Why I Favor Exchange Traded Funds (ETFs) over Mutual Funds

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This is in response to Tom Crooker's commentary, "Why I Do Not Favor Exchange Traded Stock Funds."

Tom Crooker's commentary, "Why I Do Not Favor Exchange Traded Stock Funds," argued that individual stock investments are superior to a stock ETF. Fair enough. I believe, however, that most individual investors will purchase ETFs as an alternative to a mutual fund. For the reasons that follow, I believe that ETFs are superior to mutual funds.

ETFs have been around for twenty years, but have grown rapidly in recent years. There are now 1,500 ETFs, with about $1.2 trillion in assets. ETFs still trail mutual funds, with about $12 trillion in assets.

ETFs are funds and therefore have the benefit of diversification compared to individual stocks. ETFs are structured and trade differently than mutual funds. Whereas purchases and sales of mutual funds are with the fund (you buy shares through a broker from the fund and you sell shares you own back to the fund,) buying and selling ETFs is through the stock exchanges and you buy from and sell to other investors, through a brokerage account and paying a brokerage commission (usually $8 to $10 per trade, regardless of the size of the transaction.)

ETFs have two fundamental advantages over mutual funds. First, mutual funds redeem shares from shareholders who want to sell. If a large amount of redemptions occur, then the mutual fund must sell its investments to meet the redemptions. This often triggers capital gains and tax liabilities, which are passed on to all shareholders, including those who did not sell their mutual fund shares. Since ETF purchases and sales are with other investors, no tax liabilities are generated, other than the gain or loss to a shareholder who sells. The second major advantage of the ETF structure is that purchases and sales are instantaneous, during the trading day, similar to buying and selling stocks. Mutual funds purchases and sales are priced at the end of each trading day, at 4PM. In a trading day with big price movements, an investor will pay more or less for shares purchased or sold, based on the price movements from the time the trade is placed, until the end of the trading day. (I had an unfortunate experience of selling a mutual fund in the morning, on a big down day in the market. The price moved down over 2% from the time of my sell order, until 4PM.)

Much is made of the low expenses of ETFs. Most ETFs have expense ratios of 0.10% to 0.50%. Most mutual funds have expenses of 0.5% to over 1%. Some mutual funds also have front end "loads" (sales commissions) as high as 3% to 5.75%, graduated fee structures, high minimum investments, and other negative features not shared with ETFs.

ETFs have become the investment vehicle of choice for many traders, including high-frequency traders, hedge funds, and institutional investors, and are used for speculative purposes and hedging, and gaining investment exposure to very narrow and specific parts of markets.   There are many ETFs that feature exotic and high risk strategies and leverage.   These should be avoided by most individual investors. But there are also many "plain vanilla" ETFs, most indexed to easily understood and transparent markets and sectors, such as the S&P 500, government bonds, sectors, etc.. These are suitable for individual investors, including "buy and hold" investors.

Most mutual funds are actively managed. They employ educated and highly compensated analysts and "stock pickers" who select individual investments. Those teams of "experts" cost big bucks, which drives most of the higher expenses of mutual funds compared to index funds, which rely on a computer algorithm to select investments from an index of investments stored in the computer. (Computers don't require bonuses, health insurance, vacation time, or a corner office.) In recent years, there has been growth of indexed mutual funds (including many Vanguard Funds and the Fidelity "Spartan" funds) Those indexed mutual funds have low expense ratios (about 0.10%) that are competitive with similar ETFs, such as SPY (a market value weighted S&P 500 index fund) which is the largest ETF.   However, they are still mutual funds and have the same structural disadvantages of all mutual funds.

Most mutual funds are actively managed and most ETFs are indexed. However, some mutual funds are indexed, and recently, actively managed ETFs have been introduced. (Actively managed ETFs also have higher expense ratios to pay for their investment analysts and stock pickers.) So a critical question for all fund investors is: Indexed funds or actively managed funds?   Increasingly, fund investors have been gravitating toward indexed funds and, since most ETFs are tied to indexes, explains much of ETFs' growth. Why the shift to index funds? Simple answer. Historically, about 75% of managed funds do not "beat" their relevant indexes. In 2011, 80% of managed funds performed worse than their indexes. So investors in managed funds are paying an additional .5% to 1% in expenses for 1 in 5 odds that the fund managers will do better than an index fed into a computer algorithm. And even the best known fund managers (such as Bill Miller) have done poorly in recent years, failing to beat their indexes.

In recent years, several actively managed ETFs have been introduced, but most have not been popular. Probably for the reasons in the previous paragraph, regarding the "alpha" (superior performance, or lack of it, compared to indexes.) Mutual funds sponsors are piling into ETFs, even creating ETFs that are identical to their own mutual funds. The recently introduced, actively managed PIMCO Total Return ETF (similar to the PIMCO Total Return Fund, the largest mutual fund in the market) may be a "game changer," for managed ETFs.   Bottom line: there is nothing a mutual fund can do that cannot be done in an ETF, and the ETF will have greater tax efficiency and instant trading.

My bottom line and bold predictions. Unless a fund investor must have an actively managed fund (and recognizing that the investor is paying a high price for 1 in 5 odds of the fund beating the index,) there is an ETF out there that does what the investor wants, that is cheaper and more efficient. ETFs will continue to grow, at the expense of mutual funds, as more mutual fund investors come to appreciate the structural advantages of ETFs. And in twenty-five years, there will be very few mutual funds left, most funds with be ETFs, and they will include actively managed ETFs. I can say this, knowing that in twenty-five years, not many of you will be checking on my prediction.

Caveat Emptor. ETFs are used by traders, including high frequency traders. There have been anomalies in the market, that must be watched and controlled via regulation and/or "circuit breakers." The "flash crash" of May 2010 remains scary and not fully understood, in my opinion. ETFs played an important role in the flash crash, and their use by high frequency traders. I believe high frequency trading was the primary cause of the flash crash, and they used ETFs as a vehicle for their trading. I do not believe sufficient controls have been put in place to avert another flash crash, and the next one may not self-correct as quickly (minutes) as the flash crash of May, 2010.

Final Caveat Emptor. Everything written here is the opinion of Al Smuzynski. And what are his qualifications as an investment "expert?" Nothing. Zero. Nada. Zilch. Bumpkus. But listen to me or do something based on what I say at your own (financial) peril!!