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ETF vs. Mutual Fund—What is the Difference?

Compared to mutual funds, which have been around since the 1920s, ETFs (exchange-traded funds) were first developed in the 1990s as alternatives to mutual funds to provide individual investors with access to passive, indexed funds. However, since then, ETFs have grown tremendously in popularity. Now there are many types of ETFs available with passive or active management, though the emphasis on market indexing remains, and all types of investors and traders use them.[1]

ETFs and mutual funds offer similar advantages, however there are distinguishing points to consider in determining which is right for you.

Similarities Between Mutual Funds and ETFs

Both mutual funds and ETFs share these basic advantages:

- **Diversification** without the complexity of buying lots of different investments separately.
- **A wide range of investment options**, including U.S. and international stocks and bonds and even sometimes commodities or precious metals, plus the ability to invest in the broad market or a narrow segment of it.
- **Oversight by professional managers and careful regulation** with experts choosing and monitoring the individual stocks and bonds in the fund.

Beyond these benefits, however, whether or not to invest in ETFs vs. mutual funds will most likely depend on your investment goals and strategies.

Differences Between Mutual Funds and ETFs

Mutual funds and ETFs are both popular investment vehicles, but they have key differences that might appeal to different types of investors:

- **ETFs provide greater liquidity** as they can be bought and sold throughout the trading day, while mutual funds are traded once a day at the end of the trading day.

1 https://www.investopedia.com/articles/exchangetradedfunds/08/etf-mutual-fund-difference.asp#:~:text=Mutual%20funds%20are%20usually%20actively,end%20of%20each%20trading%20day

- **Mutual funds are actively managed** by professional fund managers who select and trade securities, while many ETFs are passively managed, tracking a specific index, although there are also actively managed ETFs.
- **ETFs generally have lower expense ratios** than mutual funds due to their passive management approach.
- **ETFs often offer tax advantages**, as they can trigger capital gains taxes less frequently than mutual funds.

ETFs & Mutual Funds—Comparison Chart

Features	ETFs	Mutual Funds
Investment Minimums	**Lower or No Minimum Investment Requirements** • ETFs are traded like stocks on exchanges, allowing investors to purchase as few as one share at a time. • This eliminates the high minimum investment requirements associated with many mutual funds. • ETF share prices can be as low as approximately \$50, making them very accessible.	**Higher Minimum Investment Requirements** • Mutual funds typically require a minimum initial investment set by the investment company. • These minimums often range from \$500 to \$5,000 for individual investors.
Trading Options	**Real-Time Trading:** • ETFs are traded on stock exchanges, allowing for purchases and sales throughout the trading day. • Prices fluctuate in real-time based on market conditions. **Enhanced Trading Flexibility:** • ETFs offer the same trading flexibility as stocks, including intraday trading. • Investors can utilize various trading strategies, such as stop orders, limit orders, and short selling.	**End-of-Day Pricing (NAV):** • Mutual fund transactions are processed only at the end of each business day. • All buy and sell orders are executed at the Net Asset Value (NAV) calculated at the market close. **Limited Trading Flexibility:** • Mutual funds do not allow for intraday trading. • Trading techniques like stop orders, limit orders, and short selling are generally not available.

ETFs & Mutual Funds—Comparison Chart (cont'd.)

Features	ETFs	Mutual Funds
Trading Options (cont'd.)	**No Minimum Holding Periods:** • ETFs typically do not have minimum holding periods, providing greater liquidity and flexibility.	**Minimum Holding Periods:** • Many mutual funds impose minimum holding periods, often around 90 days, restricting short-term trading.
Fees & Costs	**Lower Management Costs:** • Most ETFs, particularly index-tracking (passive) ETFs, are less expensive than mutual funds. Actively managed ETFs usually have higher management costs than passively managed ETFs but can still be less expensive than actively managed mutual funds. • This is because passive ETFs use computer programs to replicate the performance of a chosen index, reducing the need for costly active management. **Lower Transaction Costs:** • ETFs are traded on exchanges, with buyers and sellers dealing directly with each other. • This direct trading mechanism often results in lower transaction costs compared to mutual funds. • Even when comparing index mutual funds to ETFs, both actively and passively managed ETFs are often cheaper.	**Higher Management Costs:** • Actively managed mutual funds generally have higher costs relative to actively and passively managed ETFs due to the need for professional managers, researchers, and analysts. • These expenses are passed on to investors through higher expense ratios. **Transaction Costs:** • Mutual funds generally have higher transaction costs compared to passively managed ETFs. Unlike with ETFs, every mutual fund transaction involves an investment company, leading to associated fees for the services.

ETFs & Mutual Funds—Comparison Chart (cont'd.)

Features	ETFs	Mutual Funds
Tax Efficiency	**Lower Frequency of Taxable Events:** • ETFs, particularly index-tracking ETFs, tend to have fewer taxable events compared to mutual funds. • This is primarily due to their passive tracking of indices, which minimizes the need for frequent trading. **Structural Tax Efficiency:** • ETFs possess a unique structural advantage that minimizes the distribution of capital gains. • This advantage allows investors to defer most of the tax consequences until they sell their ETF shares. **Deferred Taxation:** • In most cases, the majority of tax liabilities from gains in an ETF portfolio are deferred until the investor decides to sell their shares. **Loss of Tax Benefits with Day Trading:** • Engaging in frequent day trading with ETFs negates the tax-efficient advantages, as it generates more taxable events.	**Annual Taxation:** • Mutual funds generally trigger annual taxable events based on the gains and losses within the fund's portfolio. • This means you'll likely face capital gains taxes each year, even if you haven't sold your fund shares. **Frequent Trading:** • Mutual funds often engage in more frequent trading, resulting in a higher number of taxable events (realized capital gains). **Distribution of Capital Gains:** • Mutual funds are more prone to distributing capital gains to shareholders, leading to immediate tax liabilities.

Is It Better to Invest in ETFs or Mutual Funds?

As you can see, there are differences between ETFs and mutual funds that may affect their cost, performance, and how they can be traded.

To figure out whether ETFs or mutual funds are best for your portfolio, you need to weigh these differences against your own strategies and goals. Get in touch with our experts, and consult with a Kayne Anderson Rudnick wealth advisor today.

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