ETFs? Here's What You Should Know

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Investing in stocks and bonds has become easier and easier over the years. First, there were mutual funds, then index funds. Now, exchange-traded funds are all the rage.

In fact, you could do all your investing with the 1,000 or so ETFs, most of which use index-style strategies rather than active management. It's very easy, taking just a few clicks of a mouse with your online-broker—just like trading a stock. Fees are extraordinarily low, and ETFs can be very kind come tax time.

So why not buy a few ETFs and let it go at that? Many financial advisors indeed like ETFs, but caution they are not perfect for all occasions. Like mutual funds, ETFs pool investor assets and buy stocks or bonds according to a basic strategy spelled out when the ETF is created. But ETFs trade just like stocks, and you can buy or sell anytime during the trading day. Mutual funds are bought or sold at the end of the day, at the price, or net asset value (NAV), determined by the closing prices of the stocks or bonds owned by the fund.

Because they trade like stocks, ETFs can be sold short, a way of profiting if the ETF price drops instead of rises. And many ETFs have related options contracts, which allow investors to control large numbers of shares with less money than if they owned the shares outright. Short selling and options are not available with mutual funds. This difference makes ETFs better for day-traders betting on short-term price changes of entire market sectors. For long-term investors, these features don't matter.

Most ETFs are index-style investments, similar to index mutual funds. That means the ETF simply buys and holds the stocks or bonds in a market gauge like the Standard & Poor’s 500 stock index or Dow Jones Industrial Average. Investors therefore know what securities their fund holds, and they enjoy returns matching those of the underlying index. If the S&P 500 goes up 10 percent, your SPDR S&P 500 Index ETF (SPY) will go up 10 percent, less a small fee. Many investors like index products because they are not dependent on the talents of a fund manager who might lose his touch, retire or quit.

While the vast majority of ETFs are index investments, mutual funds come in both flavors, indexed and actively managed, which employ analysts and managers to hunt for stocks or bonds that will generate alpha—return in excess of a standard performance benchmark. So investors really face two issues: Should they choose actively managed funds over indexed products? If they prefer indexed ones, are ETFs preferable to mutual funds?

Active Management

Many studies have shown that over time, most active managers fail to beat their comparable index funds and ETFs, because picking market-beating investments is very hard. Also, managed funds must charge larger fees, or "expense ratios," to pay for all that work. Many managed funds have annual charges as high as 1.3 percent to 1.5 percent of assets in the fund. In contrast, the Vanguard 500 Index Fund (VFINX), a mutual fund, charges just 0.17 percent. And the SPDR S&P 500 Index ETF just 0.09 percent. "Over the long term, taking into consideration costs and taxes, active management does not outperform indexed products," said Russell D. Francis, an advisor with Portland Fixed Income Specialists in Beaverton, Ore.

Active management is worth paying for only if returns (which account for the fees) beat those of the comparable index products. And the investor must be convinced the active manager won through skill, not luck. "A simple way to answer this question is to look at the managers' track record," said Matthew Reiner, a financial advisor with Capital Investment Advisors of Atlanta. "Have they continuously been able to outperform the index? Not just over one year, but three, five, 10 years?" In looking at that track record, be sure the long-term average has not been skewed by just one or two extraordinary years, as spikes are often due to sheer luck, cautioned Stephen Craffen, a partner with Stonegate Wealth Management in Fair Lawn, NJ.

Some financial advisors believe that active management can beat indexing in fringe markets, where a small amount of trading and a shortage of analysts and investors can leave bargains undiscovered. "I think there are areas of the market that active management may be beneficial," Reiner said, citing international bonds. Others favor active management for high-yield bonds, foreign stocks or small-company stocks. Christopher J. Cordaro, an advisor with RegentAtlantic of Morristown, N.J., said active management can be especially valuable with bond funds. "Active bond managers can avoid areas of the bond market that may be overheated," he said. "They can shorten maturities to reduce interest rate risk." That's the risk that older bonds with low yields will lose value if newer bonds are more generous—a widespread concern today. "The time I want active management is when risk is elevated," Cordaro said.

For stocks and bonds that receive heavy scrutiny, like those in the S&P 500 or Dow, it is much more difficult for active managers to find bargains, because so much is so widely known about these securities.

Many experts therefore suggest that index investments make up the core of the small investor's portfolio, since the core is typically invested in widely traded, well-known securities. Indexed products are especially good in taxable accounts because their buy-and-hold style means they don't sell many of their money-making holdings. That keeps annual "capital gains distributions"—a payout to investors late in the year—at an absolute minimum. Actively managed funds, because they do lots of selling in the pursuit of the "latest, greatest" stock holdings, can have large payouts, which produce annual capital gains taxes.

ETFs Vs. Index Mutual Funds

So if indexing is for you, are ETFs better than indexed mutual funds?

In the past few years, ETFs have moved into some very narrowly defined markets focused on very small stocks, foreign stocks and foreign bonds. While advocates think bargains can be found in esoteric markets, ETFs in thinly traded markets can be subject to problems like "tracking error," when the ETF price does not accurately reflect the value of the assets it owns, said George Kiraly, an advisor with LodeStar Advisory Group in Short Hills, N.J.

"Tracking large, liquid indexes like the S&P 500 is relatively easy," he added, "and tracking error is essentially zero for those ETFs."

Therefore, if you see worrisome discrepancies between an ETF's net asset value and price, maybe you should look for a comparable index mutual fund. This data is available on fund tracker Morningstar's ETF pages.

The biggest issue in the ETF versus traditional mutual fund battle is the broker's commission you pay with every purchase and sale. Many actively managed mutual funds carry "loads," which are upfront sales commissions, often 3 percent to 5 percent of the investment. With a 5 percent load, the fund would need a significant gain before the investor could sell for enough to break even.

ETFs, however, can also rack up fees when used with certain investing strategies. If you are employing a dollar-cost averaging strategy to mitigate the risk of investing during a big swing in the market—investing, say, $200 a month—those commissions would add up, even if they were only $8 or $10 each at a deep-discount online brokerage. You'd also pay commissions when you made withdrawals in retirement, though you could minimize that by taking out more money on fewer occasions.

"Because of transaction costs, ETFs don't work well for a dollar-cost averaging plan," Kiraly said. ETF fees do tend to be lower. And although index mutual funds have small annual distributions and low taxes, comparable ETFs sometimes have even smaller distributions.

So, for investing a large sum in one block, an ETF may be the cheaper choice. For piecemeal investing every month, the index mutual fund could be the better option.

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