Shining a Light on Ownership Costs: ETFs Are Not Always the Most Cost-Effective Choice

The popularity of exchange traded funds (ETFs) has increased substantially over the past decade, with U.S. assets at about $2 trillion—and growing*. In part, ETFs are popular because they often have lower expense ratios than mutual funds. Yet, the reflexive belief that ETFs are the more cost-effective choice in all cases is simply not true. Expense ratios are just one element of the total cost of ownership for ETFs. In addition to the expense ratio, ETFs may carry additional costs that can add up for more active investing strategies.

In order to make an informed investment decision, and choose wisely between ETFs and mutual funds, investors must understand the complete cost structure of both, so they know which investment structure is best suited to their needs.

Known vs. Unknown Costs

Ownership costs for both ETFs and mutual funds can be separated into explicit (known in advance) and implicit (harder to quantify in advance) costs. Implicit costs for each can be difficult to quantify and can vary by individual security. For ETFs, these costs include bid/ask spreads and premium/discount. For mutual funds, implicit costs include shareholder activity or potential transaction fees if they are not bought and sold on a no-transaction-fee (NTF) platform, or if they are subject to holding period penalties. (Taxes are another consideration, but are not discussed here.)

Implicit costs can be especially problematic for strategies that involve active trading, because people tend to focus on what they know, while ignoring or discounting what they have difficulty predicting. In the language of behavioral finance, this is called “availability bias” and refers to the tendency to favor easily accessible information over full information.

Because expense ratios and brokerage commissions are explicit and easily available, but bid/ask spreads are difficult to quantify in advance of making a trade, many investors focus exclusively on the former. They fail to factor the latter costs into their investing and trading strategies up front—the cognitive tendency is to deal with such unknowns after the fact.

Yet, such unanticipated costs can significantly impact an investor’s trading results, especially with ETFs: buy-and-hold strategies and active trading strategies can have very different cost profiles when taking into account all of the relevant costs and the trading frequency. In the case of an active trader, both brokerage commissions and bid/ask spreads associated with ETFs can create a drag on investment performance.

A Comparison of Mutual Funds and ETF Ownership Costs

		Mutual Funds	ETFs
Explicit	Expense Ratio	■	■
	Brokerage Commission[1]		■
Implicit	Bid / Ask Spread		■
	Premium / Discount		■
	Shareholder Activity[2]	■	
	Tax Implications[3]	■	□

■ Product characteristic □ Product characteristic in some circumstances (see disclosure)

*SOURCE: ICI 9.30.2015

1 Many mutual funds are available on No-Transaction-Fee (NTF) platforms without brokerage commission. There is limited availability of ETFs on NTF platforms. 2 Shareholder activity affects both mutual funds and ETFs, but is lessened with ETFs due to their unique creation/redemption process. However, if an ETF uses a cash or partial cash create/redemption process, then shareholder activity will create additional costs for that ETF. 3 If shares of an ETF or mutual fund are sold at a price other than their purchase price, the transaction will typically represent a taxable event. Due to their unique structure, ETFs tend to be more tax-efficient than their mutual fund counterparts because they do not need to sell securities to address shareholder activity.

Comparing Costs – ETFs vs. Mutual Funds

For the most part with NTF mutual funds, "what you see is what you get" with respect to cost, with expense ratios typically being the largest component of ongoing costs—though investors should investigate all mutual fund costs (e.g., redemption fees, exchange fees, holding periods) before investing. By contrast, ETF ownership costs are comprised of three primary elements: (1) the holding cost or expense ratio, (2) the transaction cost (or brokerage commission) and (3) the spread cost. While ETF expense ratios and brokerage commissions are explicit and easy to quantify, the bid/ask spread can be more challenging to ascertain. Investors need to have a good understanding of how both explicit and implicit costs can affect the cost of ownership.

Expense Ratio. Mutual fund and ETF annual fund operating expenses (or the "expense ratio") are published in a fund's prospectus and describe the annualized cost of owning fund shares, including management fees, distribution/service fees and other expenses which are deducted from a fund's assets or charged to all shareholder accounts. The expense ratio does not include shareholder fees, such as sales charges, redemption fees, exchange fees and account-related fees.

Brokerage Commission. Typically, there are two types of brokerage commissions applicable to ETF trading: a flat commission per trade, or a flat fee per share. In the first case, the important determinant of cost is the size of the trade—as the size of the trade goes up, the cost as a percent of the transaction goes down. In the second case the most important determinant of cost is the share price of the ETF—the higher the share price, the lower the cost as a percent of the value of the trade.

Bid/Ask Spread. Then there is the bid/ask spread, which can be one of the larger costs of ETF ownership. Prices for ETF shares fluctuate during the trading day, just like a stock or a bond. And when ETFs trade, they can be subject to bid/ask spreads, just like individual securities—sellers can sell at the bid price and buyers pay through the spread and can buy at the offer price. The bid/ask spread on the largest, most liquid ETFs is generally a few basis points, but bid/ask spreads for smaller, thinly traded ETFs can be considerably higher—a percent or two.

The issue of bid/ask spread is particularly important for advisors using ETFs for satellite exposure (e.g., short-term thematic exposure, sector exposures or hard-to-access niche markets). In cases where ETFs may be subject to frequent trading, even small bid/ask spreads can add up quickly. Moreover, patient ETF investors who sit on the bid or ask price to get better terms may find that it takes more time to get their trades executed, their trades may not get executed at all or the market may move away from them.

How Many Round-Trips Are You Making?

Consider the following example: the weighted average of U.S. equity and fixed-income ETFs trade with a three basis point bid/ask spread. An investor making six round trips a year (12 trades total) would pay 0.18% a year. Although at first glance a small bid/ask spread may not appear to move the needle on cost, consider a very active trader who makes 100 round trips a year. Even U.S. equity and fixed-income ETFs trading with a three basis point bid/ask spread would cost the investor 3% a year.

Now consider the weighted average trading spread for sector ETFs (the most commonly used ETFs by advisors, according to a recent wealthmanagement.com survey) is seven basis points[4]—double the spread for U.S. fixed income. The chart below compares a hypothetical scenario of trading a tradable NTF sector mutual fund (expense ratio of 1.26%[5]) vs. the average sector ETF (spread of .05%[5][6] and expense ratio of

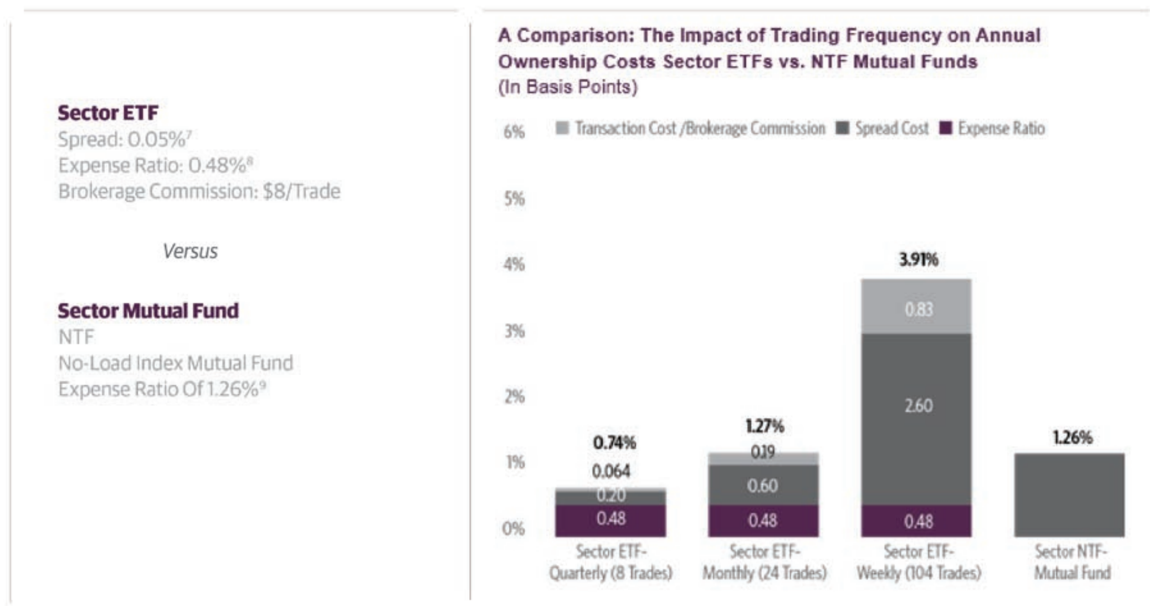
[4] SOURCE: ETF.com. November 2014

[5] Average sector mutual fund expense ratio is 1.26% (as of January 2015).Source: Morningstar

[6] Weighted average spread for Sector ETFs is .05%,SOURCE ETF.com December 2014

.48%[1]) based on three trading frequency scenarios— quarterly round trips (eight trades), monthly round trips (24 trades) and weekly round trips (104 trades). In this example, the ETF is the cost-effective choice for quarterly trades, but with more active trading (monthly and weekly), the mutual fund becomes the cost-effective choice.

A Comparison: Sector ETFs vs. NTF Sector Mutual Funds



This example is hypothetical and for illustration purposes only. It is not meant to represent any particular fund. 7 Weighted average spread for sector ETFs is .05%, SOURCE ETF.com, December 2014. 8 Average sector ETF expense ratio of .48%, Source Morningstar January 2015 9 Average sector mutual fund expense ratio is 1.26% as of January 2015. Source: Morningstar. .

The weighted average for currency ETFs is 0.12% and the weighted average spread for inverse ETFs is 0.12%[10], approximately three times higher than U.S. fixed income. In addition, one has to factor in the commission cost. And when the three are added together (expense ratio, commissions, and spreads), the total ownership cost for ETFs can be many times that of NTF mutual funds for active traders. Strategic buy-and-hold investors may find ETFs better suited to their needs, but in many cases NTF mutual funds may make more sense, for example:

- If the investor will be making more than 10 round-trip trades a year
- If the ETF trades with a high bid/ask spread (most commonly sector or niche ETFs)

Simply focusing on the “race to zero” in expense ratios is an understandable cognitive bias, but it can blind investors to costs like commissions, bid/ask spreads and departure from NAV, hence masking the true cost of ETF usage. It is up to each investor to include both explicit and implicit costs into the due diligence process—looking at the wide range of trading factors that can increase cost. An active ETF investor should make sure that trading profits exceed any potential additional costs. In doing so, investors may well find that—despite potentially higher expense ratios—commission-free and NTF tradable mutual funds may be a more cost-effective and efficient option.

---

[8] Average sector ETF expense ratio of .48%, source Morningstar January 2015

10 Source: ETF.com, December 2014. Core methodology reviews one-minute trading windows over 60 calendar days. Each ETF is assigned an “average” spread from those data points. That data point is fixed per fund. In asset class or sector buckets, each bucket is then calculated as an average weighted and median based on period ending assets under management (AUM).

By Carl Resnick
Director, Rydex Funds Distribution

This material is not intended to be relied upon as a forecast, research or investment advice, and is not a recommendation, offer or solicitation to buy or sell any securities or to adopt any investment strategy. Past performance is no guarantee of future results. There is no guarantee that any forecasts made will come to pass. Reliance upon information in this material is at the sole discretion of the reader. Investment involves risks.

This material contains the opinions of the author but not necessarily those of Guggenheim Investments and such opinions are subject to change without notice. This material has been distributed for informational purposes only. Forecasts, estimates, and certain information contained herein are based upon proprietary research and should not be considered as investment advice or a recommendation of any particular security, strategy or investment product. There is no guarantee that results will be achieved. Information contained herein has been obtained from sources believed to be reliable, but not guaranteed.

ETFs may not be suitable for all investors. •Investment returns and principal value will fluctuate so that when shares are redeemed, they may be worth more or less than original cost. Most investors will also incur customary brokerage commissions when buying or selling shares of an ETF. •Investments in securities and derivatives, in general, are subject to market risks that may cause their prices to fluctuate over time. •ETF shares may trade below their net asset value ("NAV"). The NAV of shares will fluctuate with changes in the market value of an ETF's holdings. In addition, there can be no assurance that an active trading market for shares will develop or be maintained. Securities are not guaranteed by any bank, are not insured by the FDIC or any other agency, and involve investment risks, including the possible loss of the principal amount invested.
NOT FDIC INSURED • NOT BANK GUARANTEED • MAY LOSE VALUE

Inverse and leveraged funds are not suitable for all investors. •These Funds should be utilized only by investors who (a) understand the risks associated with the use of leverage, (b) understand the consequences of seeking daily leveraged investment results, (c) understand the risk of shorting, and (d) intend to actively monitor and manage their investments. •The more a Fund invests in leveraged instruments, the more the leverage will magnify any gains or losses on those investments. •Inverse Funds involve certain risks, which include increased volatility due to the Funds' possible use of short sales of securities and derivatives, such as options and futures. •The Funds' use of derivatives, such as futures, options and swap agreements, may expose the Funds' shareholders to additional risks that they would not be subject to if they invested directly in the securities underlying those derivatives. •Short-selling involves increased risks and costs. You risk paying more for a security than you received from its sale. •Leveraged and inverse Funds seek to provide investment results that match the performance of a specific benchmark, before fees and expenses, on a daily basis. Because the Funds seek to track the performance of their benchmark on a daily basis, mathematical compounding, especially with respect to those Funds that use leverage as part of their investment strategy, may prevent a fund from correlating with the monthly, quarterly, annual or other period performance of its benchmark. **Due to the compounding of daily returns, leveraged and inverse Funds' returns over periods other than one day will likely differ in amount and possibly direction from the benchmark return for the same period.** For those Funds that consistently apply leverage, the value of the fund's shares will tend to increase or decrease more than the value of any increase or decrease in its benchmark index. The Funds rebalance their portfolios on a daily basis, increasing exposure in response to that day's gains or reducing exposure in response to that day's losses. Daily rebalancing will impair a fund's performance if the benchmark experiences volatility. **Investors should monitor their leveraged and inverse Funds' holdings consistent with their strategies, as frequently as daily.** •For more on these and other risks, please read the prospectus.

There can be no assurance that any investment product will achieve its investment objective(s). There are risks associated with investing, including the entire loss of principal invested. Investing involves market risk. The investment return and principal value of any investment product will fluctuate with changes in market conditions.
Shares of mutual funds are not deposits or obligations of any bank, are not guaranteed by any bank, are not insured by the FDIC or any other agency, and involve investment risks, including the possible loss of the principal amount invested.

Guggenheim Investments represents the investment management businesses of Guggenheim Partners, LLC. **Securities offered through Guggenheim Funds Distributors, LLC**.. Guggenheim Funds Distributors, LLC, is affiliated with Guggenheim Partners, LLC

6