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Differences between ETFs and index funds

ETFs and index funds present a few differences that investors need to be aware of.

If you invest in a 401(k) or 403(b) through your employer, there is a good chance you will have index mutual funds as an investment option, but not ETFs.

If you want to buy ETFs, your best bet is usually to open an IRA, Roth IRA, or a taxable brokerage account. Depending on where you open these accounts, you will likely have access to a much broader range of funds, including a wide variety of mutual funds and ETFs.

ETFs vs. index funds: How they're similar

Despite their differences, ETFs and index funds are quite similar, and they can serve a lot of the same roles for the investor.

Diversification

One of the biggest benefits of both index funds and ETFs is how easy they make it to diversify your portfolio. Total stock market funds, for example, track the performance of every publicly traded company in the United States, meaning at the moment, they track nearly 4,000 U.S. companies. Vanguard funds VTSAX and VTI track this same index, but the former is a mutual fund and the latter is an ETF — but they're both still index funds.

Low fees

The fees on both index funds and ETFs are low, especially when compared to actively managed funds. Many ETFs track an index, and this investment style keeps fees low. Since the fund changes based only on changes to the index — a passive approach — there are few labor costs associated with index funds.

In 2023, the average expense ratio for index equity mutual funds was 0.05 percent, according to the Investment Company Institute's latest report. For equity ETFs, it was 0.15 percent. On the other hand, the average fee in 2023 for actively managed mutual funds and ETFs was 0.65 percent and 0.43 percent, respectively.

Passive investments

Index funds and most ETFs simply try to replicate an index of stocks or other assets. They don't make active trading decisions and try to beat the market. Instead, they try to mimic the index and match its returns over time.

And investors can use index funds and ETFs as a passive investment strategy. For instance, you may have an employer-sponsored retirement plan that allows you to invest using payroll deductions. If you invest a certain percent of your salary every pay period in index funds, your portfolio will need little to no ongoing maintenance.

The same is true if you invest in ETFs or index funds in a brokerage account. When you buy S&P 500 index funds, for example, most brokers offer the option to invest automatically.

Strong long-term performance

Another benefit of both index funds and ETFs is strong long-term performance. An active fund manager or stock picker might make a few winning trades here and there; few, though, can do so for a sustained period and beat the market. Over the long term, most active fund managers fail to beat or even meet their benchmark.Meanwhile, index funds and ETFs provide more consistent performance that wins in the long run. The S&P 500, for example, has historically returned about 10 percent per year, on average. This makes broadly diversified index funds and ETFs solid long-term investments.

Index funds or ETFs: Which are better?

Determining whether an index fund or ETF is better is difficult because the answer depends on the specific funds being discussed and your goals as an investor. Many index funds are available in ETF form, which provides trading throughout the day and rock-bottom fees. If you're buying an index mutual fund, you'll likely run into investment minimums of a few thousand dollars, plus you'll only be able to buy and sell at the end of each trading day.

But it's important to remember that mutual funds and ETFs aren't investments in and of themselves, they're just vehicles for investing in securities like stocks and bonds. If you're investing in a mutual fund and an ETF that both track the same index and therefore hold the same underlying securities, you're likely to end up with similar performance over longer periods of time as long as the fees for each fund are similar.

Bottom line

Whether you invest in an ETF or an index fund, you are choosing to invest in your future. The differences between the two tend to be small; in fact, index funds and ETFs are often (but not always) the same thing. Thus, which one you choose is less important than the choice to start investing. In doing so, you take advantage of low fees and diversification, and an investment that will grow over time.