

## Should you use ETFs or Index Funds?

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For our three recommended model portfolios in "The Retirement Advisor Newsletter," we use index funds rather than Exchange Traded Funds, or ETFs. ETFs are like index funds in how they attempt to track various indexes. ETFs offer several advantages for traders but index funds offer the best overall return for long-term investors who do not trade.

### Differences between ETFs and Index Mutual Funds

Index mutual fund prices are calculated once a day at the market close based on the prices of the stocks in the fund plus any cash held for liquidity. Most index funds have some cash available for handling redemptions. Often the fund manager will use the leverage available with "Stock Futures" to offset the money in cash to minimize the fund's tracking error. When you buy or sell an index mutual fund, you must place the order before the market closes and you get the price calculated at the day's end.

You can buy and sell ETFs many times in during the trading day, making them ideal for traders. Their prices are determined in real time just like the stocks they track, although the actual price of an ETF can sometimes deviate from its fair value if there is an overwhelming supply or demand for that particular ETF.

ETFs are more tax efficient than index mutual funds due to a regulatory loophole. ETFs are considered to be created by trading equivalent certificates for the shares in what is called an in-kind trade by the IRS. In-kind trades do not trigger capital gains. On the other hand, index mutual funds must go into the open market to buy and sell stocks that make up the index as money enters and leaves the fund. This exchange triggers the realization of capital gains that must be passed on to the shareholders. The overall difference is slight but measurable.

Some people prefer ETFs while we recommend and track the index funds in our model portfolios. The differences in performance are small so we are comfortable with readers using either but you should pick the one that has the lowest fees and best performance for your needs.

### What has the best overall performance for investors?

ETFs are more tax efficient but the frequent trading lowers the after tax return such that index mutual funds are better for long-term investors!

The May 7th, 2007 "Wall Street Journal" did a story called "A Close Race, a Surprising Finish" that concluded the index funds we recommend from Fidelity and Vanguard for the S&P500 and Wilshire 5000 did slightly better than their equivalent ETFs after taxes for the last three and five years through March 31, 2007. We summarized the results in the table below, highlighting the winners for each period in bold text. The Journal writers were surprised that index funds beat ETFs even before trading costs were included. ETFs are bought and sold like stocks where commissions are paid on each transaction which will lower their overall performance compared to index funds that are bought and sold with no broker commission.

### Why do people use ETFs if they under perform?

To limit expenses, index funds often limit short term trading. Index funds try to have the best performance for long-term investors so they can optimize for performance. ETFs were designed for buying and selling often. Traders are willing to give up a tiny bit of performance for the ability to buy and sell many times a day.

The commissions for each buy and sell add up while there are no commissions to buy index mutual funds. We see no reason to pay a commission to get slightly lower performance for how we rebalance our portfolios.

Another advantage of ETFs is they allow investors to use a discount broker to buy low cost index funds without having to pay the fees charged by the discount broker to buy the index funds. Many investors do not want separate accounts at Vanguard and/or Fidelity so they aggregate their funds at their discount brokers. A commission to buy an ETF with a large sum of money at a discount broker is usually much lower than paying the commission to buy an index mutual fund from Fidelity or Vanguard.

For example, to purchase \$3,000 to \$100,000 of VFINX (Vanguard's S&P500 index fund) at Schwab, it costs \$49.95. However, it only costs \$12.95 to buy a similar dollar amount of SPY, the ETF for the S&P500.

We chose "The Retirement Advisor," model portfolios to offer the lowest index fund price at a single fund family that offers all the index funds we want for good international diversification. Mixing and matching from a discount broker or another fund family is fine for convenience, but you could have slightly higher expenses. After Tax Returns for index mutual funds and ETFs through March 31, 2007

| Ticker                  | Annual                               | Annualized | Average Return                      | Symbol                             | Expenses %                      |
|-------------------------|--------------------------------------|------------|-------------------------------------|------------------------------------|---------------------------------|
| Vanguard 500 Index Fund | VFINDX                               | 0.18       | 11.379                              | 615.80                             | Vanguard 500 Index Admiral Fund |
| VFIAX                   | 0.09                                 | 11.469     | 705.87                              | Fidelity Spartan 500 Investor Fund | FSMKX                           |
| 0.10                    | 11.489                               | 705.84     | Fidelity Spartan 500 Advantage Fund | FSMAX                              | 0.07                            |
| 11.51                   | SPDRs ETF                            | SPY        | 0.08                                | 11.329                             | 605.78                          |
| Shares S&P500 Index     | ETF                                  | IVV        | 0.10                                | 11.339                             | 615.80                          |
| Total Stock Market      | Vanguard Total Stock Market Index    | VTSMX      | 0.19                                | 10.83                              | 10.547                          |
| 19                      | Vanguard Total Stock Admiral Fund    | VTSA       | 0.09                                | 10.92                              | 10.637                          |
| 26                      | Fidelity Spartan Total Market Fund   | FSTMX      | 0.10                                | 11.05                              | 10.707                          |
| 26                      | Fidelity Total Market Advantage Fund | FSTVX      | 0.07                                | 11.08                              | Vanguard Total Stock Market ETF |
| VTI                     | 0.07                                 | 10.95      | 10.637                              | 26                                 | Shares Russell 3000 Index       |
| ETFIWV                  | 0.20                                 | 10.74      | 10.366                              | 71                                 |                                 |