BREAKING: US stocks open mostly flat as investors await Trump news conference, earnings season

Hopping on ETF wagon? Tread carefully, advisors say

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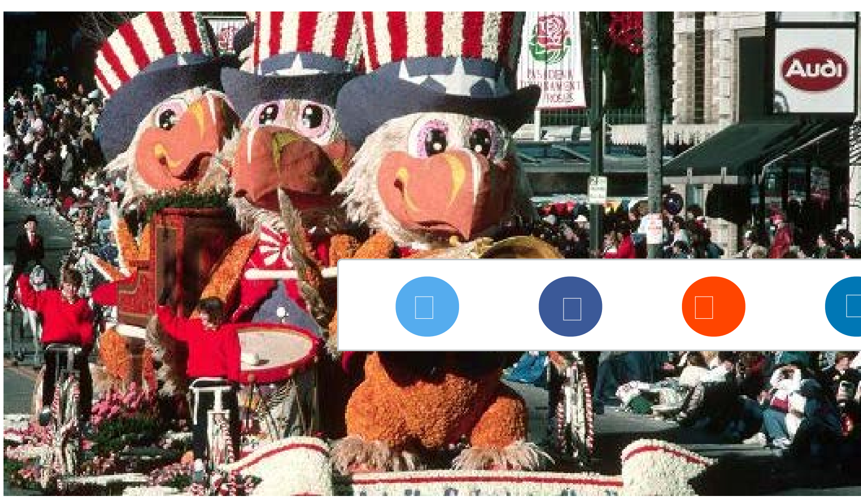
The sun had yet to rise the morning after Donald Trump's surprise presidential election win, but financial advisor Kashif Ahmed already was responding to the news by changing client holdings of exchange-traded funds through orders to be executed upon the stock market's 9:30 a.m. opening.

"If those ETFs had been mutual funds, we would have had to wait until the end of the day to make trades," said Ahmed, a certified financial planner and the founder and president of American Private Wealth. "If you want to act on an idea and your money is in mutual funds, the opportunity might be gone by the end of the day."



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Because ETFs trade throughout the day like stocks rather than at the market's close, as with traditional mutual funds, Ahmed was able to more quickly shift ETF money to investments that potentially could perform well under a Trump administration.

While such liquidity is one of the reasons ETFs hold such big appeal for financial advisors, Ahmed and others say the popular investment option only makes sense for do-it-yourself investors if employed properly and vetted thoroughly.

"There's a lot of hype and excitement about them … but I wouldn't recommend them for the vast majority of investors unless you are very active about managing your portfolio and like to be a little speculative," said CFP Robert Schmansky, a personal financial advisor and founder of Clear Financial Advisors. He generally prefers mutual funds but uses ETFs for exposure to certain niche markets.

"And don't think of all ETFs as one homogenous investment type," he added.

With investors increasingly focused on investment costs, and a long-running bull market contributing to attractive gains in lower-cost passively managed index-based options, ETFs as a whole are pulling in more assets than traditional mutual funds.

Data from Morningstar show that for the month ended Nov. 30, ETFs pulled in nearly $51.7 billion in new money. Actively managed mutual funds — those headed by professional stock pickers — shed $67.8 billion. Index funds — passively managed but nevertheless traditional mutual funds — took in $19.7 billion.

The outflows for the year ended Nov. 30 reflect the shift from actively managed funds to passively managed investments: While $292 billion flowed out of actively managed mutual funds, ETFs attracted more than $268 billion and index funds saw inflows of $218 billion.

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Aside from liquidity, ETFs come with other benefits, including generally lower costs. Recent Morningstar data show that the average expense ratio for all ETFs is 0.56 percent, compared with 1.18 percent for traditional mutual funds.

ETFs, which usually mirror an index's holdings, also offer better transparency. Investors can view a typical ETF's holdings online anytime, while traditional mutual funds are required only to disclose their withholdings quarterly.

Additionally, ETFs are more tax-efficient because any capital gains they generate are inconsequential, advisors say. In taxable accounts, unpredictable capital gains distributed inside mutual funds can cause tax headaches.

But some advisors say that if investors buy ETFs because of hearing only the good things, that's a problem.

"Things become fashionable, and then there ends up being pandemonium," said Ahmed of American Private Wealth.

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One of Ahmed's biggest concerns is the rush of new ETFs coming to market. Already this year, a couple hundred new ETFs have joined the fray, putting the number available at more than 1,900, according to ETF.com.

"Some of the new ones are 'me too' products that replicate what's already out there," Ahmed said.

One problem with duplicative ETFs, or those that have arisen from a market being overly "sliced and diced," Ahmed explained, is that their liquidity is limited if they are thinly traded.

Also, if a new ETF fails to attract enough assets, it's at risk for shuttering or getting rolled into another ETF.

"Make sure [the ETF issuer] has a solid reputation and is going to back the product," said Schmansky of Clear Financial Advisors.

"If you aren't comfortable trading individual stocks, I don't see the benefit of investing in ETFs."

-Robert Schmansky, founder of Clear Financial Advisors

Advisors also stress that two ETFs with similar names might have decidedly different holdings at different weightings. And their performances could vary wildly.

Even an individual ETF can be trading at a price that doesn't match the value of its underlying assets, for reasons that are complex. And if you buy at a premium, Schmansky said, it could wipe out the value you assumed you'd derive from picking a lower-cost ETF over a mutual fund.

Additionally, the low fees that typically come with ETFs do not automatically translate into strong gains. Any fund — whether an ETF or traditional mutual fund — can only perform as well as its underlying investments. If you invest in an ETF that tracks a tanking index, your ETF also tanks. In comparison, active fund managers can rearrange their mix of holdings to try avoiding huge losses.

Even for advisors who are self-professed fans of ETFs, their enthusiasm comes with warnings for individual investors.

Elijah Kovar, an advisor and partner at Great Waters Financial, said his firm has removed all traditional mutual funds from their portfolios and now uses ETFs exclusively. Nevertheless, he cautions investors that using ETFs means you don't get to sleep at the wheel.

"You can't just set it and forget it," Kovar said. "The risk in any asset class is not static."

He said that once you've determined your risk tolerance — your ability to stomach market volatility — and have created a portfolio of all key asset classes at weightings that reflect that tolerance, you'll probably need to rebalance your portfolio two or three times a year to ensure it adheres to your initial asset allocation.

Morningstar, for its part, hopes to make it easier for investors and advisors to compare ETFs not only to each other but also to traditional mutual funds. The company recently rolled out forward-looking analyst ratings on roughly 250 ETFs listed around the world, more than 100 of which are U.S.-based.

Most importantly, advisors say that unless investors are willing to take on the role of investment manager, investing mostly in ETFs probably makes no sense.

"If you aren't comfortable trading individual stocks, I don't see the benefit of investing in ETFs," said Schmansky of Clear Financial Advisors.

— By Sarah O'Brien, special to CNBC.com

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