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ETF vs Index Mutual Fund: Which One's Better?

ETFs and index mutual funds are very similar, but a few small differences can mean a lot to investors.

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Investors who are just getting their feet wet in the stock market are often told that the simplest way to start investing is to buy an index fund or ETF (short for "exchange-traded fund"). But that's not very helpful if you don't know the difference between an index fund and an ETF.

First off, people often use "index fund" and "ETF" interchangably. That's because most ETFs track an index, and when people refer to ETFs, they're generally referring to index-tracking ETFs. And when people talk about index funds, they could be referring to either an ETF or a mutual fund that tracks an index.

This article compares the subtle differences between index-tracking ETFs and index-tracking mutual funds.

Deciding which is better -- an index ETF or an index-tracking mutual fund -- will vary from person to person. Here are some quick factors to consider:

- ETFs usually have lower investment minimums than index mutual funds, lowering the barrier to entry for beginner investors.
- ETFs usually have expense ratios less than or equal to comparable mutual funds.
- ETFs trade like stocks in that investors can buy and sell shares on the open market throughout the day. Index mutual funds trade once per day, after the market closes, so investors have less control over the price at which they buy or sell shares.
- ETFs can be more tax-efficient than index mutual funds.
- Index mutual funds don't require investors to pay a commission to a brokerage company, but ETFs do. (Some brokers offer a limited set of commission-free ETFs.)
- Index mutual funds allow investors to buy a set dollar amount of the fund on a regular basis. ETFs require investors to buy whole shares, making the process a bit more difficult and leaving at least some cash unused.
- Index mutual funds allow shareholders to reinvest their dividends automatically, commission free. ETFs don't usually offer that service, and if they do, they're less efficient.

We'll take a deeper dive into the differences between ETFs and index mutual funds soon. First, we need to define what exactly an index mutual fund and ETF are.

Both ETFs and index mutual funds track indexes

Index mutual funds and ETFs are both designed to track the performance of an index. An index is a group of securities investors use to describe how the stock market's performing. Indexes typically use a weighted average of all the securities in the group to generate a value called a level.

The level is not the same as a price. You can't actually buy shares of an index like the S&P 500 or Dow Jones Industrial Average. It's just a weighted average of different stock prices.

If you want to mimic the performance of an index, you'd have to buy shares of each individual company listed in the index in the exact amounts specified by the index. That can really start to add up when you take into account the costs of commissions and having to buy whole shares of each stock. The Wilshire 5000 index, for example, has nearly 3,500 individual stocks listed.

Index mutual funds and ETFs do the legwork for you, purchasing exactly the number of shares of each company that it takes to recreate the index's weighting. They also use scale to minimize the costs associated with buying and selling stocks. To cover the costs of managing the portfolio, index mutual fund and ETF companies charge a small fee known as the expense ratio. That's the percentage of assets under management (i.e., the total amount a shareholder has invested in the fund) investors pay to the index mutual fund or ETF company.

Whenever an investor buys a share of an index mutual fund or ETF, they're buying a portion of the underlying portfolio. That way investors can get by with owning partial shares of each individual security, making it much more affordable than trying to match an index on your own.

Both index mutual funds and ETFs makes it easy for investors to match the performance of their specified index. There are lots of indexes for investors to choose from, and which one is right for you depends on a lot of personal factors, including your investment goals and tax planning strategy.

The main differences between ETFs and index mutual funds

Index mutual funds are just a special type of mutual fund. Mutual funds have a portfolio manager who determines which stocks and bonds to buy and what to sell. Those that are actively managed put faith in the portfolio manager to make buy and sell decisions with the expectation that they will outperform their benchmark market index over time.

Index mutual funds are passively managed; the holdings won't change unless the index changes. In that way, index mutual funds simply try to meet the index's performance.

While actively managed mutual funds may sound appealing -- who wouldn't want a professionally managed portfolio? -- consider that they typically come with much higher expense ratios than index mutual funds. Those high expense ratios often wipe out any excess returns the portfolio manager is able to produce. In fact, most actively managed mutual funds underperform their benchmark indexes over time when including expenses.

Mutual funds collect a pool of money and issue shares to their investors. The shares themselves represent a proportional stake in the underlying fund portfolio.

Most mutual funds in the United States allow shareholders to redeem shares for cash at the end of every day for their net asset value -- the combined value of all the underlying stocks or bonds represented by the redeemed shares. They'll also create new shares as investors pool more money. That means most mutual funds, including index mutual funds, have to face buy and sell decisions every day based on the money flowing into or out of the fund.

ETFs, or exchange-traded funds, look a lot like index mutual funds except they trade on an exchange just like a stock or bond. Shares can be created when a broker/dealer acquires all of the underlying assets in the fund themselves and exchanges them directly with the ETF company for shares of the ETF. Shares can be redeemed in the same way -- the ETF company will exchange all the underlying assets to retire shares of the fund.

The fund itself isn't in charge of buying or selling the underlying securities when assets flow into or out of it. That eliminates a lot of the capital gains considerations for ETF managers, making ETFs more tax-efficient than index mutual funds.

Advantages of ETFs over index mutual funds

ETFs have several advantages over index mutual funds.

Tax efficiency

ETFs, as mentioned, are generally more tax-efficient than index mutual funds. Since an ETF is sold on an exchange, that means there has to be a buyer for every share sold. The fund itself never has to redeem shares for cash.

When a broker/dealer wants to redeem shares for the underlying assets, the manager can exchange securities with the greatest amount of capital appreciation, taking the potential tax liability off the books. ETF investors probably won't have to worry much about capital gains taxes at all while they're holding shares. Taxes only come into the picture when they sell shares, at which point they may have to pay taxes on any capital gains made on the investment.

That said, index mutual funds are also incredibly tax-efficient. They can be managed in such a way that capital gains are practically eliminated as well, but they generally come with a higher expense ratio than an ETF tracking the same index.

Lower expense ratios

Indeed, another advantage of ETFs over index mutual funds is that they typically have very low expense ratios. Expense ratios are typically lower than those of comparable index mutual funds, even from the same fund company.

The Vanguard 500 (NASDAQMUTFUND:VFINX), an index mutual fund tracking the S&P 500 from Vanguard, has an expense ratio of 0.14%. The ETF version, **Vanguard S&P 500 ETF** (NYSEMKT:VOO), has en expense ratio of just 0.04%. Vanguard does offer an option, a class of the mutual fund called Admiral Shares, that offers the same expense ratios as the corresponding ETFs, but require a $10,000 minimum investment.

Lower minimum investments

Minimum investment is another area where ETFs typically trump index mutual funds. Many index mutual funds require you to invest a minimum amount just to get started. ETF investors can start with just one share of an ETF, which might not cost very much at all. It's certainly a lot less than the thousands of dollars required to invest in many index mutual funds.

Granted, there are index mutual funds available with small minimum investment requirements. These funds typically track a broad market index and are very popular. They may be suitable for beginner investors, but investors looking to invest a small amount in specific sector indexes will likely have a hard time finding index mutual funds with low minimum investment requirements.

Greater liquidity and flexibility

Since exchange-traded funds are traded on an exchange throughout the day, they have much greater liquidity than index mutual funds. Investors can buy or sell shares all day, whereas index mutual fund trades are all settled in bulk at the end of the day at the net asset value of shares at the market close. If the underlying assets tank in price mid-day but come back by the end of trading, there's no way for index mutual fund investors to capitalize on that drop.

ETFs also offer more flexible investment options since they're traded on an exchange. Investors can put in limit and stop orders. They can use margin accounts to trade shares, and they can even buy options contracts on ETFs.

Advantages of index mutual funds over ETFs

index mutual funds have their own advantages, which will likely appeal to many investors.

No commissions

Index mutual funds don't require investors to pay a commission to invest in the fund. Instead, banks make money from the expense ratio.

ETFs, on the other hand, often require investors to pay a broker to execute a trade for them. That can make ETFs more expensive than index mutual funds despite their lower expense ratios, especially if an investor wants to invest a small amount every month.

An ETF investor who wants to invest about $500 in the same fund every month but pays a $5 commission on every trade is essentially paying a 1% fee right off the bat for their investment. That said, this "fee" will drop as the investor's stake in the ETF grows.

If the ETF has a lower expense ratio than a comparable index mutual fund by 0.1 percentage points, then it would still take an average holding time of 10 years for the ETF investor to recoup the cost of commissions. The more money you invest at once, and the longer you hold an ETF, the less impact commissions have on your investment.

Many big brokers offer a list of commission-free ETFs. While investors won't have to pay any additional fees to trade these funds, picking from the short list of commission-free ETFs at your broker can limit your options and result in suboptimal fund selection.

Invest in dollars, not shares

Index mutual funds have no problem issuing shareholders partial shares. So if you want to invest $500 per month in an index mutual fund, you can be sure the entire amount will be fully invested.

ETFs require investors to buy whole shares on the exchange, so if you can only afford to invest a fixed amount of money each month, you'll always have a little bit of cash left uninvested. That could mean you would earn better overall returns by investing in index mutual funds rather than ETFs. Some brokers may allow you to buy partial shares of ETFs if you agree to invest a certain amount every month, though.

Automatically reinvest dividends

Index mutual funds allow shareholders to automatically reinvest dividends paid out by the fund back into more shares. Since mutual funds keep their own records, investors who opt to reinvest their dividends will see transactions happen the same day the dividend is paid out.

ETFs don't always offer dividend reinvestment options. Some ETFs offer a DRIP, and some brokers will handle dividend reinvestment for their clients as well. Still, ETF investors will have to wait for dividend payments to settle in their brokerage account before they're reinvested, which means waiting an extra three days. That means an ETF won't track the index as efficiently if you're reinvesting dividends.

What are your priorities?

Each person is in a different situation. Investing $100 may be a big commitment for one person, while another may be able to easily plunk down $10,000 to start investing in ETFs or index mutual funds. As such, you'll have to consider your priorities when it comes to investing.

If you want to minimize taxes

The easiest way to minimize taxes on your investment accounts is to invest in tax-advantaged retirement accounts like an IRA or 401(k). If you're only investing in tax-advantaged accounts, you don't need to worry about the capital gains taxes incurred by index mutual funds or ETFs when portfolio managers change their holdings. (You don't need to worry about capital gains when you sell shares for a gain or loss in tax-advantaged accounts, either.)

Furthermore, the tax differences between index mutual funds and ETFs are very minimal. The tax advantages of ETFs over index mutual funds shouldn't be the only factor you consider when deciding between the two types of funds.

If you only have a little to invest

ETFs offer one of the cheapest ways to start investing. With just a few dollars, you can buy a share of an ETF with your broker.

That said, there are some index mutual funds that allow you to get started with as little as $1. The **Schwab S&P 500 Index Fund** (NASDAQMUTFUND:SWPPX), for example, requires just $1 to get started, and it has an extremely low 0.03% expense ratio to boot.

If you do some homework, you may be able to find a suitable index mutual fund with a low minimum investment. Even if you decide ETFs offer better options, you may consider switching from an ETF to an index mutual fund as you meet minimum investment thresholds, especially if you're investing in a tax-advantaged account and won't incur any capital gains taxes from selling shares. Index mutual funds usually offer a more efficient way to track an index and keep all your cash invested.

If you want to set it and forget it

If you want to automate your investing as much as possible, index mutual funds offer a lot more capabilities than ETFs. You can set up an automatic investment program with your a mutual fund company to automatically invest a certain dollar amount every month, quarter, or year. The mutual fund company will automatically withdraw funds from your bank account and invest them in your pre-selected index mutual fund(s). You don't have to worry about buying whole shares.

You *might* be able to automate regular ETF investments through your broker, but most brokers won't allow you to set up an automatic investment program like index mutual funds. Those that do are unlikely to offer commission-free ETFs, which means those commission fees will eat into your returns, especially if you're investing a relatively small amount at fixed intervals.

If you want to be a trader

If you want to trade in and out of certain indexes and use leverage and options to help maximize your returns, then ETFs are your only choice. Index mutual funds are extremely limited in how they're bought and sold.

But most investors, especially beginners, aren't interested in using index mutual funds as instruments to try to beat market returns. They're just looking for a simple way to buy and hold the underlying assets and match the index's long-term performance.

Index mutual funds are probably better for most beginner investors

The advantages of ETFs over index mutual funds are often easily overcome with a little extra research. Most investors should be investing in their tax-advantaged accounts first, negating the tax advantages of ETFs. It's also possible to find index mutual funds with low minimum investments and low expense ratios. And for investors just looking to buy and hold, the ability to buy and sell ETFs throughout the day isn't important.

In fact, that last point can help index investors avoid acting irrationally. The index mutual fund company won't encourage you to sell your shares, but a broker might so they can make a commission. That's one reason why Warren Buffett and Jack Bogle both recommend index mutual funds over ETFs.

Meanwhile, ETFs' substitutes for features like commission-free and automatic dividend reinvestment are significantly weaker than the options available through index mutual funds. And the fact that most investors will have to manually make additional investments in ETFs leaves further room for them to be less disciplined than they would be if they set up automatic investments with an index mutual fund.

For most beginners, index mutual funds offer a better option than ETFs. There will always be exceptions, of course, and knowing what you're looking for when comparing the two -- expense ratios, commissions, dividend reinvestment options, etc. -- will help you make the right decision for your situation. If an ETF has a significantly lower expense ratio than the index mutual fund counterpart, for example, it's probably worth taking a closer look at your options for investing in the ETF. See if you can find a broker that has it on its commission-free ETF list.

Either way, you can't go wrong picking an index mutual fund or an ETF. Both are effective ways of matching the index you're looking to track and will get the job done.