Mutual funds or ETFs -- which one wins?

What you should consider before you buy

BY KARIN MIZGALA, FINANCIAL POST JUNE 19, 2009

For most Canadians, mutual funds are a mainstay of their investment portfolio. Many investors, however are angry and frustrated with the high fees they are being charged and with mutual funds that barely outperform the market -- if they do that. (Studies are showing that 70-80% do not outperform). The big question is whether to switch out of mutual funds into ETFs (exchange traded funds).

In a couple of important respects ETFs are similar to mutual funds in that they are packages of investments bundled by a financial institution for sale to the investor and they are designed to diversify risk and opportunity. The essential distinction of ETFs is that they are a basket of investments tied to a specific "index", such as the S&P/TSX composite index, Dow Jones Industrial Average or the S&P 500. Your personal ETF investment therefore mirrors the fortunes of whatever index your ETF fund is tied to. If the S&P/ TSX, largely comprised of bank and commodity stocks, does well, then you do well. If not..., well, you get the picture.

Here are some things to consider in making your decision on which one to purchase: z Lower fees are certainly a good reason to consider an indexing strategy. (As I wrote in a previous column, recent studies have shown that Canadians are being charged amongst the highest fees in the world for their mutual funds.) Fees for indexing typically range between one-half and 1% -- as opposed to costs of up to 2 1/2 % for equity mutual funds.

z ETF fees are lower for three primary reasons. First, they do not require the same level of market research that mutual funds do, because they simply track an index instead of deciding on the merits and demerits of a bundle of stocks. Second, they are mainly sold through discount brokerage firms and this helps to keep costs down. Third, with ETFs you get little or nothing in the way of advice or service.

Lower fees are not everything, however. One of the main downsides to ETFs is that you are largely on your own to research, evaluate and to buy/sell them.

There are now hundreds of ETFs to choose from and you have to ask yourself if you're really willing to do the background investigative work.

- One reason to invest in a mutual fund portfolio is the advice that you get -- or should get -- when investing this way. Yes you pay more, but a good advisor will consider such things as your risk tolerance, net worth, your retirement plans, and the rest of your portfolio mix, to better advise you on the funds that are best suited to you at the various stages of your financial life.

- If you have over $500,000 to invest, you may qualify to work with an investment counsel firm where fees are much lower than the typical mutual fund portfolio, and you get advice too. If you don't fit that profile, but don't want to go it completely alone, then check out low cost mutual funds, like those offered by Steadyhand, Leith Wheeler or Phillips Hager & North. The level of advice that you get with them will largely depend on the size of your portfolio, but their funds are well worth considering.

Whatever route you decide to go, ETFs, traditional or lower cost mutual funds, you will be best served if you keep your investment decisions in line with your overall financial objectives and the time and energy you want to devote to your investments.

- Karin Mizgala is a Vancouver-based fee-for-service financial planner with an MBA and a degree in psychology. She's the President of LifeDesign Financial and co-founder of the Women's Financial Learning Centre.