Money 101 – Investments
12.46 Electronic Traded Funds (ETFs) vs Mutual Funds – what is the difference?

Reprint from https://www.putnam.com/etf/etfs-vs-mutual-funds

ETFs vs. MUTUAL FUNDS

ETFs and mutual funds offer investment diversification.

They are pooled vehicles that give investors exposure to many securities simultaneously.

Why diversification may help investors

- A stock represents a share in one company, and its price can change for issues related to the company or its sector, the economy, interest rates, or many other factors.
- Bad news for a company can come in many forms — a drop in profits, a scandal, a natural disaster, etc. — and some are difficult to see ahead of time.
- Owning more than one stock can be a strategy for navigating some of these risks because the performance of a large group of stocks—20, 50, or even 500—does not depend on the performance of one company.

Both ETFs and mutual funds offer diversification by including the stocks of many companies, which is a tool for reducing risk that also saves you the trouble and expense of buying many securities yourself.

VALUE CHANGES AT DIFFERENT TIMES

ETF is an abbreviation for "exchange-traded fund," and that's the basis for the most important differences from a mutual fund. ETFs own many stocks and trade on exchanges alongside some of the stocks they own. From 9:30 a.m. to 4:00 p.m. Eastern Time, the price of an ETF can change as stock prices change, as well as for other reasons. Investors can buy or sell at the current market prices.

Mutual fund buying and selling, in contrast, happens at the end of the day and is based on only the net asset value of the fund, which reflects the closing prices of the underlying stocks held by the fund.

An ETF investor can buy or sell at intraday prices, a flexibility that a mutual fund investor does not have.

ETF vs. mutual fund — pricing practices

ETF prices change during market trading from 9:30 a.m. to 4 p.m. ET.	Mutual funds are priced once per day when the market closes at 4 p.m. ET.

ETF prices are updated several times per minute as stock prices change.	Closing (4 p.m.) prices of stocks are used to calculate the fund's net asset value.

ETFs may offer tax efficiency.

ETFs invest in bundles of securities. The sponsor that issues the ETF assembles these bundles when investors purchase them (or, in the case of certain types of ETFs, called semi-transparent ETFs, the sponsor assembles a bundle that represents the underlying securities). As with buying a stock, there is no tax involved in the purchase. While ETFs are subject to taxes on capital gains and dividend income, they can be more tax-efficient than mutual funds.

Most traditional mutual funds are called open-end funds because they create or redeem shares whenever investors want. In the process, however, the funds might buy or sell securities — buying securities to create shares or selling securities to redeem shares. When a fund sells holdings that have increased in value, it realizes a capital gain. Tax law requires funds to distribute realized capital gains to shareholders each year, making shareholders liable to pay capital gains tax, unless they are invested in the fund through a 401(k) plan or another tax-advantaged structure that allows them to defer taxes. In other words, even shareholders who do not sell their fund shares might still have a capital gains tax liability from the fund. This tax liability, and its timing, is beyond the control of the shareholders in taxable accounts.

Also, capital gains are distributed evenly across each fund share — whether a shareholder has owned the fund for a long time, and participated in the increase in value of the fund, or purchased shares following that increase.

By comparison, ETFs do not redeem shares in the same way. They do not need to sell securities for cash to pay shareholders who redeem the shares, and the process does not typically cause tax liabilities for other shareholders.

ETF vs. mutual fund — capital gains taxes

The investor chooses when to sell ETF shares, which is when capital gains liability may occur.	Capital gains liability can occur when the fund manager sells portfolio holdings that have embedded capital gains or when the investor sells fund shares.
The process of creating and redeeming shares is less likely to cause tax liabilities for shareholders who are not trading shares.	The process of creating and redeeming shares can trigger capital gains tax liabilities for all fund shareholders.

ETFs are easier and cheaper to buy.

ETFs, like stocks, are available through brokerages. It's easy for the average person to set up a brokerage account and have access to hundreds of ETFs in one convenient place. While you might pay a brokerage fee for trading, ETFs do not have sales charges like many mutual funds.

Costs in general are an advantage for ETFs:

- ETFs do not have sales charges.
- Many ETFs follow passive strategies, reducing management expenses.
- Even newer active ETF strategies try to keep management expenses lower than on a mutual fund, to compete against passive ETFs.

As you consider your investment options, you might find that ETFs offer a unique combination of diversification, low costs, and tax efficiency.