Mutual Funds or ETFs--Which to Choose?

Traditional open-end mutual funds have long been the staple of many investors' portfolios. Over the past 20 years, however, an alternative has emerged--exchange-traded funds. While ETFs have been around since the early 1990s, their popularity has soared in recent years, and they are being used by more and more brokers and financial advisors. In addition, ETFs are popping up in company retirement plans.

ETFs, like conventional mutual funds, hold a basket of securities (stocks or bonds). The primary difference is how the investor buys and sells his or her shares. Whereas investors in conventional mutual funds buy their shares from a fund company and sell them back to the fund shop when they want to redeem, investors buying or selling ETF shares must trade with other investors in the market, much as they would do if they want to buy or sell shares of Microsoft. For that reason, individual investors must use a broker when they want to buy and sell ETF shares.

As the name suggests, exchange-traded funds are priced and traded on an exchange (for example, NYSE or Nasdaq) throughout the day just like stocks. In contrast, traditional mutual funds' prices are set once a day (usually 4 p.m. Eastern) and investors must place their orders before that time in order to get that day's price. Also unlike mutual funds, you can do just about anything with ETF shares that you can with a stock, including setting market and limit orders, shorting, and buying on margin.

So, how do you tell whether an ETF or a conventional mutual fund is best for you? Here are some things to consider:

What You Want to Invest In

ETF providers have increasingly aimed to provide funds for investors looking to invest in a narrow market segment. The ETF universe is flush with funds that focus on a single market sector, industry, or geographic region. Say you favor indexing and want to own a specific corner of the market such as biotech. There may not be many index mutual funds that track those sectors--but there are ETFs that do. Also, there are many more ETFs than funds that track single foreign countries. Exchange-traded funds offer investors a way to invest in a corner of the market without having to load up on just one or two individual stocks (plus, it's more cost-efficient in terms of brokerage commissions).

However, it's also worth noting that narrowly focused funds--whether ETFs or conventional offerings--can be too hot to handle for many investors. That's because investors are often inclined to buy and sell narrowly focused funds at inopportune times, as evidenced by Morningstar Investor Return statistics.

That's not to say that focused ETFs can't be used intelligently, however. For example, ETFs may trade at discounts to the aggregate value of their holdings. If you're inclined to invest in more-focused ETFs, it often makes sense to be a contrarian, not to chase what's been hot recently.

Taxes

ETFs are also structured to shield investors from capital gains better than conventional funds. Currently, nearly all ETFs are index funds, so they typically trade less than most actively managed funds and should generate fewer taxable capital gains. Also, because most investors buy and sell ETF shares with other investors on an exchange, the ETF manager doesn't have to worry about selling holdings--thereby triggering capital gains--to meet investor redemptions. Moreover, because the big institutions can make share redemptions "in-kind" (rather than redeem shares for cash, the ETF gives the institution a basket of stocks equal in value to the share redemption), ETFs can unload their lowest-cost-basis stocks in the portfolio, thereby reducing their capital gains exposure.

Costs
Because ETFs don't have to manage hundreds of customer accounts or staff call centers, they have lower overhead charges that translate into lower expense ratios. However, you will pay brokerage commissions to buy and sell ETF shares, and the costs of rapid--or even occasional--trading can more than offset the initial advantage of an ETF's lower expense ratio. For those reasons, an ETF will be the most cost-effective choice for those who use discount brokers, invest a large lump sum of money, and are willing to hold the investment for the long term. For others, an exchange-traded fund may not have a big cost advantage over a plain-vanilla, low-cost index fund.

Special Situations
ETFs may also be a suitable option for areas of the market where traditional mutual fund offerings are scarce, expensive, or run by managers with little experience. As in choosing traditional index mutual funds, it's best to evaluate an ETF's fees and the usefulness of the benchmark it tracks before buying in.

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