes with the ability to instantly establish or close out a position.

Purchases or sales of mutual fund shares are processed at the end of the trading day, which means that there can be a delay of several hours between the time an allocation decision is made and when it is implemented. Depending on the asset class and the day, that lag can translate into several hundred basis points and a potentially significant change in the value proposition.

Trades in most ETPs can be executed in a matter of seconds, meaning that investors can utilize limit orders and other trading tools with greater efficiency [see Alternatives To The 20 Most Popular ETFs]. The ability to trade throughout the day might not be much of an advantage to certain investors keeping an eye on the big picture over the long term. But for the more hands-on crowd, this feature is incredibly important–and potentially very valuable.

3. Enhanced Precision

ETFs may have originally been designed for the buy-and-hold crowd, but these securities have become increasingly popular among more active investors as well. While the “first generation” of ETFs focused on broad, plain vanilla asset classes, the products that have debuted in recent years have generally been more precise in nature. In other words, the new additions to the ETF lineup focus on narrow sub-sectors and asset classes, as opposed to broad exposure to large cap stocks or Treasuries.

ETFs allow for what seem like an oxymoron: “diversified precision.” In addition to the blunt instruments covering core asset classes, there are dozens of hyper-targeted tools that allow investors to focus in on desired exposure. A few examples include:

- Solid State Drive Stocks (SSDD)
- Emerging Markets Utilities (UGEM)
- China Infrastructure (CHXX)
- Junior Gold Miners (GDXJ)
- Australian Bonds (AUD)
- Platinum Miners (PPLT)

- Cloud Computing (SKYY)
- South African Rand (SZR)
- Fishing Stocks (FISN)
- Small Cap German Stocks (GERJ)

Many of these products are of little use to those with a long-term outlook and desire to simply capture beta. But for more active traders, the precision nature of exposure available through ETFs is certainly a big step up from mutual funds that generally offer broader strategies [try our Free ETF Screener].

To be fair, there are certain asset sub-classes that are accessible through mutual funds but not through ETFs (at least not yet). For example, investors looking to target municipal bonds from specific states would be better off using mutual funds unless they're looking to New York or California (there are three ETFs each covering muni bonds from those states).

4. Additional Firepower

While ETFs have grown in popularity among investors with long-term time horizons, they're also more popular with active traders that are willing and able to take on considerable risk. Leveraged ETFs have drawn the ire of those who fail to understand the nuances of daily resets and compounding returns, but they have also been embraced by the risk-tolerant crowd looking to amplify their exposure and make big short-term bets [see The Ultimate Guide To Leveraged ETFs].

Leveraged ETFs, which seek to deliver amplified returns to a target index over a specified period of time, are not appropriate to all investors but can be tremendously powerful tools for those able to use them correctly. Just as ETFs can be tremendously useful for the long-term, buying-and-holding crowd that measures holding periods in decades, they can come in handy for the more active bunch who measure holding periods in minutes and hours.

The leveraged ETF lineup has become quite precise; investors can amplify returns to both broad asset classes and targeted niches with these products. Again, they're not for everybody, but are another tool that makes much more sense in the ETF wrapper as opposed to traditional mutual funds.

5. Tax Efficiencies

ETFs are known for being cost efficient, but their tax efficient properties can be equally compelling. Using ETFs won't make your tax liabilities disappear, but these vehicles can give investors more control over the timing of tax events [see Tax Loss Harvesting With ETFs: 6 Ideas To Lower Client Liabilities]. That's because the nuances of the creation / redemption mechanism generally allows ETFs to avoid incurring short-term capital gains taxes when creating or redeeming new shares. Mutual funds, on the other hand, generally set up investors to be impacted by the selling decisions of others.

When your fellow investors in a mutual fund decide to close out their positions, there is the possibility that the fund will incur capital gains taxes when liquidating the underlying securities in order to deliver the cash to the departing shareholder. Any tax liabilities are then spread across all investors in the fund, which can be unfair for those who are simply holding steady but find themselves paying capital gains rates. ETFs give investors more control over their tax liabilities, and can help to delay payments to Uncle Sam for as long as possible.

6. Transparency

Another often overlooked advantage of ETFs is the transparency they offer; at least for now, investors can know exactly what an ETF holds in close to real time. With mutual funds, the glimpse under the hood comes about once a quarter, which can be of little use if attempting to evaluate your exposure to a collapsing stock. When companies like Enron or MF Global start imploding, it can be useful to know immediately just how much of your retirement portfolio is tied up in a sinking ship. With ETFs, you can get the answer almost immediately. With mutual funds, you might not know until it's too late.

7. Commission Free Trading

One downside to ETFs when stacked up next to mutual funds has historically been the commissions that investors must incur when establishing or liquidating positions in these securities. But that disadvantage has been partially eliminated thanks to the introduction (and expansion) of commission free ETF trading programs in recent year.

Though ETFs have attracted huge cash inflows as a result of their superior costs efficiency, the industry has continued to lower fees in recent months. In addition to cuts to management fees, commission free trading platforms have become increasingly popular. This development has helped to level the playing field between mutual funds and ETFs, in many cases eliminating a fee that partially eroded the expense ratio advantage held by exchange-traded products [see Are Investors Embracing Low Cost ETFs?].

With more than 200 ETFs now available commission free, many investors can manage a diverse portfolio without ever paying trading fees. That's a positive development that helps to put ETFs on equal footing with mutual funds in this element of the cost equation.

8. No Minimums

Most mutual funds come with minimum investment thresholds that prevent investors from buying in unless they're willing to fork over a certain amount. In some cases, it's just a few thousand dollars, but for certain products it can take five figures just to be let into the club.

ETFs avoid that exclusivity nonsense altogether; investors can purchase a single share if they want, a distinction that should have tremendous appeal to the little guys.

9. No Redemption Fees

In addition to charging higher fee while investors maintain a position, many mutual funds also gouge you if you try to close out a position before a certain amount of time has elapsed. Investors who find themselves maintaining relatively short holding periods can get burned by so-called "redemption fees," which are charged if they don't remain invested for a certain minimum period.

With ETFs, there's no penalty for flipping a position quickly (except for the commissions incurred to do so). That's another feature that gives enhanced flexibility that can't be found elsewhere.

10. Money Managers On Demand (At A Fraction Of The Price)

ETFs have become popular with investors who believe that efficient markets make active management a waste of time and money. But many exchange-traded products to hit the market in recent years have been tailored for those looking to implement an alpha-seeking strategy with all the benefits of the exchange-traded structure [see Talking Actively-Managed ETFs With Tom Graves Of S&P]. Besides actively-managed ETFs-which are generally much cheaper than active mutual funds thanks to the structural efficiencies–there are a number of indexed ETFs that tap into popular investment strategies [see our Alpha Seeker 2.0 ETFdb Portfolio].

Looking to follow a contrarian strategy? There's an ETF for that–two of them actually (CNTR, SCTR). Want to pursue high beta stocks? There are a handful of products that seek to replicate rules-based indexes to do just that–but without requiring investors to fork over a healthy percentage to a manager. Thanks to an impressive run of innovation in recent years, anything mutual funds can do, ETFs can do better.