ETF vs Index Fund: Which Should Canadians Invest In?

Description

At first glance, it can be tough to distinguish exchange-traded funds (ETFs) from index funds.

Both offer you a basket of securities (stocks, bonds, commodities, currencies, to name a few). Both passively follow an underlying index market (like the S&P/TSX), rather than a fund manager's investing strategy. And both enjoy relatively low operating fees.

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But beyond these similarities, ETFs and index funds have significant differences. A savvy investor knows the difference between these two investment vehicles and which one will help them build long-term wealth based on their investing strategy.

This article will help you understand the differences between ETFs and index funds and determine which fund is right for you.

What is an Index Fund?

An index fund is a batch of investments that match or track an index market, such as the **S&P/TSX Composite Index**. Keep in mind: Index funds don't try to *beat* the market (like a mutual fund does). They simply aim to *match* the market's performance.

Pros and cons of index funds

Pros of Index Funds	Cons of Index Funds
Low cost. Index funds have fewer fees than more actively managed investments	**No opportunity to outperform the market.** Index funds track an index, but they'll never beat it.
Instant diversification. The fund's stocks (or other investments) are hand-picked for you, helping you diversify with one share.	**Limited control.** You don't get to pick your stocks, nor have you any say in how the fund is composed.

Easy to understand. No complicated investing strategies or fundamental analysis involved.	**No intraday trading.** Your index fund will trade at the end of market hours,but not during them.

What is an Exchange-Traded Fund (ETF)?

Like index funds, exchange-traded funds (ETFs) are baskets of investments that follow an index market, a certain sector of the economy, or even a foreign market. ETFs trade on an exchange (hence, the name), meaning investors can buy or sell them during market hours.

Pros and cons of ETFs

Pros of ETFs	Cons of ETFs
Low costs. ETFs are much less expensive than mutual funds.	**Trading commissions.** Like stocks, you'll pay commissions to your broker when you buy or sell ETFs.
Lots of choices. These days, there's no shortage of ETF options.	**Less upside potential.** Most ETFs are passively managed, which limits how much you can gain.
Intraday trading. ETFs can be traded during normal market hours.	**Frequent trading fees**. Actively trading ETFs like stocks can result in high trading fees that erode gains.

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How are ETFs and index funds similar?

As you can see, ETFs and index funds aren't radically different. In fact, they have several overlapping benefits, including the following.

	ETFs	Index funds
Do they provide diversification?	?	?
Are they passively managed?	?	?
Do they have lower expense ratios than mutual funds?	?	?

How are ETFs and index funds different?

ETFs are the new kid on the block: founded in the early nineties (a decade or so after index funds), ETFs were designed to bring passive investing to a broader audience. They were modelled after index funds (hence, the similarities), but with several differences. Here are the most significant ones:

	ETFs	Index Funds
How are they traded?	**Intraday.** Like stocks, you can trade ETFS at any time during market hours.	**Once per day.** You have to wait until the end of the day to make a trade.

How much do they cost?	**Trading commissions** to your broker + an **expense ratio**. The expense ratio on ETFs is usually smaller than index funds.	No commissions, but you might pay **transaction fees** + **the expense ratio**.
How frequently are dividends reinvested automatically?	**Infrequently.** The investor often must invest dividends earned on an ETF.	**Frequently.** Fund manager usually converts dividends—free of charge—into more shares.
Do they have investment minimums?	**Low.** Investors can buy one share or fractionals.	**High**. Investors might need to buy a certain number of shares upfront.

Which is the safer long-term investment?

The short answer—both ETFs and index funds are equally safe investment vehicles that can strengthen your long-term investing strategy.

If you want the opportunity to trade your basket of investments like a stock, you'll enjoy the flexibility of an ETF. Just keep in mind day trading isn't always the best investing strategy, as you could be tempted to grab short-term gains at the expense of long-term growth. And, in addition, you'll pay commissions for each trade you make.

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Alternatively, if you don't have a lot of money to start investing, an ETF can be a safe and inexpensive gateway to the investing world.

But not all index funds have minimum investments. If you don't care about day trading, an index fund could be the better investment. An index fund allows you to "set it and forget it," which is a surefire way to help you build wealth. On the other hand, because of the way index funds are structured, you might pay more capital gains taxes than you would in an ETF (there's always a drawback, right?).

Beyond these minute (but significant) differences, no matter which one you choose, always know *what* you're investing in. Take a good look at the underlying investments in your ETF or index fund. At the end of the day, it's the performance of *these* investments that could help you build long-term wealth.

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Should you invest in ETFs or index funds?

Here are a few factors to help you decide which is right for you.

Choose an ETF if you want …

- **To trade frequently.** If you're an active day trader, or you'd like the opportunity to sell your investment fund during market hours, an ETF might be right for you.

- **Lower minimum investments.** Most ETFs don't require you to invest a minimum amount to get started. Often you can buy a single share, or even a fraction of one.
- **More tax efficient.** ETFs are slightly more tax efficient than index funds. If you're investing a substantial amount of money, then an ETF may help you cut more of your tax bill than an index fund.

Choose an index fund if you want …

- **To avoid trading commissions.** Unlike ETFs, you won't pay commissions to trade index funds. You may, however, pay transactions fees, depending on your brokerage.
- **To "set it and forget it."** Because an ETF trades like a stock, it could tempt you to trade more frequently than you'd like. If you're a long-term investor, a top Canadian index fund may better fit your investing strategy.

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