Considerations Involving Mutual Funds and Exchange-Traded Funds

Many investors rely on mutual funds and exchange-traded funds ("ETFs") to pursue their financial goals. Both mutual funds and ETFs offer investors the ability to invest in diversified pools of securities that follow a variety of investment strategies with exposure to various types of asset classes. Despite these similarities, it is important for you to understand the differences between these products with respect to: (1) how they are priced, (2) their fees and expenses, and (3) tax efficiency. The following information pertains to domestic mutual funds and ETFs.

Pricing

Mutual funds and ETFs are priced in different ways.

Purchases and redemptions of mutual funds are priced in accordance with the net asset value ("NAV") of a fund. A fund's NAV is calculated by (1) taking a fund's assets, which include the fund's securities and cash, (2) reducing that sum by the fund's liabilities, which include its fees and expenses, and then (3) dividing that sum by the number of shares outstanding. This means that a mutual fund is valued by reference to its actual investments.

Most mutual funds determine their NAV at the end of each trading day, which is typically 4:00 p.m. ET. As a result, if you place a purchase or redemption order for a mutual fund at 10:00 a.m. ET, you will not know the final terms of your transaction until after the end of the trading day, when a final value for each of the fund's underlying assets is ascertained. In this way, although mutual funds generally require investors to wait until 4:00 p.m. ET for final trade values, those values are derived from the actual investments held by the fund.

Purchases and redemptions of ETFs, on the other hand, are priced differently. Shares of ETFs are bought and sold on the secondary market (e.g., on stock exchanges), which means that investors do not transact with funds at prices based on NAV. Rather, the price of an ETF share is determined by the market—i.e., the price the buyer and seller of ETF shares agree on—as opposed to the value of the assets held by the ETF. One benefit of trading in this manner is that investors can buy and sell ETF shares throughout the trading day and instantly know the price at which they transacted.

Trading ETF shares in the secondary market, however, can impact the liquidity and the price of an ETF's shares. If an ETF has a lower trading volume, an investor may have to accept a lower price to sell their ETF shares in the short term. This risk may be pronounced during times of market stress or if more market participants want to sell rather than buy an ETF's shares. Any of these situations, among others, could lead to an investor selling their shares at a "discount" to what the ETF's underlying holdings are actually worth.

Other trading scenarios can cause ETF shares to trade at higher prices than what the ETF's underlying holdings are worth (i.e., buying shares at a "premium"). Purchasing ETF shares at a premium and selling those shares without a premium, or at a discount, can significantly affect the realized return earned by an investor, with it being likely that such realized return would substantially differ from the return of the ETF's market price or the performance of its underlying holdings and, if applicable, the index the ETF may seek to track.

ETFs rely on large institutions to make a market in their shares, which provides liquidity to the trading of the ETF and can help keep the market price of ETF shares close to the ETF's NAV. Although this process has been generally successful, market disruptions, new types of ETFs and/or other events can make it challenging for such institutions to continue their market-making activities. This means that ETFs can trade at discounts to their NAVs, which will negatively impact ETF shareholders, particularly those that need to sell their shares at such times.

Taken together, when considering an investment in ETFs, you should consider the effects of trading in the secondary market. In addition, certain platform providers may limit the availability of ETFs to retirement plans.

Lastly, it bears noting that mutual funds and ETFs can also differ in terms of how often each product discloses its portfolio holdings. Mutual funds, for example, publish their holdings after each quarter end. Many mutual funds also display their top-10 holdings throughout the year. Many ETFs, however, publish their holdings on a daily basis. A minority of actively managed ETFs, however, meaning those that seek to outperform an index or other benchmark, disclose their holdings less frequently than daily.

Fees and Expenses

Fees and expenses are an important investment consideration because they reduce investment performance.

Although the overall investment costs an investor pays will depend on the types of funds being considered, whether an investor is utilizing a brokerage or an advisory account and whether any commissions or sales loads are assessed, you should know that many ETFs are less expensive than similarly managed mutual funds. For example, in brokerage accounts, mutual funds, but not ETFs, are generally subject to so-called 12b-1 fees, which are ongoing fees charged against mutual fund assets for marketing, distribution and/or shareholder services costs. Mutual funds, but not ETFs, also provide Morgan Stanley with compensation for providing record keeping and related services.

Further, although revenue sharing payments are generally paid by the sponsors of mutual funds and ETFs, and not by the investors in such products, it bears noting that Morgan Stanley charges revenue sharing fees to more mutual funds than it does to ETFs.

Because Morgan Stanley generally receives more compensation from mutual funds than it does from ETFs, Morgan Stanley has a financial incentive to promote and recommend mutual funds, which is a conflict of interest. In order to mitigate this conflict, Morgan Stanley seeks to charge the same revenue sharing rate schedule for mutual funds and those ETFs that are subject to revenue sharing, and for advisory clients there are account type and program exceptions and the fees are rebated to clients. Likewise, 12b-1 fees are either not charged to advisory clients or the fees are rebated to advisory clients. Mutual fund administrative services fees are also rebated to advisory clients or subject to account type and program exceptions. Lastly, Financial Advisors/Private Wealth Managers and their Branch Managers do not receive additional compensation as a result of mutual fund or ETF revenue sharing payments or mutual fund administrative services fees received by Morgan Stanley.

For more information on 12b-1 fees, administrative services fees and revenue sharing payments, including the conflicts of interest associated with them, please see the brochures titled "Mutual Fund Features, Share Classes and Compensation," "ETF Revenue Sharing, Expense Payments and Data Analytics Fees," and "Mutual Fund and ETF Revenue-Sharing Families," which are available at morganstanley.com/disclosures. Please see the applicable ADV brochure for additional information related to advisory accounts.

Tax Efficiency

Although it can vary by fund, ETFs are often more tax efficient than mutual funds.

Mutual funds and ETFs are generally required to distribute dividends and net realized capital gains on their holdings to shareholders. Unless a mutual fund or ETF is held in a tax-advantaged account, investors will typically have to pay taxes on such gains and income. This is true even if the fund loses value during a given tax year.

The manner in which ETFs create and redeem their shares typically allows ETFs to experience fewer net realized capital gains. For investors utilizing taxable accounts, investing in ETFs could increase their returns on an after-tax basis, as compared to investing in a similarly managed mutual fund. Please consult with your tax advisor on the tax implications of investing in mutual funds and ETFs. Morgan Stanley does not provide tax advice.

Conclusion

Mutual funds and ETFs allow investors to pursue professionally managed and diversified investments in convenient packages. Each product, however, has different characteristics regarding pricing, fees and expenses, and tax efficiency that should be considered.

Please carefully review a fund's prospectus before investing. The prospectus contains important information about fees, risks and investment objectives and should be carefully considered before investing.

07/2024 CRC# 3640705