When Switching to ETFs from Mutual Funds Makes Sense

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With exchange traded funds gaining wider acceptance, many investors are considering switching out their open-end mutual fund positions for the cheaper ETF options.

Michael Kitces, a CFP professional and director of planning research at the Pinnacle Advisory Group, argues that shifting assets away from mutual funds and into ETFs makes sense for some retirees, especially for those more well off, reports Chris Kissell for Bankrate.

ETFs trade like any stock on a brokerage account and come with trading fees. Consequently, wealthy investors, who plan on withdrawing a few times a year, are better off switching to ETFs since the commission fee would only make up a fraction of a large withdrawal.

“Compared to paying an ongoing mutual fund fee that is higher, it’s a huge savings,” Kitces said in the article, adding that as a general rule, “the larger the dollar amounts involved, the more it pays to get a low-expense ETF.”

However, Kitces points out that smaller investors need to factor in cost considerations before making a move.

“In many cases, the cost you pay in transaction fees dramatically trumps the cost you pay for everything else,” Kitces said.

For instance, those who regularly withdraw $1,000 from an ETF position on a monthly basis at a cost of $9.95 per trade could end up losing 1% each time. However, there are now a number of commission-free ETFs that may be traded across a number of brokerages, including Fidelity, TD Ameritrade, Charles Schwab, E*Trade, Vanguard and Merrill Lynch, among others. [Six Popular Commission-Free ETF Trading Platforms]

The commission-free ETF trades allow investors to make regular portfolio rebalances, monthly investments or monthly withdrawals at no extra cost.

Additionally, Nathan Kubik, a Certified Investment Management Analyst at Carnick & Kubik, argues that ETFs offer tax advantages over mutual funds. Due to the way ETFs are constructed, ETFs are able to exchange holdings through in-kind transactions, which limit taxable events, whereas mutual funds typically have to sell into cash and owe taxes on the capital gain before acquiring another position. [Popular Commission-Free ETFs on Schwab OneSource]

Kubik also advises investors to take a closer look at ETFs before converting over from their mutual fund investments. For instance, potential ETF investors should be aware that most offerings passively track an index, whereas many people are invested in active mutual funds. Traders should watch overall feels, which include expense ratios, commissions and trading costs. Investors should not expect some kind of magic bullet and make sure that ETFs fit their investment horizons.

For more information on investing in ETFs, visit our ETF 101 category.

Max Chen contributed to this article.

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