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Index funds versus exchange-traded funds

Q. What's the difference between an index fund and an exchange-traded fund?
— Trying to learn

A. We love when investors want to learn more. It's your money, so you should understand an investment before you buy. Let's start with the definition of a mutual fund, which is the common denominator between the two investments you've asked about. A mutual fund is a pool of money from many investors that invests in a portfolio of securities, said Jeff Rossi, a certified financial planner with Peak Wealth Advisors in Holmdel.

"Mutual funds issue redeemable shares to each investor that are priced based on their Net Asset Value (NAV)," Rossi said. "The Net Asset Value is the total value of all of the securities in the portfolio, divided by the total shares issued." So if you own shares of a mutual fund, it's equivalent to owning a proportionate amount of the securities held within the portfolio, he said. Rossi said a mutual fund portfolio can be managed actively, which means the portfolio manager is buying and selling securities based on criteria established by the fund and listed in their prospectus. A portfolio manager's primary goal is to seek out investment opportunities that help enable the fund to outperform its benchmark.

Mutual funds can also be managed passively, which occurs when a portfolio manager manages the portfolio to track a specific index, such as the S&P 500 or the Russell 2000. A passively managed mutual fund that tracks an index is an index fund, Rossi said. Exchange-traded funds (ETFs) are set up a bit differently, but they can also track an index, Rossi said.

"ETFs are also portfolios of securities, and they can be actively and passively managed — most are passive — but they're packaged so that they trade on the stock market, as opposed to mutual funds that provide redeemable shares," Rossi said. "ETFs have a Net Asset Value which is calculated the same way as a mutual fund, but since the shares are bought and sold on the stock exchange, their price can be slightly different than their NAV." Mutual funds, including index funds, are traded when the market closes and all securities held in the fund have been priced, unlike individual stocks, which are traded throughout the day.

"This lack of liquidity and inability to trade intra-day was the driving force behind the creation of the first ETF in 1993, which was based on the S&P 500," said **Claudia Mott, a certified financial planner with Epona Financial Solutions in Basking Ridge**. "ETFs must be listed on a major stock exchange and can be bought and sold throughout the trading day just like a stock." Mott said investors will see quotes for both the "bid" (selling price) and "ask" (purchase price), as well as the trading volume for that day. She said investors of all types have found this trading flexibility to be an incredibly attractive feature of ETFs. "Since 1993 over 1,400 ETFs have been created," she said. "Many are no longer strictly designed to follow a broad index but may track a particular economic sector or an investment strategy." Index funds and ETFs that invest in the same index could hold very similar if not identical investments, but there are still differences.

Let's start with the cost to investors.

"While it is often stated that ETFs are cheaper than mutual funds, that is not typically the case when comparing index fund products," Mott said. "Index-oriented ETFs are likely to have lower expense ratios than actively-managed mutual funds, especially those that carry upfront loads or have 12-b1 fees."

Then there's the tax efficiency of the investment. Mott said the tax efficiency of ETFs comes from the way capital gains are handled within the fund. Dividends and interest are taxed in the same way regardless of whether an investor purchases a mutual fund or an ETF, she said. "Mutual fund managers create capital gains that are passed on to their investors when they have to sell securities to meet redemptions or rebalance the fund's holdings," Mott said. "Because an ETF is like a stock, there are no redemptions that occur if a large number of investors sell their holdings." But, she said, if a security in an ETF needs to be sold, and in-kind exchange can be used to minimize the capital gain. When an investor sells a mutual fund or ETF, they may incur another form of capital gain — either short or long term, if their security has appreciated from the time it was purchased, Mott said. The calculation of this gain is no different between the two investments.

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