ETFS V MUTUAL FUNDS: WHAT YOU MAY NOT KNOW

Wisdomtree EU
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Exchange Traded Funds (ETFs) have many structural benefits that are already widely known to the marketplace, especially when compared to mutual funds: cost, transparency, efficiency and intraday liquidity are just some of those often cited benefits. If you look a little harder you'll uncover an equally important, but an often overlooked aspect which really separates ETFs from mutual funds: the creation/redemption process.

ETFs have a unique creation/redemption process that isolates trading costs to that specific investor transacting and allows the existing investor to be shielded from impact and actions of other investors. This is incredibly important because in mutual funds, the costs associated from the actions of specific investors are borne by the entire fund. This means that all investors in the fund pay for the costs generated by other investors. With ETFs it is different: transaction costs are isolated to an investor's own transactions.

In this blog we will dig deeper into how these processes work and why they are important.

Buying and selling mutual funds

When an investor buys a mutual fund, the cash is wired to the mutual fund company. The mutual fund portfolio manager takes that money and invests in the underlying securities. When the investor wants his/her money back, the mutual fund company is informed and the portfolio manager sells the securities in the portfolio to raise the cash to distribute back to the investor. This is considered a primary market transaction.

How does this compare to ETFs?

ETFs have a primary market and a secondary market. In a primary market transaction of an ETF, only authorised participants (APs) can create or redeem ETF shares directly with the issuer. During a primary market transaction, the AP will notify the ETF issuer and will either exchange cash or underlying securities for ETF shares. In this process, the fund is interacting directly with an AP, which is typically a large bank. Any costs associated with the creation or redemption are borne by that specific AP – and ultimately by that specific investor who inputted the original order by paying trading costs. This is one critical difference between ETFs and mutual funds.

ETFs can be bought and sold not just on the primary market, but also on the secondary market (that is, the exchange). The secondary market adds another layer of liquidity and is where ETF investors can buy or sell shares directly on the exchange. The primary market and secondary market interact regularly when it comes to ETF trading as shares are created or redeemed on the primary market to satisfy demand on the secondary market.

Why does this matter?

Simply put, the allocation of cost. In a mutual fund, trading costs from creating and redeeming mutual fund shares are borne by the fund. So when an investor redeems a mutual fund, the portfolio manager has to sell more securities to generate cash which translates to additional costs for these trades: bid/ask spreads of the underlying securities, taxes, trading commissions or exchange charges to name a few. These costs have a knock on effect on the NAV of the fund and a direct impact for the other investors in the fund. In essence, all of the investors are paying for the actions of one investor.

In practice

- An investor wants sell an ETF and will engage the broker or ETF trading desk and submit an order (this often takes place on the secondary market)
- Depending on a variety of factors, the AP may choose to redeem those shares on the primary market
- The AP will go to the ETF issuer and submit a primary market order for the shares to be redeemed
- The portfolio manager will then either sell the securities to generate cash or will deliver the AP the underlying shares and the ETF shares will be redeemed.

This process and any costs associated with it are borne by the specific investor that generated the trade. The costs will flow through the trading desk, or authorised participant. Existing investors in the ETF are isolated from these costs. With the many advantages that ETFs have, it's no wonder ETFs continue to gain ground on the mutual fund industry. While liquidity, transparency and efficiency often enjoy the spotlight, we believe the ETF creation/redemption process drives value and should never be overlooked.

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