Financial Services Advisory
GROW WISER®

Mutual Funds and ETFs: Tools of the Trade
April Market Review—May 8, 2017

In managing clients' assets, one of the most important decisions investment advisors make is choosing what types of investment vehicles to use to grow and protect those assets. While the tools available to advisors have certainly expanded over the years, the traditional choices fall into four categories: stocks, bonds, mutual funds, and exchange-traded funds (ETFs).

FSA has generally favored mutual funds in portfolios because they offer diversification and liquidity with less volatility than often occurs with individual stocks and bonds. We still favor mutual funds, but the growing popularity of ETFs has made them a compelling alternative for us to consider in your portfolios.

How do these investment vehicles differ? A mutual fund is a portfolio of stocks and/or bonds that a professional investor manages on behalf of the fund's shareholders. Shares of the fund are bought or sold at a price calculated at the end of each market day. An exchange-traded fund is also a portfolio of stocks and/or bonds. In contrast to a mutual fund, however, an ETF is a basket of securities that tracks a specific benchmark, such as the Russell 1000 stock index or the MSCI World index, and is not actively managed by a professional. An ETF trades like a stock throughout the day, which means investors can buy or sell it anytime during market hours.

FSA has included ETFs in portfolios for a number of years. Now, as we increase our use of these vehicles, we want to make you aware of what this may mean to you as a client. The effects are likely to be felt in three areas: cash requests, fees, and volatility.

Cash Requests

The table below illustrates the difference between a mutual fund and an ETF when you request money from your account. When a mutual fund is sold, the money becomes available the next market day; a cash request from an ETF, however, requires three market days to process. Therefore, as the table shows, there could be a gap of up to five market days until the cash you requested appears in your bank account outside of Schwab.

INVESTMENT VEHICLE	Day of Sale	Day Cash is Available for Distribution	Day Cash Received in Your Bank Account via MoneyLink
Mutual Fund	Monday	Tuesday	Wednesday

ETF	Monday	Thursday	Friday
Mutual Fund	Friday	Monday	Tuesday
ETF	Friday	Wednesday	Thursday

Bottom Line: Should you want to make a withdrawal, FSA may need more time to get that money to you. Please give us a week's notice so we can generate the cash within your portfolio by the time you need it.

Fees

Overall, FSA assesses the benefits and costs when choosing mutual funds and ETFs within your portfolio. Because mutual funds have a portfolio manager selecting the securities for the portfolio, these vehicles charge higher management fees than exchange-traded funds, which simply track an index.

Separately, Charles Schwab charges differently for the purchase (or sale) of a mutual fund or an ETF in your account. A few ETFs (roughly 200) can be traded at no charge, while the majority (about 2,000) cost $4.95 per trade, reduced from $8.95 per trade earlier this year. A mutual fund trade, on the other hand, is made at no charge (the so-called One Source funds—over 5,000) or at a flat rate of $15.00. Before making a purchase we generally do an assessment based on the size of your account.

Volatility

According to data from the Investment Company Institute, the assets of the nation's exchange-traded funds stood at $3 trillion by the end of the first quarter. While this number pales in comparison to the roughly $17 trillion in assets in the nation's mutual funds, ETFs have been experiencing tremendous growth in the form of incoming money flows—often at the expense of mutual funds. Additionally, quick-trading hedge funds and high-frequency traders are using ETFs at an increasing rate, which means that ETFs are bought and sold very frequently, usually throughout the day.

Though increased use of ETFs has benefits, it can also lead to greater volatility when big market players are trading at the same time. There may be quicker and more severe sell-offs as large amounts of money rush for the same crowded exit. The volatility of ETF trading during the day can be a challenge for long-term investors and stomach-wrenching for investors trying to keep an eye on their funds. Mutual funds do not exhibit intra-day volatility for investors since these funds only price at the end of the day. We are factoring in this added volatility as we make greater use of ETFs in your portfolios. We set the FSA Safety Net® on each security in your portfolio, including mutual funds and ETFs, and we could find that ETFs trip through their exit points more quickly than their mutual fund alternatives.

Summary

At FSA, we generally have no preference between mutual funds and ETFs. Mutual funds price once daily and often entail higher internal expenses, but offer quicker availability of cash. ETFs allow us to trade throughout the day, generally have lower internal expenses, may involve a cost in buying or selling, and take three days to provide cash after a sale. We consider these and other factors when we look to make an investment in managing your accounts. Fortunately, we can take advantage of both types of funds as we build portfolios that meet your long-term investment goals.

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