WHY EXCHANGE-TRADED FUNDS HAVE LOWER EXPENSES THAN MUTUAL FUNDS

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One way to lower your investment expenses is to replace mutual funds with Exchange-Traded Funds (ETFs).

ETFs are a diversified portfolio of individual securities like mutual funds. Unlike mutual funds, ETFs can be traded on a stock exchange just like an individual stock. This is because ETFs are structured differently than mutual funds and this structure difference is what creates the cost advantages ETFs have over mutual funds.

- **MANAGEMENT EXPENSE:** ETFs are based on an index of securities like the S&P 500 index. Therefore, ETFs are unmanaged and don't incur management expenses. ETFs will typically incur only 0.07% to 0.70% (7 to 70 basis points) annually in administration expense, depending on the index. Contrast this with a managed equity mutual fund which may incur management expenses as high as 1% to 2% (100 to 200 basis points) or more.

- **COMMISSIONS:** The portfolio managers of actively managed mutual funds buy and sell investment securities within their funds. For example, a mutual fund manager will sell one security and buy a new security that offers greater profit potential. Additionally, when new money flows into a fund or when money flows out of a fund, the managers must buy or sell securities. Whatever the reason, when mutual fund managers buy or sell securities, they incur commission expenses. In total, these commissions can add another 0.50% to 1.5% (50 to 150 bps) annually to the cost of a mutual fund.

  In contrast, ETFs only make changes to the portfolio on rare occasions when there is a change to their index, thus avoiding the commissions associated with managing the portfolio. ETFs also avoid commissions because they don't sell securities in their portfolios to redeem investors, nor invest cash from acquiring investors. Investors simply buy or sell ETF shares in the market to acquire or liquidate positions like they would buy or sell a stock.

- **TAX ADVANTAGES:** Whenever a mutual fund sells securities in its portfolio, either to reallocate its portfolio or to accommodate shareholder redemptions, U.S. law requires that net realized capital

gains be passed through to the remaining shareholders. This tax liability paid by the remaining shareholders in mutual funds can be 0.5% to 1.5% (50 to 150 bps) or more of invested assets annually.

Because ETFs don't sell securities in their portfolios to redeem investors or to manage the portfolio, ETF investors generally realize capital gains only if they sell their ETF shares to other investors in the market at a price above their cost basis.

CONCLUSION: Investing in ETFs rather than mutual funds can reduce investment expenses by 2% to 3% or more annually. An excellent resource for quantifying all relevant expenses related to a mutual fund is www.personalfund.com.

Vern Sumnicht and his team developed iSectors'® diversified ETF allocation portfolios, using the knowledge gained from 25 years as a successful financial planner. Vern has been recognized four consecutive times by "Worth Magazine" as one of the nation's top wealth managers. For more information about iSectors'® ETF allocation portfolios, visit www.iSectors.com, email Vern at vern@isectors.com or call 1-800-iSectors.

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