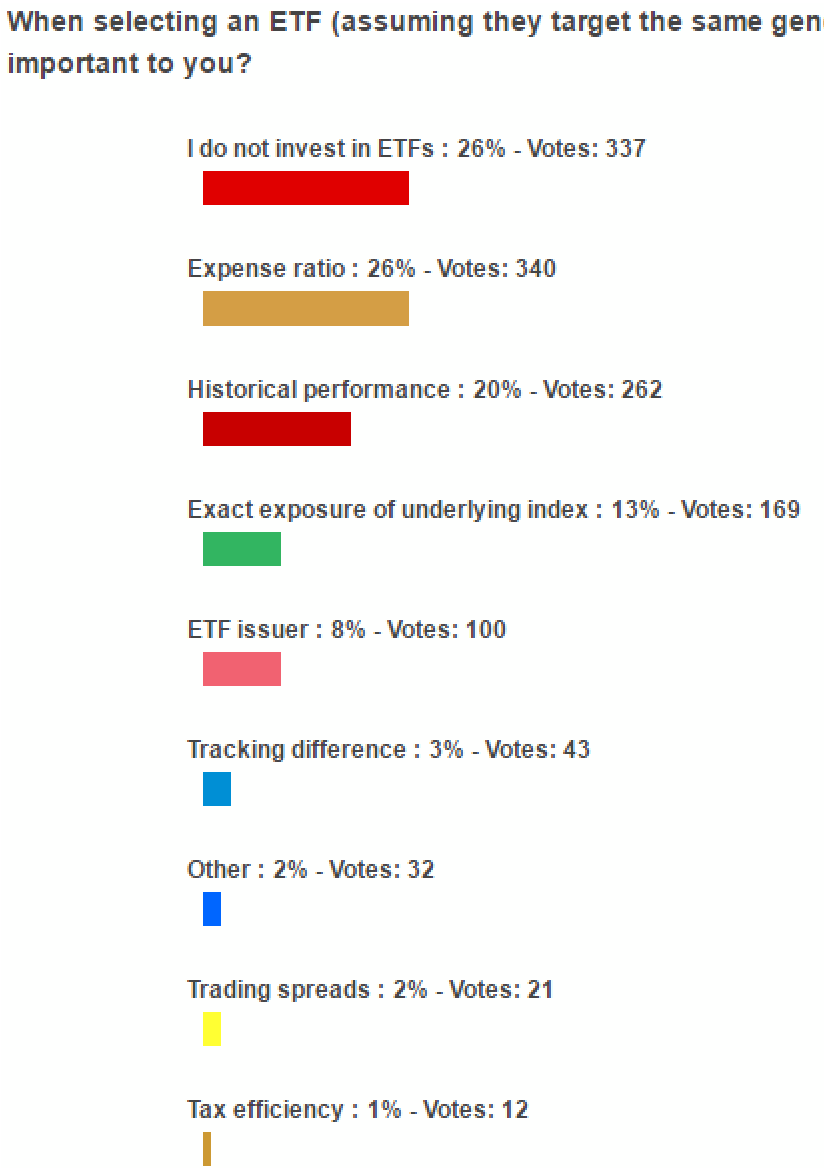
Investors Overwhelmingly Choose ETFs over Mutual Funds, Lower Costs Primary Factor

Since the launch of the first public index mutual fund on December 31, 1975, mutual funds have been a popular vehicle for investors to invest in a basket of stocks as an easy means of achieving portfolio diversification. In the 23 years since the first exchange-traded fund (ETF) was launched in January 1993, exchange-traded funds continue to gain in popularity now with over $1 trillion in assets under management. Often promoted as cheaper and better than mutual funds, ETFs offer low-cost diversification, trading and arbitrage options for investors.

Given the rising popularity of ETFs, we posed the following question to our readers last week:

When selecting an ETF (assuming they target the same general area of the market), what is most important to you?

Here are the results:



Out of the 1,316 votes we received through 3 p.m. (Central) on Sunday, 26% do not invest in ETFs. Another 26% said that the expense ratio what the most important determinant when selecting an ETF. Historical performance was the key factor for 20% of respondents while 13% said it was the exposure to a specific index that was most important to them.

Weekly Special Question

In an attempt to better understand why an investor would choose ETFs over mutual funds, or vice versa, last week's special question asked:

If you were looking to invest in a particular area of the market, why would you choose an ETF over a mutual fund, or vice versa (assuming they target the same general area of the market)?

In all, 223 readers answered the question. Among them, only 6% said they preferred mutual funds over ETFs. For the 94% who voiced a preference for ETFs over mutual funds, close to 50%–46.6% to be exact–said that the lower costs of ETFs, on average, was the primary reason why the invested in them over mutual funds. Another 31.3% of those who preferred ETFs over mutual funds said “tradability” was the keep factor, including intra-day pricing, stock-like characteristics, etc. The third most popular reason for choosing ETFs over mutual funds was tax efficiency, listed by 10.1% of respondents.

Here is a sampling of the responses:

- “Ability to trade during the open market hours, rather than the NAV at the end of the trading day.”
- “Because of the ease of being able to sell an ETF without a penalty enforced minimum holding period incurred with a mutual fund.”
- “Depending on whether I needed the convenience of investing a fixed amount on a frequent basis (in which case I would choose a mutual fund) or the flexibility of being able to “set my own price” (in which case I would choose an ETF) for the particular investment. The overriding factor would depend on the role of that investment in the overall portfolio. A “core holding” for me would most likely be in a mutual fund rather than an ETF. An investment in a sector of the market that is not quite as efficient would most likely be in an ETF.”
- “ETFs are less transparent and have bid-ask spreads, and hence are more expensive to trade. Morningstar covers Mutual funds in much better detail. ETFs are good for the marketers and promoters, and have a greater ethics risk.”
- “ETFs don’t impart trading restrictions like mutual funds tend to do if you sell shares too often or too soon after purchases are made. I’m not a frequent trader and tend to hold investments for relatively long periods, but bumping up against mutual fund trading restrictions is more a benefit to the mutual fund than the investor.”
- “With an ETF, I can control when to take profits. Mutual funds distribute gains without regard to my own specific needs, e.g., I may already have too many gains in a tax year.”

Want to weigh in? Participate in our weekly member poll, updated every Tuesday, and see the results online at http://www.aaii.com/memberquestion.