

HOW THE STRUCTURE OF AN ETF REDUCES MANAGEMENT FEES, COMMISSIONS, AND TAXES

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Mutual Funds vs. ETFs: Why the new kid on the block is the better choice.

Similar to mutual funds, exchange-traded funds (ETFs) are a diversified portfolio of individual securities (stocks and/or bonds). However, while ETFs are similar to mutual funds in that they are a diversified basket of individual securities, ETFs are different because of their structure and how they are bought and sold. For example, ETFs get their name Exchange-Traded Funds because ETF shares are traded on the stock exchange like an individual stock. This is one example of the unique advantages ETFs have over mutual funds. These advantages collectively lead to significant cost reductions versus mutual funds. The advantages can be summarized as follows:

- **MANAGEMENT EXPENSE:** ETFs are historically unmanaged or passive index investments; therefore, they don't need a manager and do not pay active management fees. This is one reason why ETFs are less expensive than professional money managers or managed mutual funds. The bottom line is that passive ETFs simply mirror various indexes such as the NASDAQ, S&P 500, Dow Jones Industrial Index and hundreds of others. So, rather than a 1% to 2% (100 to 200 basis points) management fee, ETFs will only incur a 0.10% to 0.70% (10 to 70 basis points) annual administration expense, depending on the index.*

*[Note: In addition, ETFs don't charge investors marketing, distribution, and accounting expenses; only mutual funds charge investors 12b-1 fees, upfront or back-end loads.]

- **COMMISSIONS:** Mutual funds sell shares directly to investors or redeem (buy) shares from investors. When the mutual fund sells or redeems shares from investors, the fund receives cash (from buyers) or pays cash (to sellers) for the shares. When a mutual fund receives cash, they purchase securities for the fund with it and when they need to distribute cash, they sell securities. Each time a mutual fund buys or sells securities, they use a brokerage firm and pay commissions on each purchase or sale. In addition, when the mutual fund's professional money manager (discussed above)

decides to sell one security and buy a new security, the mutual fund pays commissions on each purchase or sale.

The net result for investors is that the commissions a mutual fund (and therefore a mutual fund owner) pays can add 0.50% to 1.5% (50 to 150 bps) annually in costs to a managed mutual fund.

An ETF does not incur commissions to buy and/or sell securities within the fund like a mutual fund does. First, ETFs are index funds and don't have a professional manager buying and/or selling securities. ETFs typically only make changes to the portfolio when there is a change to the index.

There are also structural differences in how ETFs are created and grow. ETF shares are created when financial institutions deposit large baskets of individual shares of stocks in-kind into the fund. In exchange, the institution receives ETF shares from the fund. Because individual investors don't buy or sell shares directly from the ETFs, the ETF doesn't incur commissions to invest cash they receive from buyers, nor do they incur commissions to sell securities in order to raise cash to redeem those who wish to get out of an ETF. When individuals buy or sell ETF shares, rather than going directly to the fund, they go to the securities exchanges and buy or sell shares of an ETF just like they buy or sell shares of a stock. As a matter of fact, ETF shares can even be bought on margin or sold short -- something that cannot be done with a mutual fund.

The ETFs redeem outstanding shares when a financial institution purchases large baskets of individual securities from the ETF using ETF shares rather than cash. These large baskets of securities that institutions use to purchase or redeem ETF shares vary in size as determined by each individual ETF, from 25,000 to 200,000 shares and they are called "creation units".

- **TAX ADVANTAGES:** Whenever a mutual fund buys or sells some of its portfolio securities to reallocate its portfolio, accommodate new purchases, or to fund shareholder redemptions, it may realize a net capital gain. Any realized net capital gains are taxable (pro rata based on percentage ownership) to all shareholders. Under U.S. law, all mutual fund net capital gains must be passed through to shareholders of the mutual fund. This means that even those who may have recently purchased their mutual fund shares could pay taxes before they have any returns on their investment.

While this may sound complicated, the process is rather simple. As of a particular date each year (typically in December), the mutual fund's accountants calculate the total value of all accumulated realized capital gains from securities that have been sold throughout the year. The fund then matches up that sum against the amount of capital losses the fund realized during the past year. If the result is a net gain, the fund will make an announcement as to when the fund will distribute (allocate those gains on a pro-rata basis) to the current shareholders that hold the mutual fund as of a particular date, which is called the record date. Those shareholders holding the fund on the record date will then receive that distribution and they must report those capital gains on their tax return. However, rather than a gain, let's suppose that the net result of all of the fund's securities sales for the year was a loss. In this instance, the losses cannot be "passed through" to existing shareholders to report as a write-off on their returns. Instead, the fund carries those losses forward to future years and uses them to offset capital gains for those periods (which would then reduce the amount of capital gains distributed to shareholders in those future years). This process can continue until all of those losses are exhausted.

As noted above, ETFs do not purchase or redeem an individual investor's shares directly as a mutual fund does. Instead, an individual investor simply buys or sells their ETF shares on the stock exchange to other investors as they would any other security. Thus, ETFs generally realize capital gains only when they sell their ETF shares to other investors at a price above their cost basis.

Consequently, this tax liability paid by investors in mutual funds can be 0.5% to 1.5% (50 to 150 bps) or more of invested assets each year. Thus, investing in ETFs (at least in taxable accounts) is more "tax friendly" for shareholders of ETFs when compared to mutual funds.

SUMMARY

The structure of Exchange-Traded Funds reduces management fees, commissions, and taxes. The annual savings of investing in ETFs rather than managed mutual funds may amount to 2% to 3%.

Vern Sumnicht has 25 years experience as a successful financial planner and has been recognized for four consecutive years by Worth Magazine as one of the Nation's Top Wealth Advisors. Vern and his team developed iSectors'® diversified ETF allocation portfolios. For more information about iSectors' ETF allocation portfolios, visit www.iSectors.com, email Vern at vern@isectors.com or call 1-800-iSectors.

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