ETF vs. Mutual Fund—What is the Difference?

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

Compared to mutual funds, which have been around since the 1920s, ETFs (exchange traded funds) were first developed in the 1990s to provide access to passive, indexed funds to individual investors with smaller amounts to invest. However, since then, ETFs have grown tremendously in popularity. They are now available with passive or active management, although the emphasis is still on market indexing and all types of investors and traders use them.

Both types of funds 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. You can use funds to invest in the broad market or a narrow segment of it.
- Oversight by professional managers and careful regulation. Experts choose and monitor the individual stocks and bonds in the fund, saving you the effort, and funds are regulated to protect investors.

Beyond these benefits, however, some differences may make one or the other a better fit with your investment goals and strategies.

Investment Minimums

The original goal of ETFs was to offer a diversified investment vehicle for people with modest amounts to invest. Similar to individual stocks, ETFs are not purchased from investment companies and are traded directly from investor to investor on major exchanges like the New York Stock Exchange or overseas equivalents. You can purchase as little as one share of an ETF at a time and share prices can be as low as $50.

Mutual funds generally require minimum investments in dollar amounts set by the investment company from which they are purchased. That amount is typically between $500 and $5,000 for an individual investor.

Trading Options

The fact that ETFs are traded on exchanges creates some of their most interesting differences. For one thing, ETFs can be traded at any point in a daily session. Like any stock, your purchase or sale will go through at the price of the moment, based on market conditions. Pricing of mutual funds, however, takes place only at the end of each business day: all transactions for the day, regardless of the time they were initiated, are completed at the end of the day using the NAV (net asset value) that is determined then.

Because of their real-time pricing, ETFs allow for the kind of active short-term trading techniques that can be done with stocks, including intraday trading, stop orders, limit orders and short selling. These techniques cannot be used with mutual funds. Most mutual funds also have a minimum holding period (often 90 days), while ETFs do not.

Fees and Costs

In general, ETFs are a less costly option than mutual funds. Much of the cost difference is accounted for by the difference in management between index funds—which use computer programs to track the returns and price movements of a chosen index—and actively managed funds—which require the expensive attention of managers, researchers, analysts, etc. Although there are index mutual funds, ETFs are still often the less expensive option. This is because, with an ETF, buyers and sellers are doing business directly with each other. However, every mutual fund transaction involves an investment company and fees for their work.

Tax Efficiency

Investors in both types of funds are taxed annually based on gains and losses in their portfolios, but the ETF structure tends to result in fewer taxable events for an investor. Tracking an index typically doesn't require frequent trading, so index ETF shares do not generate a large number of internal trades. ETF shares also have a structural benefit over mutual funds built into them, minimizing the capital gains they are required to distribute. Most of the tax consequences of gains in your ETF portfolio are deferred until you sell your shares. Of course, if you want to take advantage of ETFs' day trading opportunities, you will lose these tax benefits.

Which is Best For You?

As you can see, there are differences between ETFs and mutual funds that affect their cost, performance and how they can be traded. ETFs tend to be more cost-effective and more liquid. Mutual funds are more likely to offer active management, which is geared to beating the market and maximizing investor profits. To figure out which one is best for your portfolio, you need to weigh these differences against your own strategies and goals.

For additional information and guidance in investing, consult with a Kayne Anderson Rudnick Wealth Management advisor today.