ETFs v. Mutual Funds: The Long Term Impact of Fees and Compounding

By: Don Freeman

ETFs (exchange traded funds) have been available for a relatively short period of time compared to mutual funds, and investors are discovering that they have certain benefits. One of these benefits is the generally lower costs and fees they enjoy, see Figure 1.

ETFs	Mutual Funds
Trade during trading day	Trade at closing NAV
Low operating expenses	Operating expenses vary
No investment minimums	Most have investment minimums
Tax-efficient	Less tax-efficient
No sales loads	May have sales load

Figure 1 Differences between ETFs and mutual funds

ETFs were introduced to the US market in 1993, and developed in Europe in 1999. Only large institutional investors buy directly from the fund management, and individual investors buy them on a stock exchange, hence their name. **The purpose of an ETF is to provide investors with the means to buy a diversified selection of shares at low cost**, trading as they would in individual shares. ETFs are often organized to reflect the value of a particular market index, and this means they need less active management than many mutual funds. In fact, it was only in 2008 that the Securities and Exchange Commission (SEC) authorized ETFs to go beyond their traditional role as index funds, and allowed them to become actively managed.

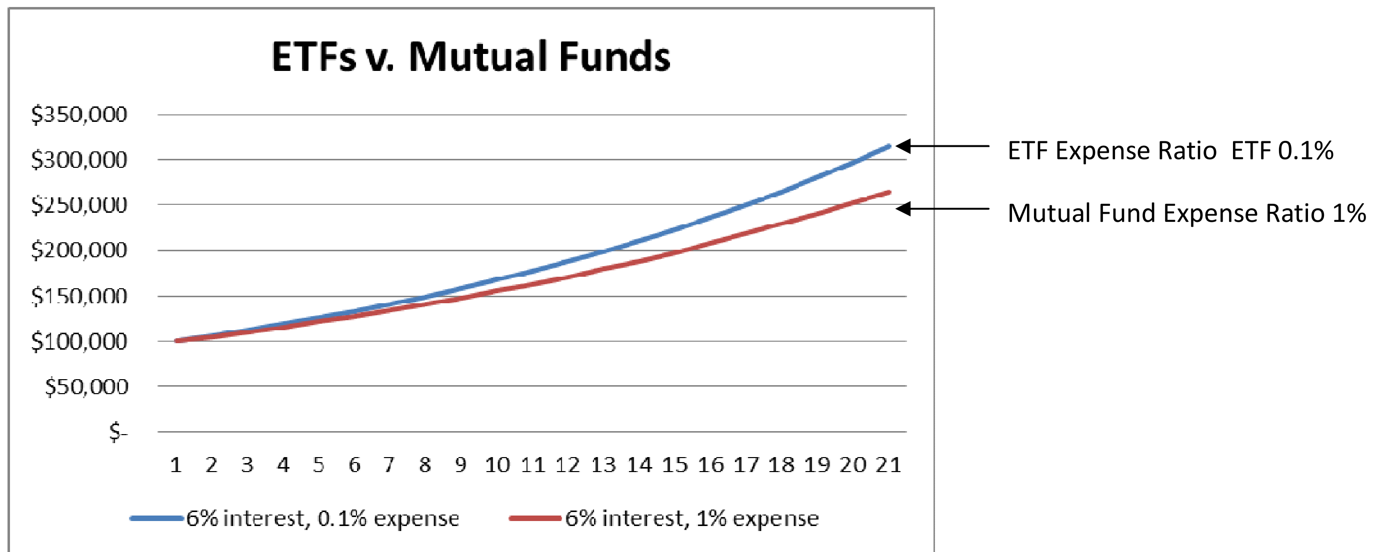
In contrast, mutual funds lay great store on the quality of their managers, and use this as a selling point, pointing to past performance. It's an inevitable fact of life that a managed mutual fund must include costs to pay for the management, and this is the built-in disadvantage that mutual funds cannot evade. When you consider that only one-third of equity mutual funds equal or beat their particular stock indices, you may start to wonder whether it is worth paying for the privilege of a mutual fund manager. (*Source: Standard & Poor's Index Versus Active*)

You may know that, statistically, there is no point in choosing a mutual fund that charges a "load" or fee in order to buy into it. This type of fund used to be the most common, but investors have got wise to this fee which handicaps your investment at start, and they usually select a no-load fund. Most investors also know to check that there is no backend load or redemption fee when they leave the fund.

But even if you minimize these administrative charges, you are still left with an ongoing expense ratio that is charged every year that you have the mutual fund. With an actively managed fund,

even the largest, where they have economy of scale, will charge around 1.5% per year and it is not unusual for the expense ratio to be 2.5%. The expense ratio on an ETF may be one-tenth of this because there is little or no active management required – for example, the expense ratio for the iShares S&P 500 ETF is 0.09% per year.

If you have only short term requirements for your funds, this difference may not mean much, but if you intend to keep the investment for some years, you will find that the loss of income or capital growth starts becoming significant because of compounding.



Here's an example. This simple chart shows the results of investing $100, 000 in two funds, both of which yield 6% per year. The only difference is the blue line shows an expense ratio of 0.1%, and the red line has a ratio of 1%, which is the best you are going to get from a managed fund such as a mutual fund. You can see a difference of over $50,000 after 20 years, that's half of your initial investment!

This comparison assumes that you are not paying any loads or other charges, and that the mutual fund is keeping up with the index ETF fund, which as stated above the majority of mutual funds do not.

It clearly demonstrates the important lesson that even a regular charge which sounds small can seriously affect your investment performance. The power of compounding clearly demonstrates the importance of selecting investments with low fees. Not only do ETFs have lower fees but they are transparent, can be bought throughout the day and can be used to diversify across many different asset classes.

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