MARKET MICROSCOPE – Mutual Funds vs. ETFs: Which is Right for Your Portfolio?

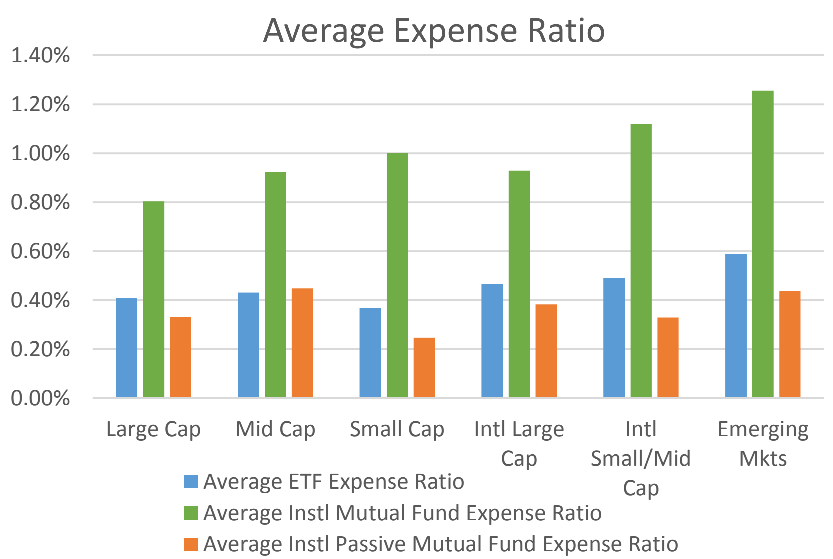
Mutual funds and exchange traded funds (ETFs) both function to provide small investors with access to professionally managed, diversified portfolios of stocks, bonds, or other investments that would be difficult and expensive to replicate on an individual basis. While they both accomplish this broad goal, they operate with distinct differences that could have a material impact on your final rate of return.

Mutual Funds: A mutual fund is an open ended investment vehicle that is priced and traded once each day. Investors own shares in the fund, which in turn owns shares in the underlying investments. Mutual fund shareholders can buy and sell their shares at the net asset value (NAV) of the underlying securities at the close of each trading day.

ETFs: An exchange traded fund is a security that seeks to track an index or basket of underlying investments. ETFs trade on an exchange in the same manner as a stock which allows investors to purchase or sell the security at any point throughout the trading day. The price of an ETF is determined by buyers and sellers in the market and can deviate from the NAV of the underlying securities.

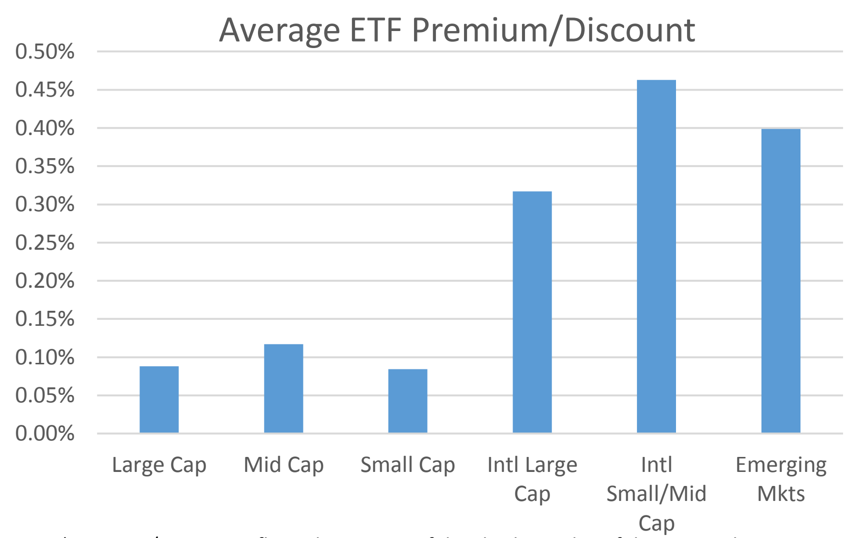
Proponents of ETFs often cite the lower cost of investing in ETFs as compared to mutual funds. However, most ETFs follow a passive strategy while most mutual funds are actively managed. The fee differential disappears when we compare ETFs to passively managed mutual funds.

The graph below compares fees of ETFs, institutional share class mutual funds, and institutional share class index mutual funds for six large Morningstar categories.



ETF investors are subject to the risk that the ETF may trade at a price that is different from the net asset value of the underlying securities – this is known as the ETF trading at a premium or discount.

The graph below shows the average of the absolute value of premiums or discounts of ETFs in the same six Morningstar categories.



*Premium/Discount reflects the average of the absolute value of the 12 month average premium or discount of every ETF in each Morningstar category

As you can see above, institutional share class index mutual funds are priced comparably to ETFs. Mutual funds offer certainty that you are buying the fund at the net asset value of the underlying securities. ETF premiums and discounts, although they generally converge in the long run, can create tracking error and cause the investors return to be higher or lower than the index the fund is designed to track.

Alpha Investment Consulting Group, LLC