Mutual Funds ETFs and Index Funds

"Don't put all of your eggs in one basket", Harry Markowitz

On paper a mutual fund is simple. Many people pool their money in a fund, which then invests in various securities. Each investor shares proportionately in the fund's investment returns—the income (dividends or interest) paid on the securities and any capital gains or losses caused by sales of securities the fund holds. Every mutual fund has a manager, also called an investment advisor, who, for a fee directs the fund's investments according to the fund's objective, such as long-term growth, high current income, or stability of principal. A fund may invest in stocks, bonds, cash investments, or a combination of these financial assets.

Mutual funds are the most popular investment vehicle of investors because they are said to offer four **advantages**:

Diversification- A single mutual fund can hold securities from hundreds or even thousands of issuers, far more than most investors could afford on their own. Diversification may reduce the risk of a large loss due to problems in a particular company or industry.

Professional Management- Few investors have the time or expertise to manage their personal investments every day. With access to extensive research, market information, and skilled securities traders, the professional fund advisor decides which securities to buy and sell for the fund.

Liquidity- Shares in a mutual fund can be bought and sold any business day, so investors have easy access to their money.

Convenience- Fund shares can be bought or sold by mail, telephone, or the Internet, or even scheduled automatically to and from your account. You can easily move your money from one investment to another as your financial needs change.

Similarly, mutual funds have some **disadvantages**:

No Guarantees- Unlike bank deposits, mutual fund shares are not insured or guaranteed by the Federal Deposit Insurance Corporation (FDIC) or any other agency of the U.S. government. All mutual fund values will fluctuate.

Diversification "penalty"- While diversification eliminates the risk of catastrophic loss that would occur if you own a single security whose value plummets, it also limits the potential for making a killing in the market if that security's value shoots up.

Potentially High Costs- Annual mutual funds costs can vary from .25% to about 3%. A combination of sales commissions and high operating expenses at some fund companies will reduce your investment returns. Compare the costs of mutual funds.

Tax Impact- The profits on a mutual fund investment made by individuals are typically subject to federal (and often, state and local) income tax. Because funds have to distribute their gains, you can incur substantial capital gains, even while receiving mediocre returns.

Types of Mutual Funds

Active Funds- Active Funds are managed by an investment advisor who makes daily buy and sell decisions. The theory is that active management adds value in potential return.

Index Funds- Index Funds try to track market averages, not to beat them, by buying and holding all, or a large representative sample, of the securities in their target indexes (like the S&P 500). Index investors aspire to be average, and approximate the benchmark they mirror. On the other hand their costs are low.

Open End- An Open End Investment Company is a mutual fund not listed on exchanges and sold directly to investors. When the investor sells, the fund is the purchaser. They can issue as many shares as people want to buy.

Closed End- A Closed End Fund is listed on exchanges and is bought and sold like stocks. The number of shares in a Closed-End Fund is fixed.

As with any investment—do your homework and be careful.

How to Buy Mutual Funds

“The big fast gains have already been made”, Bob Olstein

The time to consider buying stocks is when the market goes down. The time to sell is when the market goes up. Simple. The investment vehicle of choice is the mutual fund. A mutual fund is a basket of securities and you own a pro-rata share of the basket. Note that you do not own the securities. Equity mutual funds are the primary investment vehicle of 401K and IRA accounts. There are about 6000 mutual funds in our country today, and more mutual fund assets outside the US than in the US.

The economic stress the past few years has changed us somewhat from a nation of spenders to a nation of savers. That is very good for the mutual fund industry, and not bad for us either. We are currently seeing $50-80 Billion in new stock and bond fund investments every month. More and more mutual fund investors are looking to them as real investments and there are fewer attempts to trade funds or time the market. That stuff never works anyway. An interesting point of fact is that 401K investors have made virtually no changes in funds within their plans in the past 6 months.

So how do you determine which mutual fund or funds to buy? You could ask your stockbroker and pay her to buy some for you. If you don’t like the idea of paying your broker fees to recommend mutual funds (or even worse, paying a broker 1% to

“manage” mutual fund assets), you could go to vanguard.com where they have a vast array of very low cost mutual funds to pick from. An index fund from Vanguard will cost you much less than a similar fund from your broker. In addition, they have sector-specific funds, country-specific funds, industry-specific funds and a large selection of even lower cost fixed income funds.

If you are looking for some help in analyzing mutual funds, there are financial websites that provide information on Funds and have calculators that help you evaluate your current situation and set up a road map to retirement. Let’s look at some of them.

AARP:
Takes into account inflation, your social security expectation and your life expectancy. You can even factor in plans for charitable gifts, what you want to leave to your kids (if anything!). If you seem to come up short of your goals, you get suggestions as to how much more you need to save, or where you need to cut back (food and clothing not an option here).

Financial Engines:
Designed by Nobel Prize winner Bill Sharpe, this is a sophisticated calculator which has a lot of nimbleness. It even has a Director of Investment Analysis and Research.

Brokerage Firm or Fund Families:
While some are good, they steer you toward their funds (of course), and you need to be wary of that. No one firm has the best or most appropriate funds in every category.

Fidelity or Schwab:
The financial supermarkets have calculators for everything: retirement planning, IRA deposits, savings. Of course they all point you toward their own products or advisors.

Financeware.com:
They utilize the only liability-based analytical tools in the system--and they’re product neutral. Some good books, too.

Morningstar.com:
The rating giant characterizes and ranks mutual funds. They have asset allocation and portfolio allocation tools, but be wary of their fund rankings, as they are recent performance oriented with little qualitative reasoning.

Remember, investment tools are only that--tools. Use them accordingly.

ETFs Are Not Mutual Funds or Index Funds

To understand ETFs (Exchange Traded Funds), you need to know a little about index funds. Index funds are mutual funds that are unmanaged (passive) and represent a collection of stocks or bonds that compose particular indexes. Examples of index funds are the S&P 500 fund, the Russell 3000 fund, and others. No one fund company has a monopoly on index funds and you will find several S&P 500 funds, for example. It is worth noting also that no two index funds using the same index will have exactly the same performance because of things like a difference in fees, so careful attention should be paid to the details of the fund and its costs. Usually an index fund will have very low expenses, mostly due to the fact that there is no Manager to pay and trading costs are minimal. Index funds don't trade unless there is a change in the underlying index (which is seldom). The performance of an index fund will mirror the underlying index, but slightly underperform it because of a small fee that the fund charges. Index fund manufacturers like Vanguard and T. Rowe Price often sell funds directly to investors, with no broker involved, and they are cheaper yet.

Exchange Traded Funds (ETFs)

Exchange Traded Funds (ETFs) are not mutual funds; rather they are generally passive baskets of portions of those securities in a particular index. Although they are not the entire index, they track like market indices and can be traded like stocks. The best known ETF is the Standard and Poor Depositary Receipt or SPDR (pronounced "spider"), which tracks the S&P 500, however hundreds of ETFs have been created which replicate virtually every major index. Some of the most popular include VIPERS offered by Vanguard, and iShares, provided by Barclay's. Vanguard and the iShares website are good starting points for finding more information on ETFs.

The benefit is that ETFs provide an inexpensive vehicle for reducing risk and adding diversification without producing a great deal of extra work. The risk levels of ETFs may be less than on a single stock because of their diversification. On the other hand, the risk is higher than on traditional index funds, because they are concentrated in a sampling of the overall index not the entire basket. Fees of between .25% and 2% per year are an issue because ETFs are virtually guaranteed to underperform their index. Different manufacturers have different fees on their ETF, so investors need to look at their fee structure carefully.

Furthermore since, like indices, many ETFs are style concentrated, a bad year for the style may result in unacceptable losses (say you owned a financial sector ETF in 2008).

While qualified professionals claim to be able to create diversified portfolios of ETFs that can provide an adequate investment strategy, it is difficult for a money manager to add significant value beyond style diversification and asset allocation. Still, there are variations on "managed" ETFs, which seems to be contrary to the goal of replicating an index. While ETFs do not typically produce big returns, over the long term, a well-diversified indexed element can be a valuable addition to many portfolios.

Contrasting Mutual Funds, Index Funds and ETFs

- A mutual fund is actively managed by a professional money manager who makes buy and sell decisions.

- An index fund is a passive collection of securities taken from an index.

- An ETF is a collection of certain stocks that track an index.