

INDEX FUNDS VERSUS MUTUAL FUNDS



By: Debbie Carlson, Paul Curcio & David Tony
October 14, 2024

Passively managed index funds and actively managed mutual funds are different ways to invest in securities and are suitable for people of all investing experience levels.

When deciding whether to buy an index fund versus a mutual fund, you first need to define why you are investing, your goals, risk tolerance, time horizon and asset allocation.

What are index funds?

Index funds are found in both exchanged-traded funds (ETFs) and, to a lesser extent, mutual funds. An index fund invests according to the structure of the index it follows, such as the S&P 500, said G. Walter Christopherson, chairman of Linscomb Wealth.

Index funds seek to replicate the underlying index's return, minus the cost of administering the fund. If a fund is an index fund, it will include in its fact sheet the name of the index it follows. Aside from the S&P 500, common indexes include the Nasdaq Composite for stocks and the Bloomberg Aggregate for bonds.

Ron Tallou, an investment adviser representative who's founder and owner of Tallou Financial Services, said in addition to index funds that follow well-known indexes, some focus on niche sectors such as technology or financial services.

These vehicles are passively managed,

meaning the portfolio manager doesn't make active decisions with the holdings contained in the fund. The holdings of an index fund do not change unless the underlying index changes its constituents. For example, when the S&P 500 replaces one stock with another, index fund managers must sell the jettisoned stock and add the new stock. Index funds rebalance monthly, quarterly or yearly to ensure the fund continues to closely track the index.

Because index funds produce relatively reliable returns, they are generally suited for investors who don't want to spend a lot of time researching the market, Tallou said.

"I would say an index fund is really excellent for somebody that just wants to put some money away and take the guessing out of the equation on what to buy. You just buy the overall market," he said.

What are mutual funds?

Many mutual funds are actively managed, so a portfolio manager picks securities and positions the portfolio around an indexed benchmark with an attempt to outperform the index, said Madeline Hume, a chartered financial analyst (CFA) who's senior research analyst with AlphaCore Wealth Advisory.

Active fund managers can take more, or less, risk than the benchmark index they follow. Christopherson said when investors seek an actively managed mutual, they should look at both the returns the managers produce and the risk they take to achieve those returns. Managers who take less risk to produce the same return or better than an index or their peers have a better risk-adjusted basis.

"There are managers with long-term track records who have, over time, been able to outperform the indices on a risk-adjust-

ed basis. Some managers will have a hot streak for a while, and then they'll fall behind. So finding consistency takes a lot of homework, and you've got to stay up with how that active manager is doing," Christopherson said.

Breaking down the costs

Passively managed index funds are cheaper than actively managed mutual funds because the index fund needs little hands-on fine-tuning. In an active fund, investors essentially pay managers for their skill in selecting securities. Managers are paid through fund fees, so that's an added layer to an active fund's cost.

- **Expense ratios:** ETFs, whether they are indexed or actively managed, are usually cheaper than mutual funds overall, whether the mutual fund is passive or active. ETF costs are also more transparent because there is one annual expense ratio for anyone who buys it.
- **Fund fees:** Mutual funds may have a host of fees, including 12b-1 fees, which are reflected in the expense ratio and cover the cost of marketing and distribution, and sales loads, a commission-like fee that investors pay to buy or sell mutual funds, in addition to the annual expense ratio. Different share classes also have different costs, as share classes designated for retail investors are higher than for institutional investors.
- **Capital gains:** Tallou said mutual funds also pass on capital gains at the end of the year to their owners, who must pay taxes on them annually.

Morningstar data as of 2023 show investors' average fund fees, regardless of investment strategy, were 0.55% for passive index funds compared to 1.01% for all active fund strategies.

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“That can be a durable advantage for investors, depending on the asset class and the efficacy of replicating that benchmark in a passive vehicle,” Hume said.

Passive versus active fund management

Adam D’Acierno, founding partner of Strategic Capital, said each type of investment vehicle has pros and cons.

Passive management pros

- Index funds work well in markets where information is efficient, such as the S&P 500.
- You should get close to the same return as the benchmark, minus fees.
- Indexing is often the cheapest way to own securities.

Passive management cons

- Indexes have set rebalancing times, so index funds cannot take advantage of buying or selling securities when favorable conditions exist.
- Index funds can never beat the index’s return because they invest in the same holdings and proportions as the index.

Active management pros

- In smaller or less efficient markets, such as small-cap stocks or bond markets, active management can outperform similar benchmarks.
- An active fund may close to new investors if the fund manager believes it has become too large to successfully

execute its investment strategy.

Active management cons

- You need to keep up with the manager’s performance versus a benchmark or its peers. You also have to watch to see if managers change because new managers may or may not be as good as the previous manager.
- Costs are typically higher because of higher portfolio turnover and management expenses.
- They are often less tax efficient, especially in a mutual fund.

Investment goals

As a diversified investor, you may own a mix of index funds and mutual funds, D’Acierno said. Which ones are right for you depends on your investment goals.

- **Time horizon:** When held over a long time, index funds are a lower-cost way to participate in the market.
- **Asset allocation:** An index fund can be a good choice for a large-cap US stock holding, while an active fund may be a better choice for international stocks and bonds.
- **Retirement versus brokerage account:** Most tax-advantaged, employer-sponsored retirement plans only have index or active mutual funds, whereas a taxable brokerage account allows you to choose from ETFs or mutual funds. Furthermore, index ETFs are tax-efficient because of their structure and are ideal holdings for taxable accounts. Active mutual funds are less tax-efficient and are best held in a

tax-sheltered account.

Flexibility and risks

All investment carries risk, whether you own index funds or mutual funds.

Depending on the vehicle, index funds and active funds can be flexible on the fund structure side or the investor side. The portfolio managers of actively managed mutual funds have flexibility to buy or sell holdings when they see fit. They can take advantage and buy stocks when shares are cheap or sell to take profits or stem losses. Portfolio changes in an index fund happen on a set schedule.

For investors, mutual funds may have investment minimums before you can buy the fund. For index-based or actively managed ETFs, the cost to buy the fund is the current trading price. ETFs can trade throughout the day, while mutual funds are priced once a day, at the end of the trading session.

Investing for your future

The experts said there’s no one right answer whether to use index funds versus mutual funds. Tallou said he uses a mix of active and passive funds, which allows him to take advantage of the best these funds have to offer.

Whatever mix you choose, don’t forget to take fees into account. In the chart below, you can see how small differences in expense ratios can have a large impact on the future value of your investments.

Ron Tallou is the founder and owner of Tallou Financial Services. Ron holds a Life/Accident & Health Insurance License, and Series 6 and 63 registrations as a registered representative of CoreCap Investments. Ron believes the financial service field gives him the tools to help make others’ dreams come true by focusing on wealth preservation and wealth accumulation.

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