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# Should You Trade in Mutual Funds for Exchange Traded Funds?

BY THOMAS C. CORLEY, CPA, CEREFICE & COMPANY

Exchange traded funds (ETFs) are quickly becoming the new darlings of Wall Street. The first U.S. ETF was the Standard & Poor's (S&P) Depository Receipt, or "spiders," which was introduced on the American Stock Exchange in 1993. Their popularity rapidly increasing, ETFs grew from 100 funds at the beginning of 2006 to more than 400 funds by the end of that year.

## Just What Are ETFs?

Originally designed to compete with index funds, ETFs are similar to a mutual fund in that each share gives the investor a small piece of the numerous companies held in the fund. Similar to an index mutual fund, an ETF is a type of investment company that invests its funds in stocks that mirror some particular market index, such as the S&P 500 or the NASDAQ 100.

The ETF fund's portfolio of public company stocks is packaged into creation units, which are then sold to large investors (e.g., institutional investors) in the primary market. These institutional investors then divide the creation units into smaller shares, which are then sold as ETF shares to smaller investors on the secondary market. All ETFs seek to achieve the same returns as the particular market index it mirrors. For example, spiders invest in all of the stocks contained in the S&P 500 Composite Stock Price Index.

## Categories

ETFs can be grouped into four basic categories: (1) broad-based; (2) fixed-income; (3) international; and (4) sector ETFs. Broad-based ETFs follow specific index styles, such as growth, value, small-cap, mid-cap or large-cap indexes. Fixed-income ETFs track indexes for corporate and treasury bonds. International

ETFs track indexes for foreign countries or global regions, such as Asia or South America. Sector ETFs track indexes for specific industries, health care being one.

## Benefits

Investors are drawn to the low expense ratios of ETFs compared to those of mutual funds. An ETF typically charges from 0.1 to 1 percent, whereas mutual fund fees can range from 1 to 3 percent.

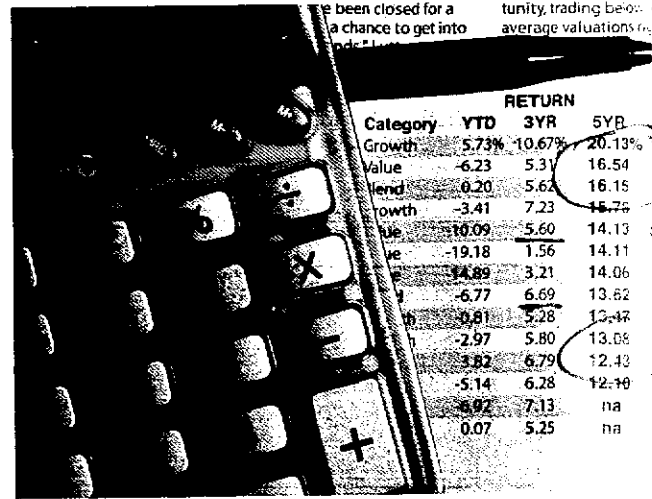
ETFs also have a much lower turnover ratio compared to traditional mutual funds. This lower turnover ratio means less capital gains distributions to investors, and thus lower taxation. ETF investors generally only realize capital gains when they sell their ETF shares. As such, ETFs are considered tax-efficient investments.

Because ETFs trade just like stocks, their stock-like features include the ability to sell short, use stop-loss orders or buy on margin. ETFs also have the capability for options to be written against them. Another important point is that ETFs are more liquid than mutual funds. ETFs trade throughout the day, whereas mutual fund investors can only purchase or sell units at the end of the day.

ETFs can also minimize market risk by allowing a broad investment opportunity. Imagine having the opportunity to invest in 3,000 companies at once. The entire U.S. economy would have to suffer a disaster to negatively impact your ETF investments.

## Downsides

While ETFs may appear to be an ideal investment, there are some disadvantages. Like stocks, ETFs charge



a commission every time an investor buys or sells an ETF. Commissions make ETFs somewhat unattractive, due to their high cost. One of the biggest advantages of mutual funds is the ability to buy and sell them without incurring any commissions.

ETFs often trade their shares more rapidly to maintain a higher cost basis of their underlying shares, and this can result in ETF dividends failing to be treated as qualified dividends. Qualified dividends have a low, 15-percent tax rate.

Individuals work hard for their money and rely on their financial advisors to provide them with as much upside potential as possible while limiting the downside. ETFs help both financial advisors and their clients sleep better at night by offering diversification, liquidity and tax efficiency like no other investment vehicle. ☒

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