Using ETFs and Mutual Funds in a Portfolio – the Best of Both Worlds.

Red Paper

REDHAWK WEALTH ADVISORS

The Benefits of Having Mutual Funds and ETFs in Your Portfolio

As exchange-traded funds ("ETFs") grow more popular, it's not uncommon for investors to wonder how ETFs might fit into a portfolio. Let's start off by understanding what an ETF and mutual fund are:

What's an ETF?

ETFs were invented to combine the simplicity and low costs of index mutual funds with the flexibility of individual stocks. Unlike most mutual funds, ETFs trade on exchanges, where investors can buy and sell them anytime the market is open. With ETFs, investors can track broad market indexes such as the S&P 500, thus gaining instant diversification. ETFs in general have very low fees and investors typically don't get hit with a tax bill until it's sold. One of the biggest advantages of ETFs is their low annual operating costs. Their expenses are not only well below those of traditional mutual funds, but in many cases even less than the expenses levied by their index fund counterparts.

What's a Mutual Fund?

A mutual fund is a pool of money from thousands of people that invests in certain things. One mutual fund might invest in the stocks of large U.S. companies. One might invest in Treasury bills. Another might invest in a huge assortment of stocks, bonds, real estate, cash equivalents and other securities. You name it, and there's probably a mutual fund that's already investing in it. Each investor in the fund gets a slice of the total pie, sharing in the fund's gains or losses.

Every company that manages a mutual fund charges an annual fee that's generally ranges from 0.50% to 2.50% of assets. The mutual fund share class determines the annual fees and if an advisor or third-party is compensated to distribute the fund (the 12b-1 fee). Additionally, some funds have a sales charge that's incurred over and above these fees and are called "load funds." Mutual funds that do not impose sales charges are known as "no-loads." The sales charges are either a cut of new money the investor put into the fund or a cut of withdrawals the investor made from the fund.

It's important to note that Redhawk will only use mutual funds that have an institutional share class, which means they are the lowest cost mutual fund and do not include 12b-1 fees or sales charges.

So why use Both?

While there's no shortage of articles comparing the two investment vehicles, we believe that there are plenty of benefits to using both mutual funds and ETFs to help investors reach their retirement goals. We've described some of the benefits below:

1. Increased Diversification

ETFs and mutual funds can be ideal for many portfolios, for they help investors gain exposure to a wide variety of asset sub-categories, sizes, style and desired market segments. Including both of these funds

as part of an investing strategy offers a number of benefits, with diversification being one of the strongest. A well-diversified portfolio can be built with both that hold a broad selection of stocks and bonds in the United States and around the world. Since there are roughly 2,000 ETFs and 15,000 mutual funds, each sub-category will have either an ETF or mutual fund as its top performing fund.

2. Active Management

Just as it's no secret that Redhawk Wealth Advisors is a proponent of active management, it's a myth that all ETFs are passively managed. Actively managed ETFs are actually a fast-growing segment of the ETF industry. This can be a huge benefit for investors because while passively managed funds seek to match the holdings and returns of a particular market index, such as the S&P 500, actively managed funds generally seek to outperform a particular market index or strategy.

Active ETF and mutual fund managers build and maintain portfolios by making deliberate decisions on securities to buy, sell, or hold, which means they can take into account company fundamentals, economic trends and cycles for industries or asset classes. Furthermore, at Redhawk Wealth Advisors, we take it a step further with our proprietary investment selection, monitoring, and replacement methodology, so we can identify those investments that deliver consistent long-term performance which is a crucial component in helping investors get to where they want to go.

3. Investment Minimums

Some mutual funds come with minimum investment requirements, which may preclude investors from buying into the fund. In comparison, ETFs generally do not have an investment minimum and allows investors to purchase a fund for as little as one share.

It's important to note that the number of ETFs and mutual funds in the various asset sub-categories varies widely. By including both ETFs and mutual funds, Redhawk Wealth Advisors has more investments to choose from to develop strategies that help investors achieve their goals. Our screening and selection process includes both ETFs and mutual funds which ensure that we are selecting the top performing investment for that particular asset sub-category. One of our screening criteria is to make sure that the fund has a minimum initial investment amount of $5,000 or less.

4. Dividends

Most investors take advantage of the automatic dividend reinvestment feature of mutual funds. For the most part, it saves the hassle of deciding what to do with the cash dividend that is automatically deposited into the account. If and when the mutual fund pays out a cash dividend, the dividend is automatically reinvested in shares, or partial shares of the fund. With dividend paying ETFs, the cash dividend is deposited into the investor's brokerage account, just like the dividend on a regular stock. If the investor wants to reinvest that cash, a separate purchase will have to be made and usual trading fee will be incurred.

ETF Advantages

The major advantages that ETFs have over mutual funds are that they generally have:

- a lower expense ratio,
- the ability to buy and sell them at any time the market is open, and
- the ability to tax-manage them according to individual requirements.

Mutual Fund Advantages

These funds add value if the investment approach used provides a return, net of expenses, that exceeds what can be obtained from an index fund or similar ETF. Additionally, mutual funds invest in areas where there are few ETFs. We believe that there are mutual funds that meet these criteria over the long run, and choices from these are included in our wrap account strategies.

Comparison

While ETFs are gaining in popularity, few have a 10-year history. Because of this, we have modified our screening process to take this into account. While it is handy for traditional broker-dealers to keep mutual funds and ETFs separate when reporting on them, an effective portfolio should combine them to take advantage of the strengths of each. That is exactly what we have done in our wrap account strategies.

The chart below summarizes some of the major differences between ETFs and mutual funds:

Vehicle Characteristics for Actively and Passively Managed Funds		
	ETFs	Mutual Funds
Buying and Selling	ETFs are continuously priced throughout the trading day, and investors buy and sell them in the secondary market (stock market). We place orders through the client's brokerage account, which allows us to place limit, stop-limit, and short-sale orders, and to trade on margin.	We cannot buy mutual funds on margin, or set price limit orders. Trades are executed based on the end-of-day price.
Pricing	Share prices fluctuate intraday on a stock exchange and have bid and offer prices. Price may differ from the Net Asset Value "NAV" and trade above (premium) or below (discount).	All trade orders receive the same daily NAV price calculated at 4:00 p.m. Eastern time.
Disclosure	Portfolio holdings are disclosed daily and released to the exchange every 15 seconds during trading hours. This also includes the number of days that shares traded at a premium/discount for the previous year and	Generally, disclosures of portfolio holdings are monthly and quarterly with a lag disclosure of NAV performance.

Vehicle Characteristics for Actively and Passively Managed Funds		
	ETFs	Mutual Funds
	disclosure of performance at NAV and at market.	
Costs†	Brokerage commission plus bid/ask spread (difference between) on each buy and sell order. We pay for these costs in the Wrap accounts.	Customary trading costs when bought through a third-party custodian. We pay for these costs in the Wrap account.
Holding Period Return	Market price return (plus distributions).	Change in NAV (plus distributions).
Tax Implications	Possibly more tax efficient because investor trades match on secondary market versus in the fund.	When investor redemptions are not offset by cash inflows from investors, the redemptions can trigger portfolio trading, which may have tax implications for shareholders.

† ETFs and mutual funds are subject to management fees and other expenses.

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