Vanguard

Answering the Top 5 Questions About ETFs

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A few months ago, one of my colleagues and I participated in a webcast intended to demystify and simplify ETFs. (A replay of that webcast is available, if you're interested.) We always invite questions before and during these events, but we never expected to get *more than 6,000 of them*!

I live and breathe ETFs—which stands for "exchange-traded funds"—on a daily basis. It's my job, after all, as the head of ETF product management for Vanguard. But when you're immersed in something all day long, it's easy to forget that not everyone understands the same details you do. The questions we received were wide-ranging, thoughtful, and eye-opening.

It occurred to us that if our webcast viewers had these questions, it's likely that some of you do too. So we combed through them looking for trends and found that most fell into 1 of 5 categories. I'll do my best to answer those questions here. I'll also debunk a few myths along the way.

We're going to cover a lot of territory, but I hope you come out of this understanding that ETFs aren't that complicated and can be an appropriate investment option for just about any investor.

Which are better: ETFs or traditional index mutual funds?

When comparing ETFs with index mutual funds, there are only a few black-and-white differences. In most cases, you'll find them more similar than not. But sometimes, it simply comes down to personal preference—in an "it depends" kind of way.

Clear differences

- **If you need a lower investment minimum, ETFs are for you.** ETFs can be bought for the price of 1 share, typically ranging from $50 to a few hundred dollars. Meanwhile, most index mutual funds usually require an initial investment of $1,000, $3,000, or more.
- **If you depend on automatic transactions, index mutual funds are for you.** Mutual funds let you put investments, exchanges between funds, and withdrawals on a "set it and forget it" schedule. ETFs don't. If you're over age 70½, this includes required minimum distributions (RMDs) that you may want to automate from your IRAs.

Far more similarities

ETFs and traditional index mutual funds have more in common than you might expect. This assumes, of course, that you're doing a fair comparison between an ETF and a corresponding index mutual fund that *tracks the same index.* This is especially true when you're comparing Vanguard alternatives—for example, Vanguard Total Stock Market ETF (VTI) vs. Vanguard Total Stock Market Index Fund (VTSAX)—because most of our ETFs are structured as share classes of the same fund. So I'll stick with that specific comparison for a bit.

- **Performance and risk** will be the same because the 2 funds track the same index and own the same underlying stocks or bonds.

- **Underlying investments** will be an identical match. Keeping in mind that most ETFs follow an indexing strategy, index ETFs and index mutual funds are both designed for people who want to try to *match* market returns, not *outperform* them. This helps reduce the risk that your investments will *underperform*.

Debunking myth #1: Contrary to popular opinion, ETFs don't invest directly in the index (because that's not possible). Instead, ETFs and mutual funds both invest *directly in individual stocks or bonds*.

- **Investment options** are nearly the same. I say "nearly" because not every Vanguard ETF® has a Vanguard index mutual fund counterpart, and vice versa. For example, Vanguard doesn't currently offer any balanced ETFs—meaning, ETFs that commingle stock and bond investments. But when there are matches, they cover a wide variety of alternatives, which I'll address shortly.
- **Liquidity** is the same. You can get your money out just as quickly with either type of investment.

Debunking myth #2: Also contrary to popular opinion, ETFs ***aren't*** significantly more difficult to buy or sell than mutual funds, even in times of hour-to-hour and day-to-day market turmoil.

- **Tax efficiency** is about the same. Because the vast majority of ETFs track indexes—just like index mutual funds—they buy and sell their underlying stocks or bonds less frequently. That's a big contributor to fewer capital gains distributions and, therefore, lower taxes.

Debunking myth #3: You'll often hear that ETFs are more tax-efficient than mutual funds. In fact, when you compare *index* ETFs with *index* mutual funds, they're about the same. The confusion arises when comparing index funds with actively managed funds. Index funds—both as mutual funds and ETFs—come out on top for tax efficiency. So make sure you're comparing apples to apples.

- **Distributions** work the same way. Both types of investments distribute dividends and capital gains that come from the funds' direct ownership of individual stocks and bonds. Those distributions can then be reinvested or moved to your settlement fund to be used as income.
- **Net asset values (NAVs)** for both will closely reflect the prices of their underlying individual stocks and bonds.
- **Portfolio management** is identical between ETF and mutual fund shares of the same fund.

Debunking myth #4: Some investors have expressed concern that they're responsible for selecting and managing the individual stocks and bonds within an ETF. They're not! Just like mutual funds, ETFs are managed by experts who choose and monitor the stocks or bonds the ETFs invest in.

- **Trading** for ETFs and mutual funds can all be conducted through one brokerage account. The bonus? You can buy and sell every Vanguard ETF commission-free in a Vanguard Brokerage Account. (Commission-free trading of Vanguard ETFs® applies to trades placed both online and by phone. Learn more about other conditions & costs that may apply.)

Debunking myth #5: Some people think they're responsible for finding a buyer for their ETF shares. Not true. You buy and sell ETFs through a brokerage account, with no extra work on your part—similar to how you'd trade individual stocks.

What's left to personal preference?

If you want more transparency into and control over the price you pay or receive when you're buying and selling shares, you'll want to lean toward ETFs.

In addition to end-of-day NAVs, ETF shares are priced in real-time, based on both the supply and demand throughout each trading day and the value of the underlying stocks or bonds. Mutual funds only have NAVs, so you won't know your price until the end of the day, regardless of what time you place your trade.

Which are better: ETFs or individual stocks and bonds?

The #1 difference? Your exposure to **investment risk**.

ETFs are generally less risky because they come with built-in diversification—1 ETF invests in hundreds or thousands of stocks or bonds. If 1 stock or bond doesn't do well, the others are there to cushion the blow. But if you own 1 or even a small handful of individual stocks and bonds and they don't do well, your account balance will take a much bigger hit.

Then there are factors to consider such as:

- **Convenience:** ETFs are easier to manage. Most of them are index funds, with a professional portfolio manager who oversees the stocks or bonds the ETF owns. You don't have to lift a finger.
- **Cost:** ETFs are less expensive. When you buy or sell an ETF, you pay 1 commission, regardless of how many stocks or bonds are in the ETF. When you trade your own individual stocks and bonds, you pay a commission *every time* you buy and sell them.

To be fair, there are a couple of upsides to owning individual stocks and bonds, including:

- **Capital gains:** With direct stock or bond ownership, you'll only be subject to capital gains when *you* sell your investment for more than you bought it for. But in this respect, ETFs work much more like mutual funds in that an ETF itself could pay out an annual capital gains distribution that's potentially taxable. The bright side: Capital gains distributions are rare with ETFs. In fact, 86% of all Vanguard ETFs have had no taxable capital gains distributions in the past 5 years.*
- **Expense ratios:** Simply put, individual stocks and bonds don't have them. ETFs do because the ETF needs to cover its operational costs. The bright side: Vanguard's average ETF expense ratio is 74% less than the industry average (Vanguard: 0.07%; industry average: 0.27%).** That's a $20 savings for every $10,000 you invest. That may not sound like a lot, but it can add up over time.

Who are ETFs for: Buy-and-hold investors or frequent traders?

Here's a myth that's begging to be debunked: the belief that ETF real-time pricing (also known as "intraday" pricing) is specifically intended for market-timers and day traders. And that the availability of different order types—limit, stop-limit, etc.—encourages this behavior.

As with so many things in life, just because you *can* do something doesn't mean that you *should* or that you *have to.* ETFs can be a valuable part of just about any investment portfolio. Buy-and-hold investors shouldn't feel pressured to change their behavior just because they choose to invest in ETFs. In fact, a recent Vanguard study proved that, on average, Vanguard clients hold their Vanguard ETFs for about 9 years.

What types of investors could benefit from ETFs?

Just about every type! But let's take a small step back before I explain.

Before making any investment decision, you should determine your asset allocation—that is, how you divide your money among stocks, bonds, and cash. Why? Because your asset allocation will drive your overall investment performance more than anything else—including any specific investment choice you make.†

If you're saving for an emergency fund, it may be a good idea to put your money into a low-risk money market mutual fund. It will give you more assurance that the money will be there if you need it in a hurry. And if you're saving for college, a 529 account might be your best bet. Most offer tax benefits such as tax deductions, tax-deferred growth, and tax-free withdrawals.

Aside from those exceptions, anyone can use ETFs to save for long- and short-term goals, regardless of age. And you can invest in them through a taxable account (such as an individual or joint account or a trust) or through a tax-deferred account (such as a traditional, Roth, or SEP-IRA).††

Then, when it's time to choose which ETFs to invest in, make sure they align with your asset allocation. You can keep it simple with 4 total market ETFs or customize your portfolio any way you like.

Last but not least, the decision to invest in ETFs doesn't have to be an all-or-nothing choice. The amount you invest in them is completely up to you. And you can hold your index ETFs, traditional index mutual funds, and even actively managed mutual funds in a single Vanguard Brokerage Account.

What types of ETFs are there?

ETFs generally fall into 1 of these categories.

U.S. stock ETFs

Similar to bond ETFs, a total market stock ETF gives you the most diversification. Or you can target a specific:

- **Company size:** large-, mid-, or small-capitalization.
- **Style:** growth, value, or a blend.
- **Strategy:** ESG (environmental, social, and governance), for example.
- **Sector:** real estate, energy, technology, or health care, for example. (But remember: Because these are less diversified, they can expose you to more risk.)

U.S. bond ETFs

You'll get the most diversification from a total market bond ETF. Or you can target a specific:

- **Credit quality:** Treasuries or corporate bonds.
- **Maturity:** short-, intermediate-, or long-term.
- **Sector:** Treasury Inflation-Protected Securities (TIPS), tax-exempt, or mortgage-backed.

International ETFs

You can also extend beyond U.S. borders to invest in international stock ETFs and international bond ETFs. These may invest in developed markets, emerging markets, or specific regions, such as Europe or Asia. And some come with a mix of U.S. and international investments (usually named "global").

What about money market ETFs?

Some companies promote them, but what they're most likely offering are short-term bonds. These could provide higher yields, but they don't try to maintain the steady $1 share price of a money market fund. So be aware of the risks before you invest.

In closing ...

If you're familiar with index mutual funds, you probably have a better handle on ETFs than you might have thought. They come with all the things we love most about index funds: more diversification (which helps manage risk), less work, and lower costs. Which ones you choose, what percentage of your savings you invest in them … well, that's all up to you.