



ETF Portfolio Partners

“The Smarter Way to Invest”

Exchange-Traded Funds: A Smarter Way to Invest

By Richard D. Romey

Millions of investors who would never consider snapping a picture with a Polaroid camera or listening to music on an 8-track tape player routinely use outdated technology when investing. Mutual funds were created more than 70 years ago to meet the needs of investors in a different era. It was a time when life moved at a slower pace and brokers used ticker tape machines to check stock prices. Today, better technology is available.

Exchange-Traded Funds, or ETFs, are investment tools for the 21st century. Created in 1993, ETFs combine the most attractive features of common stocks and index mutual funds. Like index mutual funds, ETFs track the performance of a specific market index or benchmark. Like common stocks, ETFs trade throughout the day on an exchange providing a level of flexibility not offered by mutual funds.

Currently there are more than 750 ETFs available with assets under management of \$700 billion, making them the fastest growing investment product in the history of Wall Street. This remarkable growth is due to the advantages ETFs provide over mutual funds. In this column we address two advantages: lower expenses and better performance.

Expenses

Every mutual fund, whether load or no-load, has operating expenses which cover the day-to-day costs of running the fund. While fund expenses vary, research suggests that the average actively managed mutual fund has operating expenses of 1.6% per year. In contrast, the average broad-based ETF has annual operating expenses of 0.3% per year.

What does this mean to you? Maybe more than you think. At 1.6% per year the mutual fund will cost you \$16,080 in fees and foregone earnings over a 10-year period, based on a \$50,000 investment and an 8% annualized return before expenses. In contrast, the ETF will cost you \$3,195 in fees and foregone earnings over the same period, based on annual expenses of 0.3%.

In this example, the investor has an extra \$12,885 in their portfolio after 10 years by using low cost ETFs instead of mutual funds. Most investors fail to realize how much they pay each year in mutual fund fees. Unfortunately, they also fail to realize that the more they pay in fees the less they earn.

Performance

Not only are ETFs more cost-effective than most mutual funds, they typically produce better returns, as well. ETFs are index-based investment products, a strategy that has proven very difficult for most mutual fund managers to beat. Over the past five years, more than 70% of actively managed large-, mid- and small-cap mutual funds have failed to beat their comparable S&P benchmark index, according to Standard & Poor's.

Unfortunately for the mutual fund industry the last five years were no anomaly. In general, about 70% of all actively managed mutual funds fail to beat their benchmark index in any given year. Regardless of what your advisor tells you there is no proven way to predict which funds will beat the market. Mutual funds give you less than a 30% chance of beating the market. The smarter alternative is to use index-based ETFs.

ETFs are the most important financial development of the last 30 years. They are an extremely cost-effective way for investors to create diversified portfolios that should outperform most mutual-fund based portfolios. So before you grab your iPod or digital camera consider upgrading the technology in your portfolio. ETFs are a smarter way to invest in the 21st century.

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