Why are exchange-traded funds cheaper than mutual funds?

By Desautels McGill, on July 20, 2011
Edited on April 4, 2012

McGill why-are-exchange-traded-funds-cheaper-than-mutual-funds

Understanding the organizational structure and investment strategy can help you make an informed decision and add substantial returns to your bottom line.

By **Saurin Patel**

For example, the annual expense ratio of an average U.S domestic equity ETF is just 0.47% compared to 1.35% for an average U.S. domestic equity mutual fund, a cost difference of 0.85%. Not surprisingly, the cost differential is even more striking (1.43%) if you compare a Canadian ETF with its mutual fund counterpart.

But, why are ETFs so cheap? The answer lies in two simple facts: organizational structure and investment strategy.

Structural Differences

There is a structural difference in the way investors are handled by an ETF compared to a traditional mutual fund.

For example, when an individual wants to buy a mutual fund, say **Fidelity Magellan Fund** (FMGXA), they need to find a **financial advisor** and place a "buy" order with the fund company.

Fidelity then processes the order internally by recording who and how much money was deposited with the fund.

Then, Fidelity mails loads of paperwork (confirmation documents, summary prospectus etc.) to the new investor for review.

Finally, after receiving the money, the fund manager goes to the market and invests the investor's money into securities, paying all necessary **transaction costs and commissions**.

The same process is repeated for every new investor who invests into the fund, and is reversed for every investor who sells/ redeems his mutual fund shares.

Clearly, mutual fund's handling of a new investor costs a lot of time, energy and more importantly money to the fund company, which ultimately ends up in the investor's lap as higher fees.

Now compare this will ETFs, when an individual wants to buy shares of an ETF say SPDR S&P 500 (SPY). She simply enters an order (like a stock) with their brokers online and pay necessary commission. And … that's it.

Now, if the investor wants to sell his ETF share, he simply trades with other investors like a stock on an exchange where the ETF is listed.

The fund company does not do anything: no internal processing or recording of transaction, no mailing of documents and no going to the market to invest money.

Less work for the ETF companies in handling new investor reflects in their lower costs. Particularly, lower administrative costs.

Passive versus Active Management

Another reason why ETFs are cheaper is because of their investment management style.

ETFs' investment objective is to *passively* track a pre-specified equity or bond index such as **S&P 500** and **Barclays Aggregate Bond index**.

They involve in far fewer buying and selling transactions than an average actively managed mutual fund. This helps them lower their trading costs.

A quick comparison of turnover ratios across ETFs and actively managed mutual funds confirms the reasoning.

For example, the average turnover ratio for a typical U.S. domestic equity ETF is 35% compared to 88% for a typical U.S. domestic equity mutual fund.

Portfolio turnover ratio measures of how often a fund manager trades securities in a year to manage her portfolio. The lower the turnover ratio more passive the fund manager is in managing his portfolio and vice versa.

While there might exist other factors which may influence the cost structures of ETFs and mutual funds, the two mentioned here are most predominant ones.

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