Advisors debate: ETFs, mutual funds or both?

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Financial advisors weigh in on which investible vehicle works best for their clients.

- August 30, 2023
- By Gregg Greenberg

Take your pick, advisors: ETFs, mutual funds or both?

Exchange-traded funds are considered tax-advantaged relative to actively managed mutual funds because they tend to realize fewer capital gains. Moreover, ETFs generally have lower fees compared to their mutual fund counterparts and are priced continuously throughout the day, enabling greater investor flexibility.

They're also no longer a secret to either advisors and investors.

Assets invested in the U.S. ETF industry reached a record of $7.6 trillion at the end of July, up 16.8% from $6.51 trillion at the end of 2022, according to a report last week from ETF consultancy ETFGI. During July, the U.S. ETF industry saw net inflows of $56.74 billion, bringing year-to-date net inflows to $284.67 billion.

On a worldwide basis, ETFGI reported assets invested in the global ETF industry reaching a record of $10.86 trillion at the end of July, up 17.3% so far this year.

Because mutual funds have existed significantly longer than ETFs, they still hold the bulk of invested assets worldwide. The first modern mutual funds were launched in 1924, whereas the first ETF was issued almost 70 years later, in 1993.

That said, thanks to a push from advisors and a host of new funds, ETFs have been making up for a lot of lost time — so much so that financial consultancy Oliver Wyman predicts that ETFs will account for 24% of total fund assets by 2027, up from 17% today.

Will Metzner, independent investment executive at Optimus Financial of Stifel Independent Advisors, takes a Solomonic approach by using both types of investment vehicles.

“We use ETFs for accounts seeking cost and tax efficiency,” Metzner said. “They also work well for clients looking to invest in specific sectors. Mutual funds are more suitable for our clients seeking professional, active management. They can also be a good choice for long-term investors with tax-deferred accounts looking for another set of eyes on their assets.”

Nina Lloyd, president of Opus Financial Advisors, part of Osaic, also uses both mutual funds and ETFs on a regular basis, as well as situationally.

“We do favor lower-cost ETFs, but there can be compelling reasons to recommend a mutual fund,” Lloyd said. “If we are looking for active management with low investment minimums or have a client that would like to start an automatic investment plan, mutual funds may play a larger role in the portfolio.”

Dustin Thackeray, chief investment officer at Crewe Advisors, also employs a mixture of active and passive mutual funds and ETFs in client portfolios. His preference would be to employ only ETFs given their tax efficiency, but the relative newness of actively managed ETFs does not always make that possible.

“With the shorter track records of some actively managed ETFs, we may choose an actively managed mutual fund in which we have a lengthier track record to analyze,” said Thackeray.

Marc N. Balcer, director of investment strategy at Girard, a Univest Wealth division, pointed out that there are cases such as 401(k) plans where ETFs are not available, leaving mutual funds as an appropriate substitute. And fees always matter, even if intraday trading doesn’t, Balcer said.

“Especially for smaller investors, the choice may come down to varying fees, investment minimums and the ability to purchase a specific dollar amount, like in mutual funds, instead of the number of shares, like ETFs, when identical strategies are available in both flavors,” he said. “As long-term investors, we don’t place much value on the ability to trade ETFs intraday. In fact, it can encourage short-term trading which can increase risk.”

Performance, of course, matters too.

“My clients and I are happy to pay the fees of an active ETF or active/passive mutual fund if it can make up for it and then some,” said Michael Nakanishi, financial advisor at Kingswood US.

Stephen Tuckwood, director of investments at Modern Wealth Management, makes a conscious effort not to let the vehicle type be the driving factor in his investment decision-making. Instead, he focuses on selecting the best strategy and then implements that strategy via the most effective vehicle available.

“Let’s say we were looking to establish an overweight position to U.S. large-cap growth. First, we’d determine if the opportunity is best expressed by an active or passive mandate. Then we’d seek to find the best manager in that space before finally selecting the most appropriate vehicle they have available,” Tuckwood said.