

## Popular, but Not Perfect

Exchange-traded funds can enhance the portfolio of *some* investors.



BY PATRICIA M. RUDOLPH

The number and size of exchange-traded funds—basically, mutual funds that trade like individual stocks—have exploded. From one ETF in 1993, the number grew to 629 by year end 2007, with total assets increasing from \$629 million to \$608,420 million.

With all this growth, it's natural to ask whether ETFs should be in your portfolio. And the answer is, as always, it depends. It depends on your investment objectives, the size of your portfolio, the frequency of your trading, and the tax status of your investment.

What is it that has made ETFs so popular? ETFs allow an investor to trade an entire index and to time purchases and sales in response to price changes during the day. In addition, some of the newer ETFs are not broad market indices but specialize in specific sectors so that they give investors new access to a variety of asset classes.

Both mutual funds and ETFs are designed to allow an investor to buy a part of a large portfolio. For individual investors, it would be very difficult to achieve the level of diversification and economies of scale in trading costs that a fund can achieve.

Index funds go a step further and seek to minimize the cost of investing by tracking a market index and, therefore, avoiding the costs of actively managing a portfolio. Like index funds, ETFs also track an index but there are some important differences between index mutual funds and ETFs that make ETFs attractive. The most frequently cited advantages are that ETFs allow more flexibility and precision in trading, have lower costs, and are more tax efficient.

### CONTINUAL TRADING

ETF shares trade in the open market on stock exchanges, and prices are determined by the supply and demand for the shares. The price changes continually throughout the day as trading

occurs. Investors can buy on margin, place limit orders, and sell short just as they can with individual shares of stock.

In comparison, mutual fund shares are purchased from and sold to the fund. The price is determined by the net asset value of the fund. (NAV is the market value of the assets in the fund's portfolio less any liabilities divided by the number of mutual fund shares.) Mutual fund shares are priced once a day, usually at the end of the day. Any orders placed with the fund are executed at the next price. No margin purchases, short sales, or limit orders are permitted.

The continual trading of ETFs allows investors to respond to changes in market conditions and move quickly in and out of the market (if you truly want to try that sort of thing). The once-a-day pricing of mutual funds and the fees many mutual funds charge if shares are held for a short period of time make mutual funds a poor choice for an active trader.

### THE LOW-COST ADVANTAGE

Although ETFs do have low costs, whether they result in lower costs when compared with an index fund will depend upon the investor's individual situation.

The costs of investing in ETFs are the commission cost to buy or sell shares, the annual expense ratio charged by the fund, and the bid-ask spread for the shares. (The bid-ask spread is the difference between the buying price and the selling price. If you were to buy a share and immediately sell it, the buying price would be higher than the selling price by a small amount. The difference compensates the dealer for standing ready to buy and sell.)

No-load mutual funds (which include most index funds) have no charge to buy or sell and no bid-ask spread. But the annual expense ratio for mutual funds is generally higher than for ETFs.

An investor needs to balance the commission cost and the bid-ask spread against the lower expense ratio to ascertain which option would be less expensive.

If you are an investor with a large sum of money to invest, you opt for an on-line broker with low commissions, and you keep your investment for a long period of time, the lower annual expenses are likely to outweigh the commission cost, and ETFs will be the right choice.

If you are investing a small amount on a regular basis, as you would if you are making monthly contributions to retirement savings, the commission costs of an ETF would be high enough to make a mutual fund a better choice.

To make the cost comparison more concrete, let's look at two investors who want to invest in a total stock market fund.

Sarah has \$63,000, which she plans to invest for five years. Sam will invest \$10,000 now and an additional \$300 per month for the next five years. Both have accounts at on-line brokers with a flat commission of \$7 per trade. Each expects to earn 8 percent on their investments.

Using a tool provided by the investment company the Vanguard Group on its Web site to compare its ETFs with its index funds, I calculated the cost of Vanguard's Total Stock Market ETF and compared it with the cost of Vanguard's Total Stock Market Index Investor Shares. The expense ratio for the ETF is 0.07 percent compared to the index fund expense ratio of 0.15 percent. In addition, the ETF has a bid-ask spread of \$0.05 per share.

For Sarah, with her large investment and only two trades, the ETF is cheaper. The total cost of investing in the ETF is \$307.12 compared to \$574.01 for the index fund. For Sam, with his many small trades, the index fund is cheaper, with a total cost of investing of \$165.50 compared to a total cost for the ETF of \$512.32.

Remember, if you are thinking of investing in either an ETF or an index fund, you should know the costs of your funds. A quick ranking of large-cap ETFs found expense ratios that ranged between a low of 0.07 percent and a high of 1.12 percent. A similar ranking of large-cap index funds found a range of expense ratios from 0.09 percent to 2.25 percent.

Also, many fund families offer special classes of lower-cost shares to larger investors. For example, if Sarah had \$100,000 to invest, she could buy Admiral Shares of the Vanguard Total Stock Market Index Fund. With an expense ratio of 0.07 percent, the same as the ETF, and no commission fees or bid-ask spread, the index fund in these shares would be cheaper.

### **BEING TAX EFFICIENT**

ETFs may give an investor greater control over when capital gains will be realized. Both mutual funds and ETFs are conduits of income so that any capital gains realized by the fund are passed through to the investor in the year in which they are received by the fund. This is why you may

receive a 1099 tax form from a fund showing capital gains even though you never traded shares in the fund.

ETFs generally hold the shares in the index they follow. They do little trading so they don't realize capital gains. Any capital gains that have been made will be realized when the investor sells the ETF shares.

This is a significant advantage of ETFs over actively managed funds where the turnover rate is high. Index funds also do little trading and are tax efficient, so the ETF advantage is less.

For all types of funds, interest and dividends are passed through to the investor. Many investors prefer to reinvest such interest, dividends, or capital gains. Not all ETFs allow reinvestment, so investors who want this may need to make arrangements with their brokerage firm. Some brokers will reinvest the money without added fees.

### **BEWARE SPECULATION**

So when does it make sense to use ETFs?

If you have a large taxable account and trade infrequently, the tax efficiency and low expense ratio may outweigh the commissions. If you want to use ETFs as part of a trading strategy, the continual pricing and ability to sell short and place limit orders may make ETFs the right choice.

If you are making small purchases on a regular basis, the commission costs for each purchase of ETFs make no-load mutual funds a better bet. Particularly if you are investing within a tax-deferred account like an Individual Retirement Account where you are investing for the long term, a low-cost index fund would meet your needs.

Remember at the beginning I said that ETFs allow investors to time purchases and sales in response to price changes during the day.

In considering ETFs, you need to think hard about if this is something you really want to do. I believe in indexing. I don't think you can time the market. I believe that active trading is expensive and counterproductive.

It makes sense to look at ETFs as a low-cost alternative to index funds. But the use of ETFs in active trading strategies and the proliferation of specialty ETFs can make them tools of speculation—not investing.

There is nothing intrinsically wrong with speculating. As an economist, I know that speculators help make the market work.

But consider carefully: Do you really want to be speculating for your retirement? Wouldn't you rather be investing?

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*Patricia M. Rudolph is a Certified Financial Planner professional and a member of the fee-only Garrett Planning Network. Her Web site is [www.rudolphfinancialplanning.com](http://www.rudolphfinancialplanning.com), and she may be contacted at [pat@rudolphfinancialplanning.com](mailto:pat@rudolphfinancialplanning.com).*