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Research Paper

A Comparison of Mutual Fund vs ETFs

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MUTUAL FUNDS VS. ETFs: EXPLAINING THE KEY DIFFERENCES FOR INVESTORS

Mutual funds and exchange-traded funds (ETFs) are two of the most popular investment vehicles available to individual investors. Both allow investors to pool their money to gain exposure to a diversified portfolio of stocks, bonds, or other assets. While they share many similarities, important structural and practical differences can affect costs, taxes, flexibility, and how they fit into an overall investment strategy.

Understanding these differences can help investors choose the option that best aligns with their financial goals, tax situation and investment style.

WHAT IS A MUTUAL FUND?

A mutual fund is an investment vehicle that pools money from many investors to buy a diversified portfolio of securities such as stock, bonds and short-term debt. The combined holdings of the mutual fund are known as its portfolio. Investors buy shares in mutual funds, and each share represents an investor's partial ownership of the fund and the income the fund generates. Mutual funds are often actively managed, meaning a professional portfolio manager makes decisions about which securities to buy or sell in an effort to outperform a benchmark index. However, there are also index mutual funds that passively track a market index, such as the S&P 500.

Mutual fund investors buy shares directly from the fund company, usually through a brokerage account, retirement plan, or financial advisor. Transactions occur at the fund's net asset value (NAV), which is calculated once per day after the market closes.

WHAT IS AN ETF?

An ETF is similar in concept to a mutual fund in that it holds a portfolio of securities and provides diversification. However, ETFs are designed to trade on an exchange, much like individual stocks. Most ETFs are passively managed and aim to replicate the performance of a specific index, though actively managed ETFs have become increasingly common.

ETF shares are bought and sold throughout the trading day at market prices, which can fluctuate above or below the ETF's underlying NAV.

MUTUAL FUNDS VS. ETFs: A SIDE-BY-SIDE COMPARISON

FEATURE	MUTUAL FUNDS	EXCHANGE-TRADED FUNDS (ETFs)
How They Trade	Bought and sold directly via a fund company or a brokerage	Bought and sold on a stock exchange
Pricing	Priced once per day at Net Asset Value (NAV)	Trades throughout the day at market prices
Intraday Trading	Not available	Available (like stocks)

FEATURE	MUTUAL FUNDS	EXCHANGE-TRADED FUNDS (ETFs)
Minimum Investment	Often \$500-\$3,000 (may be waived in retirement plans)	Price of one share (fractional shares are sometimes available)
Expense Ratios	Often higher, especially for active funds	Generally lower, especially index ETFs
Sales Loads / Fees	Some funds charge sales loads or redemption fees	No sales loads; may have bid-ask spreads or trade commissions
Tax Efficiency	May distribute capital gains annually	Generally more tax-efficient
Management Style	Often actively managed	Mostly passive, but some are active
Transparency	Holdings disclosed quarterly or semiannually	Holdings typically disclosed daily
Automatic Investing	Well-suited for recurring investments	Depends on brokerage features
Best Use Case	Tax-advantaged accounts, hands-off investors	Taxable accounts, cost-conscious investors

EXPLANATION OF THE DIFFERENCES BETWEEN MUTUAL FUNDS AND ETFs

1. Trading and Pricing

One of the most noticeable differences between mutual funds and ETFs is how they trade.

- Mutual funds are priced once per day. Regardless of when you place your order during the trading day, your transaction will be executed at that day's NAV.
- ETFs trade continuously throughout the day, just like stocks. Their price moves based on supply and demand, allowing investors to buy or sell at specific prices and use tools such as limit orders or stop-loss orders.

This intraday trading flexibility makes ETFs appealing to investors who want more control over execution timing.

2. Costs and Expense Ratios

Costs can have a meaningful impact on long-term investment returns.

- Mutual funds, especially actively managed ones, often have higher expense ratios due to research costs, portfolio management, and marketing expenses. Some mutual funds also charge sales loads or redemption fees, though no-load funds are widely available.
- ETFs generally have lower expense ratios, particularly index ETFs. Their passive structure and lower turnover help keep costs down. ETF investors may incur trading commissions (though many brokerages now offer commission-free ETF trades) and bid-ask spreads, which represent a hidden transaction cost.

3. Tax Efficiency

Tax treatment is a major area where ETFs often have an advantage.

- Mutual funds may distribute capital gains to shareholders when the fund sells securities at a profit. These distributions are taxable to investors, even if they reinvest the proceeds and did not sell their fund shares.
- ETFs tend to be more tax-efficient due to their unique creation and redemption process, which allows many transactions to occur without triggering taxable capital gains.

For investors holding funds in taxable brokerage accounts, ETFs may help reduce unexpected tax liabilities. See Resource 4 for related information on this factor.

4. Minimum Investment Requirements

Minimum investment requirements can influence accessibility.

- Mutual funds often require a minimum initial investment, commonly ranging from \$500 to \$3,000, though some funds and retirement accounts waive these minimums.
- ETFs typically have no minimum investment beyond the price of one share. Many brokerages now offer fractional ETF shares, making them accessible to investors with smaller amounts to invest.

5. Management Style and Strategy

Both mutual funds and ETFs can be actively or passively managed, but their historical tendencies differ.

- Mutual funds have traditionally been actively managed, aiming to outperform the market through security selection and timing.
- ETFs have traditionally been index-based, focusing on tracking a specific market segment rather than beating it.

Actively managed ETFs are growing in popularity, narrowing this distinction, but mutual funds still dominate in certain active strategies.

6. Transparency and Holdings Disclosure

Transparency refers to how frequently investors can see what a fund owns.

- Mutual funds typically disclose their holdings quarterly or semiannually.
- ETFs generally disclose their holdings daily, allowing investors to see exactly what they own at any given time.

This transparency can be especially valuable for investors who want to closely monitor exposures or avoid **overlapping** across investments.

7. Automatic Investing and Dividend Reinvestment

Convenience features can also differ.

- Mutual funds are often well-suited for **setting up** automatic investments. Investors can set up recurring contributions and automatic purchases in dollar amounts.
- ETFs may require manual purchases unless the brokerage supports automated ETF investing. However, most brokerages offer automatic dividend reinvestment for ETFs.

Investors who prioritize “set it and forget it” investing may find mutual funds easier to manage in this regard.

WHICH IS BETTER: MUTUAL FUNDS OR ETFS?

There is no universal answer. The better choice depends on an investor's goals, preferences, and circumstances.

Mutual funds may be a better fit for investors who:

- Prefer professional active management
- Invest through employer-sponsored retirement plans
- Value simplicity and automatic investing
- Are less concerned about intraday pricing

ETFs may be a better fit for investors who:

- Want low costs and tax efficiency
- Prefer intraday trading flexibility
- Invest primarily in taxable accounts
- Value transparency and index-based strategies

Many investors use both mutual funds and ETFs within the same portfolio, selecting each where it makes the most sense.

SUMMARY

Mutual funds and ETFs are excellent options to help investors build diversified portfolios and pursue long-term financial goals. While they share many core characteristics, they differ in areas such as trading policies, costs, taxes, and flexibility.

By understanding these differences and aligning them with personal priorities—such as cost sensitivity, tax considerations, or a desire for hands-on investment control—investors can make more informed decisions and use each vehicle effectively as part of a well-balanced investment strategy.

RESOURCES

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