THE H. KENT BAKER INVESTMENTS SERIES

THE SAVVY INVESTOR'S GUIDE TO POOLED INVESTMENTS

Mutual Funds, ETFs, and More

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Mutual Funds, ETFs, and More

BY

H. Kent Baker,

Greg Filbeck

and

Halil Kiymaz

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ABOUT THE AUTHORS

H. Kent Baker, DBA, PhD, CFA, CMA, is a University Professor of Finance in the Kogod School of Business at American University. He is an award-winning author/editor of more than 30 books, including *Investor Behavior – The Psychology of Financial Planning and Investing* and *Investment Traps Exposed – Navigating Investor Mistakes and Behavioral Biases*. With nearly 300 other publications, Professor Baker is among the top 1% of the most prolific authors in finance.

Greg Filbeck, DBA, CFA, FRM, CAIA, CIPM, PRM, is the Samuel P. Black III Professor of Finance and Risk Management and Director of the Black School of Business at Penn State Behrend, The Behrend College. He has authored or edited 10 books and published more than 100 academic articles. Professor Filbeck has conducted training for professional designations for the last two decades.

Halil Kiymaz, PhD, CFA, is the Bank of America Professor of Finance in the Crummer Graduate School of Business at Rollins College. He maintains an extensive research agenda and has published more than 85 articles in scholarly and practitioner journals and four books. Professor Kiymaz has received several research awards and is the Finance Area Editor of the *International Journal of Emerging Markets*.

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If there's a book that you want to read, but it hasn't been written yet, then you must write it.

Toni Morrison

We took Toni Morrison's advice to heart and wrote *The Savvy Investor's Guide to Pooled Investments – Mutual Funds, ETFs, and More*. Many people played an important role in this process. We thank our partners at Emerald Publishing for their many contributions, especially Charlotte Maiorana (Senior Editor) and Nick Wolterman (Assistant Editor). We also appreciate the research support provided by our respective institutions – the Kogod School of Business at American University, Black School of Business at Penn State Behrend, and Crummer Graduate School of Business at Rollins College. Finally, we dedicate this book to our families: Linda and Rory Baker; Janis, Aaron, Andrea, Kyle, and Grant Filbeck; and Nilgun and Tunc Kiymaz.

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INTRODUCTION

Investing can be a murky business, like driving on a foggy day on an unfamiliar road. It's easy to get confused and you may want to turn around and return home. However, don't stop driving just because weather conditions are not always ideal. Learning how to become a savvy investor is not as hard as it may seem. Once you get through the murky parts, your trip won't be as daunting and you'll also enjoy a smoother and safer ride to reaching your financial goals. As Warren Buffet notes, "Investing is simple, but not easy."

Are you someone who has a relatively small amount of money to invest? If so, you may think that you have only a few investment choices, but you'd be wrong. One of the most common ways to invest is through a *pooled investment vehicle* (PIV). A PIV is an investment fund that commingles the monies of many different investors to buy a portfolio that reflects a particular investment objective. Thus, PIVs are formed by aggregating relatively small investments from many individuals who want to participate in investments that would otherwise be available only to large investors. A wide range of PIVs are available that invest in different assets with distinctive investment strategies. Investing in PIVs can be more accessible and less risky than directly buying shares in individual companies or real assets such as real estate.

PIVs offer many inherent benefits of being part of a group of investors. Perhaps, the most important advantages are professional management and diversification. Additionally, most PIVs are subject to government oversight and many offer high *liquidity*, which describes the degree to which you can quickly buy or sell an asset or security market without affecting its price.

Of course, investing in PIVs isn't without some disadvantages. Two major drawbacks involve costs and a lack of choice and control. In investments, there's an old saying that "There's no such thing as a free lunch," meaning that you don't get something for nothing. You can't invest in PIVs for free. Hence, PIVs charge fees and expenses that eat up part of your returns. Although you can select the PIV in which to invest, you don't have any control over the types of individual holdings that make up the fund. Thus, you can't customize your portfolio. You also have less control over the recognition of income as well as gains and losses for tax purposes.

You should keep in mind that all PIVs, just like all other types of investment, carry risks. Different PIVs have different levels of risk. Thus, before selecting any PIV, you should be sure it offers the right level of risk for you. That is, the PIV could be consistent with your *risk tolerance*, which is the degree of variability in investment returns that you are willing to endure. If you don't have a realistic understanding of your ability and willingness to tolerate large swings in the value of your investments, you are likely to take on too much risk and possibly panic and sell at the wrong time.

Given that you are ultimately responsible for your investment decisions, you need to avoid the common pitfall of investing in something that you don't understand. This is where *The Savvy Investor's Guide to Pooled Investments* comes into play. Although many different PIVs are available, this book focuses on PIVs that are readily available to the general public. For example, you don't need much money to gain entry into open-end funds (OEFs) also called mutual funds, exchange-traded funds (ETFs), closed-end funds (CEFs), unit investment trusts UITs), and real estate investment trusts (REITs). OEFs, CEFs, and UITs have been around for many decades compared to ETFs and REITs, which are relatively recent innovations in the fund business. Although OEFs are by far the largest, this fact doesn't mean that they are always your best choice or that you should ignore other PIVs.

Each PIV shares some fundamental similarities. For example, each investor is a stakeholder in every investment the fund makes in proportion to the size of that investor's holdings in the fund. Yet, distinct differences exist among each PIV in the pooled fund menagerie. Before choosing among PIVs, you should understand the distinctive characteristics of each investment. Remember: Don't ever put money in something you don't understand. As multi-billionaire Warren Buffett notes, "When a person with money meets a person with experience, the one with experience ends up with the money and the one with money leaves with experience."

The Savvy Investor's Guide to Pooled Investments offers a practical guide to anyone interested in gaining a basic understanding of PIVs. It uses a question and answer format to delve into issues that investors want and need to know before choosing a particular PIV. This handy and concise guide helps to uncover the nuances associated with PIVs. Each chapter clearly defines a particular PIV, discusses how it works, explains its advantages and disadvantages, specifies what type of investor is best suited for investing in a specific PIV, and sets forth criteria for selecting a PIV and evaluating its performance. If you are interested in becoming a savvy investor in pooled investments, this book is intended for you.

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CHAPTER 1

MUTUAL FUNDS

Don't look for the needle in the haystack. Just buy the haystack!

John C. "Jack" Bogle,
Founder of the Vanguard Group, Inc.

Regulated open-end funds (OEFs), which include mutual funds, exchange-traded funds (ETFs), and institutional funds are exceedingly popular. According to the *2018 Investment Company Fact Book*, there were 114,131 regulated funds worldwide in 2017. That's a lot of choices! Mutual funds continue to provide investors with the chance to invest in many stocks, bonds, and other investments with a single transaction. By accumulating funds from numerous investors, mutual funds enable you to invest and take advantage of market opportunities with the help of professional management. For many investors, mutual funds are the pooled investment vehicle (PIV) of choice.

Dutch merchant Adriaan van Ketwitch formed the world's first mutual fund in 1774 by pooling money from a limited number of investors. The fund diversified across European countries and the American colonies through the backing of income from plantations. The subscription to the fund was called "unity creates strength" and was limited to 2,000 units. The fund survived until 1824, but the concept of pooling money to create PIVs continues today. The first mutual fund in the United States, Massachusetts Investors Trust, was created in 1924. The fund grew from $50,000 to $392,000 in assets in one year. It became available to the public in 1928 and later became MFSA Investment Management. In 1940, the United States had 68 mutual funds, but this number had grown to 9,356 by 2017, with net assets under management (AUM) of almost $19 trillion.

The purpose of this chapter is to provide the necessary background to help you decide whether mutual funds should be part of your investment portfolio. Although mutual funds are extremely popular and investing in them appears straightforward, as a savvy investor, you should continue to educate yourself to stay at the top of your game and to obtain the most from your investments. The following questions and answers should help guide you to meet this challenge involving mutual funds.

1.1. WHAT IS A MUTUAL FUND AND HOW DOES IT WORK?

A *mutual fund* is an investment company that pools money from investors to buy securities and assets in financial markets according to the objectives specified in the fund's prospectus. In finance, a *prospectus* is a formal legal document that provides details about an investment offering for sale to the public. With a mutual fund, you're entrusting your savings to professional fund managers. The underlying securities and assets in a mutual fund represent its portfolio. Legally

> *Mutual funds give people the sense that they're investing with the big boys and that they're really not at a disadvantage entering the stock market.*
>
> Ron Chernow

known as an "open-end" fund (OEF) or company, a mutual fund is one of three basic types of investment companies. The other two are "closed-end" funds (CEFs) and unit investment trusts (UITs), which are discussed in Chapters 3 and 4, respectively.

An important characteristic of a mutual fund is its ability to offer new shares to investors. A mutual fund stands ready to sell additional shares to investors and to buy and redeem shares from anyone who wants to sell. When you buy shares, the fund issues them, and then invests the money received. When you sell shares, the fund either uses existing cash or sells some of its assets and uses the cash to redeem your shares. As a result, the number of shares outstanding changes over time, and no limit exists on the number of shares that the fund can issue. Mutual funds price their shares each business day, typically after the major US exchanges close. The cost of each share is calculated as the fund's net asset value (NAV) per share, which is computed by dividing the difference between the portfolio's market value and any fund liabilities by the number of shares outstanding. You buy and sell shares based on a fund's NAV per share. This price fluctuates based on the value of the securities held by the portfolio at the end of each business day. However, you don't actually own the securities in which the fund invests; you only own shares in the fund itself.

An investment company organizes a mutual fund as a corporation that relies upon third parties or service providers, either fund sponsor affiliates or independent contractors, to

> *Many financial innovations such as increased availability of low-cost mutual funds have improved opportunities for households to participate in asset markets and diversify their holdings.*
>
> Janet Yellen

manage the fund's portfolio and carry out other operational activities. The fund sponsor raises money from the investing public, who become fund shareholders. It then invests the proceeds in various securities and assets following the fund's investment objective. A portfolio manager manages the investments in a mutual fund. The manager oversees the fund on a daily basis, deciding when to buy and sell various securities. For these services, the fund sponsor charges fees and incurs expenses for operating the fund. Fund shareholders bear their proportional share of these fees.

1.2. HOW DOES A MUTUAL FUND DIFFER FROM A SEPARATELY MANAGED ACCOUNT (SMA)?

Similar to a mutual fund, a *separately managed account* (SMA) is a basket of individual securities owned directly by the client and managed by a professional money manager to achieve a specific objective. Both mutual funds and SMAs invest pools of money over a range of investments and are run by professional managers.

Mutual funds and SMAs have many differences.

- *Ownership*. Buying a mutual fund share represents ownership of a certain percentage of the fund's value, but with an SMA, you actually own the securities in the account.

The standard way of classifying mutual funds is by their investment objective and risk tolerance. Each investor owns the same assets as every other investor in the fund. With an SMA, your portfolio may be unique.

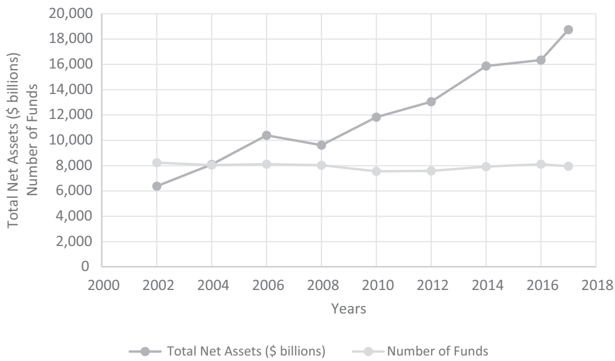
- *Tax liability*. As a mutual fund investor, you may incur a tax liability as a result of a fund paying out income and capital gains to you. For example, if fund managers sell winning stocks and hold losing stocks, the fund may decrease in value, but you may incur *capital gains*, which are defined as the difference between a security's selling price and purchase price. With an SMA, you have more flexibility to optimize a tax liability by trying to offset gains and losses in the account, potentially leaving you with no tax liability.
- *Transparency*. Mutual funds report their holdings quarterly, and many investor services track mutual fund performance. SMAs have no requirement for publicly reporting the holding's performance and style consistency.
- *Regulation*. Mutual funds are subject to the 1940 Securities Act that is enforced by the Securities and Exchange Commission (SEC), but SMAs have no specific regulation. This Act requires investment companies to register and regulate the product offerings issued to the public by investment companies.
- *Fee structure*. With mutual funds, you pay trading commissions directly and financial advisors and brokers who sell mutual funds charge management fees. Furthermore, you can sell mutual fund shares on any day. Closing an SMA requires moving the individual securities to another manager, which is a potentially complicated and time-consuming task.

- *Voting*. In mutual funds, shareholders elect the board of directors, which has a fiduciary responsibility to the fund's shareholders. No such board structure exists for SMAs.

1.3. WHAT IS THE DEMAND FOR MUTUAL FUNDS AND WHO OWNS THEM?

According to the Investment Company Institute, the US mutual fund market had $18.7 trillion in AUM at the end of 2017. Although mutual funds had more than 83% of total net assets in 2017, representing a decline from 96.1% in 2000, the overall mutual fund segment experienced a compounded annual growth of 8.4% between 2002 and 2017. Mutual funds recorded $174 billion in net inflows in 2017, while other US registered investment companies also attracted new investments such as ETFs with a net inflow of $471 billion in 2017. Households make up the largest group of investors in funds, and registered investment companies managed 24% of household financial assets at year-end 2017, an increase from 3% in 1980. The increase of individual retirement accounts (IRAs) and defined contribution (DC) plans mainly explains this growth. The proportion of mutual funds in household retirement accounts increased from 32% in 1997 to 59% in 2017. Mutual funds also manage accounts outside of retirement accounts, including $1.3 trillion in variable annuities, as well as $8.6 trillion of other assets. A *variable annuity* is a contract sold by an insurance company that provides the holder with future payments based on the performance of the contract's underlying securities. Besides households, business and other institutional investors also invest in money market funds to manage their cash holdings. A *money market fund* is a type of fixed income mutual fund that invests in short-term debt securities such as US Treasury

Figure 1. Total Net Assets and Number of Mutual Funds.



Note: This figure shows the total net assets in billions of dollars and the total number of mutual funds between 2002 and 2017.

Source: Investment Company Institute (2018) (https://www.ici.org/pdf/2018_factbook.pdf).

bills and commercial paper. These investments are highly liquid and have a high credit quality. For example, the firms operating outside the financial sector had 16% of their short-term assets in money market funds at the end of 2017, with an increase from 6% in 1990.

Figure 1 shows the total net assets and number of mutual funds between 2002 and 2017. Of particular importance is the positive compound annual growth rate (CAGR) of 8.4% for the total net assets during this period with no significant change in the number of funds.

1.4. WHY SHOULD INVESTORS CONSIDER OWNING MUTUAL FUNDS?

Owning mutual funds offers the following advantages:

- *Professional management.* A major benefit of investing in a mutual fund is professional management. Full-time, high-level investment professionals can manage and monitor a fund better than the typical individual investor. A team of experienced professionals supports a fund manager, and investment decisions are based on rigorous research and analysis.

> *Mutual funds were created to make investing easy, so consumers wouldn't have to be burdened with picking individual stocks.*
>
> Scott Cook

- *Simplicity and convenience.* Investing in mutual funds is simple and convenient. You don't have to research stocks or other assets, monitor the market, and conduct the transaction. You can easily move funds from one fund to another, allowing them to alter your portfolio to respond to fund management or economic changes.

- *Cost effectiveness.* The managers have real-time access to crucial market information and can execute trades on an extensive and cost-effective scale. They have the knowledge and experience to trade in markets that retail investors may not possess. A *retail investor* is as a nonprofessional investor who invests in securities through a brokerage firm. Mutual funds provide professional management at a fraction of the cost of making such investments independently.

> *The 'know-nothing' investor should practice diversification, but it is crazy if you are an expert.*
>
> Charlie Munger