# ADVISOR VIEWS

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A feature from **Eide Bailly**. *Advisor Views* offers timely investment news and market updates designed to keep you informed, while attempting to enhance your overall investment experience.

## MUTUAL FUNDS OR ETFS?

For many investors, mutual funds and exchange traded funds (ETFs) are the "go to" vehicles for those seeking broad diversification and access to a wide array of asset classes. Indeed, as of year-end 2016, U.S. funds held a combined $18.9 trillion in assets, with mutual funds holding approximately $16.3 trillion, and ETFs $2.5 trillion.[1] Within the fund industry at large, however, asset flows have favored index strategies over active strategies of late. Indeed, over the period 2007 to 2016, index domestic equity products have received $1.4 trillion in net new cash and dividend reinvestments, while actively managed domestic equity mutual funds have seen net outflows of $1.1 trillion.[2] Furthermore, index domestic equity ETFs have grown more quickly than their mutual fund counterparts having attracted one and a half times the net inflows of the mutual funds.[3]

While mutual funds and exchange traded funds share some characteristics including reasonable liquidity*, a broadly diversified portfolio structure, and relatively low costs, they do have some differences.

### How the Shares are Bought and Sold

When investors purchase shares of a mutual fund, they typically buy them directly from the investment company that offers the fund. Similarly, when they wish to sell, the investment company stands ready to redeem the shares. In contrast, ETF shares, once created and issued for sale in the marketplace, are bought and sold between investors on an exchange, similar to stocks. With respect to purchase fees, while some mutual funds have sales charges, or "loads," associated with them, "no-load" funds enable investors to purchase shares free of any sales charges. ETF investors, on the other hand, often face commission charges when buying or selling the shares.

### Share Pricing and Expenses

Yet another difference between mutual funds and ETFs is in the pricing of the shares. Mutual funds price their shares once a day at the close of the financial markets such that all investors who buy or sell shares on a particular date will do so at the closing net asset value, or "NAV," regardless of the time in the trading day that the order was placed. In contrast, ETF shares can be bought and sold throughout the day on an exchange with the share price fluctuating based on market activity. While ETFs also have an NAV that's based on the value of the underlying securities that comprise the fund, market forces may cause the market price to deviate from the NAV, however substantial deviations tend to be short-lived.[4]

With respect to the internal expenses of the funds – fees that include management and administrative expenses – there is a common narrative that ETFs are cheaper than mutual funds. We believe it is more accurate to say that passive (or index-based) is cheaper than active, given that indexed ETFs and mutual funds have lower expenses than their active counterparts. The reason for the view that ETFs are cheaper is that most are indexed, and the majority of mutual funds are active, but more and more active ETFs and indexed mutual funds have been coming to market of late.

### Tax Efficiency

As a general rule, ETFs tend to be more tax efficient compared to their mutual fund counterparts primarily as the result of their "creation and redemption" structure. Given this structure, fund providers are able to increase or decrease the supply of the shares in the marketplace, based on their demand, through what is known as a "transfer-in-kind." This eliminates the need to sell securities in the fund, thereby avoiding the possibility of a taxable gain that would then be distributed to all shareholders. Through this process, investors may be better positioned to maintain greater control over their own tax situations.

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In addition to the tax efficient nature of the creation and redemption structure of ETFs, they also tend to enjoy enhanced tax efficiency, relative to mutual funds, given the manner in which they trade in the marketplace.

As previously discussed, when mutual fund investors wish to liquidate their shares, the fund company redeems them at the current NAV. At times, a fund manager may be required to sell some of the portfolio's underlying securities in order to generate the cash needed to meet the redemption requests. If a capital gain is created when the securities are sold, it's passed on to all shareholders as a taxable distribution.

In contrast, given that ETFs trade on an exchange, if one chooses to sell his shares, any capital gain or loss is solely a tax obligation of the seller, and other shareholders of the fund are largely unaffected.

## So Which is Right for You?

In all likelihood, it depends on you, your investment strategy and your goals. For those who may benefit from intra-day trading and related trading strategies, ETFs may be a better choice (although frequent trading can be costly, while potentially diminishing the tax benefits of ETFs). Just keep in mind that bid-ask spreads may be quite wide if you're trading ETFs that are fairly illiquid. Similarly, buy and hold investors who are extremely tax conscious may be better suited to ETFs.

Low cost mutual funds, on the other hand, are typically the preferred vehicles in 401(k) plans given they are typically easier for the plans to administer. As well, those who choose to invest using a dollar cost averaging strategy, or who make periodic investments, may find no-load mutual funds to be more advantageous given the lack of sales charges or commissions that may be associated with the purchase of ETF shares.

If you'd like additional information on mutual funds and exchange traded funds, including which type of investment vehicle may be best for you, please contact us. Together we can explore your goals, preferences, and tax sensitivity in order to determine how we can best help you reach your unique and personal goals.

* ETF liquidity can vary greatly depending on assets under management and daily volume. This should be considered carefully when using market orders given that low liquidity may cause wide bid-ask spreads in ETF prices.

[1] www.icifactbook.org, 2017 Investment Company Fact Book

[2,3,4] Ibid.