EXCHANGE TRADED FUNDS VS. INDEX FUNDS: RISKS, RETURNS AND EXPENSES RATIOS

Steven V. Le, Department of Finance, Real Estate and Law, California State University, Long Beach, 1250 Bellflower Blvd., Long Beach, CA 90840-8505, 562.985.1608, svle@usa.net
Darrell Le, SVL Investment Management, Placentia, CA 92870

ABSTRACT

With the current scandals affecting the world of mutual funds, more investors have become interested in exchange traded funds (ETFs). The objective of this study is to compare the Risks, Returns and Expenses Ratios of ETFs and Index Funds

INTRODUCTION

Index funds surfaced in the mid-1970s, half a century after mutual funds were introduced to investors. Index funds are simply mutual funds, which attempt to emulate a market index. An investment vehicle created in the early 1990s, Exchange Traded Funds (ETFs) represent a basket of securities that mirror an index, such as the Dow Jones Industrial Average (DJIA) or Standard and Poor's 500 (S&P 500); they can also represent a particular market or industry, such as real estate and the health sector. Overall, ETFs embody a portfolio of stocks in just one security. Unlike index funds, which ETFs are often compared to, ETFs can be traded on an exchange, so they can be bought or sold anytime the exchange is open.

METHODOLOGY

Compare and Contrast the Benefits of Each

Many investors believe both index funds and ETFs are an excellent source of diversification because they include various securities in often many sectors.

ETFs have low expense rations, no 12-b1 charges, no front-end loads, but commission fees can add up quickly. Each time an investor buys or sells ETFs, he/she incurs a commission fee. Index funds, on the other hand, have a higher annual cost, but no commission fees. Unlike index funds, ETFs require no minimum investment. An investor is free to purchase however many shares he/she is interested in at a time. Additionally, index funds are often preferred because they sell at net asset value (NAV), which means they won't be under-valued or over-valued. ETFs don't necessarily sell at the NAV but close to it, so an investor runs the risk of buying an over-valued ETF and selling an under-valued ETF

In terms of flexibility, ETFs are the preferred choice because they are traded like stocks. Investors can also track ETF performance throughout the day by analyzing real time prices. Index funds, however, do not offer this flexibility. Mutual funds, in general, can only be traded at the end of the day when the net asset value has been established. An additional benefit of ETFs is that investors have the ability to buy on margin or even short sell on downticks. This benefit results in the opportunity for investors to hedge. "For example, ETFs can be sold short to hedge a core stock portfolio or interest rate fluctuations."

As far as tax-efficiency is concerned, ETFs are usually preferred over index funds because they traditionally do not make capital gain distributions. The only exception to ETFs being preferred over index funds, when it comes to tax efficiency, is when the index funds are non-taxable accounts. If this is the case, index funds are the better alternative. In general, the low activity in an index fund sometimes results in reduced capital gain distributions and therefore reduces taxes. However, if redemptions exceed additions, then stock has to be sold and the fund will distribute capital gains, which will result in taxes.

Another difference between ETFs and index funds is that ETFs can act as a type of cash management fund. Investors can temporarily place their money in an ETF account while determining where they want to invest for the long term. Unfortunately, however, the fact that ETFs pay dividends out, instead of reinvesting them usually means that the funds will often sit idle and not make money like they would if they were reinvested.

Profiles of investors

Due to commission fees, Kostovetsky (2003) suggested that Exchange Traded Funds are most cost effective when transactions involve large sums of money. In the 1990s, analysts were recommending ETFs to active traders because it allowed them to jump in and out of the market. Presently, however, ETFs are being recommended to investors interested in a buy-and-hold strategy. Dellva (2001) observed that 75% of people who invest in ETFs or plan to invest in ETFs are doing so with a buy and hold strategy, while the remaining 25% said they would use ETFs for a mix of both long-term and trading-oriented strategies. ETFs are also more beneficial to experienced investors, who are interested in features like buying on margin and selling short; features not available in index funds. Overall, these investment instruments have proved to be more popular among institutional investors, particularly those interested in a particular sector or country; these investors have experience and large sums of money to invest.

Index funds are the perfect investment opportunity for small investors who want to enter the world of investments; these people have little experience, little money and they are for the most part, risk-averse. With index funds, investors can select between funds with or without front–end loads and they don't have to worry about commission fees. For this reason, index funds are frequently recommended to investors who will make dollar cost-averaging transactions, for example individuals who will allocate $200 a month for a set amount of years.

Data

This study is based on the data of Returns, Risks and Expenses Ratios of ETFs and Index Funds from 1997 through 2004.

EMPIRICAL RESULT

Based on the analysis of 30 funds (ETFs and Index Funds), The results are shown in Table 1.
It is clear that index funds undoubtedly have higher expense ratios than exchange-traded funds. Index fund tend to outperform exchange-traded funds. This result, however, can be challenged because more historical information is available for index funds than it is for the relatively new, exchange traded funds.

TABLE 1

Category	Return		Risk		Expense Ratio	
	ETF	Index Fund	ETF	Index Fund	ETF	Index Fund
S&P 500	8.71	8.75	1.00	1.00	0.11	0.18
		2.07		1.00		0.65
Wilshire 5000	4.44		n/a		0.15	
Latin America	15.83	17.80	n/a	1.29	0.50	1.31
Emerging Markets	7.06	7.90	n/a	1.07	0.78	0.53
Energy	7.05	11.98	0.74	0.68	0.27	1.21
Telecommunication	0.29	1.13	n/a	1.59	0.65	1.34
Real Estate	15.26	15.33	0.30	0.25	0.60	0.84
Financial Services	4.18	3.68	0.86	0.85	0.60	1.09
Technology	0.05	-1.93	2.01	2.09	0.53	1.63
Canada	10.55	10.84	0.83	0.73	0.84	1.42
Consumer Products	-0.35	1.17	0.45	0.75	0.28	1.83
Health Care	3.46	12.97	0.76	0.53	0.28	0.28
Japan	2.73	15.14	0.45	0.57	0.84	1.03
Utilities	1.41	-0.70	0.68	0.78	0.27	0.69
Biotech	2.47	0.80	1.32	1.04	0.50	1.24
Average	**5.54**	**7.13**	**0.85**	**0.95**	**0.48**	**1.02**

CONCLUSIONS

Index Funds generally have higher returns and expenses ratios. ETFs, however, demonstrated a lower volatility. Despite their similarities, exchange traded funds and index funds each appeal to different investors. Overall, it is safe to conclude that the investor's profile plays a prominent role in determining, whether ETFs or index funds will be most beneficial to investors. An investor must consider how risky or risk averse he/she is; how often he/she plans to trade; how taxes will impact his/her wealth; how much money he/she is going to invest and whether or not, he/she will need features like the ability to trade on margin, etc. Once this is determined, an investor will be able to decide which of the two investment vehicles is the best. Perhaps if an investor is more experienced in the world of investing, willing to take risks and interested in pursuing a buy and hold strategy, ETFs would be the better choices; they have features designed for experienced investors (e.g. buying on margin and hedging), a higher beta and incur trading commission fees. If on the other hand, the investor is more risk averse, less experienced and plans to pursue a cost averaging strategy, mutual funds will probably be the best alternative.

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