

# Mutual Funds or ETFs: The Costs, Taxes, and Trade Offs New Investors Should Know

Two investments can hold the same stocks and still behave very differently in your account. Mutual funds and exchange traded funds (ETFs) both offer instant diversification, but they differ in how they trade, what you pay, and when you may owe taxes. Knowing how those differences show up in your real life experience as an investor can make it easier to decide which vehicle is a better fit for you.

During the 1920's the mutual fund was created and popularized and in 1990, the first ETF was launched on the Toronto Stock Exchange in Canada. The first US ETF was launched in 1993 on the American Stock Exchange (later acquired by the NYSE). Since then, both mutual funds and ETFs have grown significantly in size and popularity. At a basic level, each is a 'basket' of investments. Rather than picking individual stocks you buy a single fund that owns a wide range of investments. Depending on the fund, that basket may be actively managed by a portfolio manager or built to track an index using a rules based approach. Even though mutual funds and ETFs share this same basic idea, they work a bit differently in practice. Understanding those differences can help you choose which is a better fit for you as an investor.



## 3 Key Takeaways

- 1 **Mutual funds and ETFs share the same core idea but work differently in practice.** Both provide diversified “baskets” of investments, but they differ in how they trade, how they are priced, and the tools investors can use when placing orders.
- 2 **Costs, taxes, and management style are key distinctions.** Mutual funds are often actively managed and can carry higher expenses and more frequent taxable distributions, while many ETFs use lower-cost, index tracking strategies that can be more tax efficient for taxable accounts.
- 3 **The better choice depends on your goals and circumstances.** Factors such as whether you want intraday trading, your account type (taxable vs. tax advantaged), your preference for active or passive strategies, and your time horizon should guide whether a mutual fund or ETF is the better fit for you.

## How Mutual Funds Are Bought, Sold, and Managed

Although mutual funds and ETFs can hold similar investments, the way you buy and sell them is different. With mutual funds, you place your order during the day but do not know your final price until after the market closes, when the fund calculates its net asset value (NAV). Everyone who trades that day gets that same end of day price.

You cannot buy mutual funds on margin or place price limit orders. Instead, you trade directly with the mutual fund company, which can issue new shares as needed, so there is essentially no limit on the number of shares available, and you can often buy or sell fractional shares. Many mutual funds are actively managed by a professional portfolio manager whose goal is to outperform the mutual fund's benchmark index or "beat the market". Because of this active management, mutual funds typically have higher expense ratios than comparable ETFs. An expense ratio is a percentage-based fee, built into the fund's share price, that covers the cost of running the fund.

Mutual funds are also required, by law, to distribute to shareholders the net capital gains and dividend income earned during the year. Unfortunately, even if you do not sell any shares, you may still be liable for paying taxes on those capital gains and dividends in a taxable account, regardless of whether you have them reinvested or paid out in cash. It is worth mentioning that in tax-deferred retirement accounts, when a mutual fund pays out capital gains and dividends to shareholders, it will not create a current taxable event. Mutual funds can also have minimum initial investment requirements ranging from several hundred to several thousand dollars. Finally, mutual fund portfolio holdings are typically updated on a monthly or quarterly basis, sometimes with a reporting delay.

## How ETFs Trade, Cost, and Handle Taxes

ETFs work more like individual stocks: they trade on exchanges such as the NYSE or Nasdaq, and their prices fluctuate throughout the day as supply and demand change. Investors can buy and sell ETFs through brokerage accounts and can set price limit orders. While some ETFs are actively managed and do not track an index, most are passively managed index

## Investing Terminology Glossary

**Active management:** is a "hands-on" investing approach where a portfolio manager or team actively chooses which investments to buy, hold, or sell, with the goal of outperforming a specific benchmark or index.

**Capital gains:** are the profits you make when you sell an investment or other asset for more than you originally paid for it.

**Dividends:** are payments a company makes to its shareholders to share some of its profits, usually in cash and often on a regular schedule such as quarterly.

**Index:** an index is a group or "basket" of securities that represents and measures the performance of a particular market, sector, or asset class over time.

**Limit order:** a limit order is an instruction to buy or sell a security only at a specific price or better, which gives you control over the price but does not guarantee the trade will be executed.

**Margin:** borrowing money from your broker to buy securities, using the investments in your account as collateral.

**Nasdaq:** is a major US stock exchange that operates electronically, providing a marketplace where investors can buy and sell shares of publicly traded companies, especially many technology-focused firms

**NYSE:** the New York Stock Exchange is a major stock market in New York City where investors buy and sell shares of publicly traded companies.

**Passively managed:** investments designed to closely track a specific index by holding the same or similar securities, aiming to match the index's return rather than beat it.

**Tax-deferred retirement accounts:** are accounts where you can save and invest for retirement now and wait to pay income taxes on the money until you take it out later, such as from a 401(k) or traditional IRA.

tracking funds, which typically have lower expense ratios than comparable actively managed mutual funds. The trade-off is that while passively managed ETFs may have lower expenses, their goal is generally to match the market's performance, not outperform it.

ETFs are often considered more tax efficient than mutual funds because of how they are structured. In general, ETF portfolio adjustments—such as in kind transfers during the creation and redemption process—do not typically result in capital gains distributions to shareholders. In a taxable account, investors usually face capital gains tax only when they sell their ETF shares for a profit. However, some ETFs, typically actively managed ones, can still distribute capital

gains in certain circumstances. Because ETFs trade on a brokerage platform there may be commissions or transaction fees each time you buy and sell, depending on your brokerage's pricing. ETFs disclose their portfolio holdings daily and have their share prices updated about every 15 seconds during market trading hours. Finally, ETFs can usually be purchased in small amounts—often as little as a single share, which makes them more accessible for investors with limited initial capital.

There is no single 'best' choice between mutual funds and ETFs. Each investor has different objectives, time horizons, tax situations, and preferences that should be weighed when deciding which type of investment vehicle is the best fit.

### Some questions to consider as you decide between mutual funds and ETFs include:

- Do you prefer the ability to buy and sell during the trading day and see the price you are paying in real time?
- What type of account are you using—taxable or tax advantaged—and how important is tax efficiency for this money?
- Do you prefer a passive, index tracking approach or active management?
- Remember that both types of investment vehicles are subject to market risk, and past performance does not guarantee future results.



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