Insight

Investment Funds: A Primer

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Executive Summary

– Because the cost of investing in the stock market has fallen in recent decades, millions of people today have access to investment funds of some kind.

– The original investment vehicle is the mutual fund, but two other vehicles—index funds, a kind of mutual fund that passively tracks an index, and exchange-traded funds, which track an index but are traded like a stock—allow diversified investment at lower costs.

– The market for investment vehicles as a whole is moving away from traditional professional management and toward passive funds and automated "robo-advisors."

Introduction

The stock market seems to get more complex every year—but the cost of investing has dropped for many. Gone are the days when investment advice was out of reach for most Americans. As noted by Securities and Exchange Commission (SEC) Chairman Jay Clayton in a speech at Temple University earlier this year: "Forty-three million U.S. households hold a retirement or brokerage account. Fifty-six million U.S. households (44% of all households) own at least one U.S. mutual fund."

The best-known ways to invest are stocks and bonds, but individuals are rightfully wary of investing directly in company stocks: Not only does it often cost a lot to invest separately in individual companies, the investor faces significant risk if his investments are insufficiently diversified. As a result, the typical individual investor looks for efficient ways to diversify his investments. Investment "funds" meet this need for efficient diversification.

This primer explains three major investment vehicles: mutual funds, index funds, and exchange-traded funds (ETFs). Each represents an evolution on its predecessor, and while

the differences define each, they retain significant similarities. As explained below, the key difference between each is the declining role of human advisors: Roles that investment managers have traditionally performed are increasingly eliminated or automated. The role of these investment vehicles is an important one; investment funds make up 17.9 percent or $11.9 trillion of the $67.9 trillion in capital under management globally.

Mutual Funds

Mutual funds, perhaps the best-known investment funds, pool capital from multiple investors and invest in stocks, bonds, short-term money markets, and other securities or assets. A mutual fund may have hundreds or thousands of individual investors and may invest in hundreds of different types of securities or assets. Collectively, these securities and assets constitute the mutual fund's portfolio. The net asset value (NAV) of the mutual fund's portfolio—essentially the cumulative value of the underlying assets—is calculated once a day to determine the fund's value. The vast majority of employer-sponsored retirement plans are invested in mutual funds, such as the popular Blackrock plans.

A professional investment advisor determines in which securities the fund will invest. Fund investors pay the investment advisor on the basis of his knowledge and experience in the market, hoping that the advisor will divine market trends and "beat the market," or provide the greatest return on investment. For the services of this investment advisor, those invested in a mutual fund pay an annual management fee, usually of about 1 percent, and in some instances a performance fee if the investment advisor outperforms what was expected. Furthermore, most mutual funds charge a 5 percent one-time administration charge.

Technically, mutual funds sell to investors a product—the right to have their money invested and managed. By comparison, when you buy normal stock in a company (e.g. Apple or Nike), you become partial owner of the company, and the value of your partial ownership stake rises or falls as the value of the company changes. In contrast, when you buy shares in a mutual fund, you are not purchasing an ownership stake in the fund, nor are you purchasing ownership of the underlying assets. The product you are buying, however, behaves much as a traditional stock would—the value of your fund shares fluctuates as the value of the underlying assets shifts. When the underlying securities or assets pay dividends to the mutual fund, shareholders are granted income distributions. When the mutual fund earns capital gains from selling some of its securities or assets, shareholders are granted capital gains distributions as well. By owning shares of a mutual fund, an investor shares in its profits or losses.

Another difference between individual stocks and mutual funds comes in how one acquires them. Mutual fund shares can be bought from a stock broker, just like stocks, but they more

typically are bought from the fund directly. Furthermore, the shares are "redeemable," meaning investors who want to sell their shares sell them back to the fund itself. The shares are not traded between different owners directly.

Mutual funds offer an array of advantages to investors, not least the expertise of a dedicated investment professional. Mutual funds usually benefit from economies of scale (as buying and selling shares on an individual transaction basis can have high transaction fees attached) and usually have a diversified mix of investment assets—so a loss in one particular sector can hopefully be offset against good performance in another.

As with all managed funds, however, there is an inherent reliance on the skills of the investment manager; there is no guarantee that the value of your mutual fund will only improve. In addition, investors in mutual funds are not covered by the Federal Deposit Insurance Corporation (FDIC). Mutual funds also typically have high cash turnover as investors deposit and withdraw capital daily. The requirement to hold enough cash to cover withdrawals means that funds must hold large cash reserves not trading on the market—which decreases the amount that fund shareholders see their investment increase in value.

Index Funds

Index funds are a subset of mutual funds, but two large differences set index funds apart from mutual funds. First, an index fund does not have a professional investment advisor who actively selects what securities and assets to invest in. Instead, and second, the fund tracks a specific stock market index, e.g. the S&P 500. An index fund's underlying securities are exclusively invested in the stock of the companies their index tracks. Such an investment approach is known as "passive management," as opposed to "active management," of mutual funds.

Accordingly, the investment philosophy behind an index fund is different from that of a mutual fund, as an index fund tries to replicate the performance of its tracked index instead of trying to beat it. Nevertheless, the vast majority of index funds outperform most actively managed funds, at least over time. A study by Morningstar found that "actively managed funds have generally underperformed their passive counterparts especially over longer time horizons, and experienced higher mortality rates – that is many were merged or closed."

The introduction of passive management funds has revolutionized the investment funds industry, as index funds have become available at significantly less cost than traditional mutual funds. Removing the investment professional and their research staff (or rather their fees) from the investment equation allows access to index funds at lower costs than mutual

funds. With an index fund, investors avoid the initial charge fee and performance fee. Instead, there is usually only an annual management fee of 1 percent. Moody's Investors Service estimates that index funds will surpass active fund asset management between 2021 and 2024, indicating their accessibility and growing popularity.

Exchange-Traded Funds

Exchange-traded funds represent something of a hybrid investment vehicle, in that they have some characteristics of both an individual stock and a mutual or index fund. As their name suggests, ETFs are traded on a major stock exchange (for example, the New York Stock Exchange or the London Stock Exchange). As a result, shares in an ETF can be bought and sold as if they were any other type of security. ETFs are diversified investments, however, just like mutual or index funds. While they may be managed, the vast majority track a particular index passively. One of the most well-known ETFs is State Street's SPDR, which tracks the S&P 500.

ETFs therefore have much of the flexibility of a stock (including a low price point for a single share), but the cost efficiency and risk diversification of a mutual fund. Those invested in ETFs usually only pay their stockbroker commission and a total expense-ratio fee.

Just as with a mutual fund, the owner of an ETF does not own the underlying securities. The owner has purchased a product that functions practically much like an ownership stake. Investors receive dividends or earned interest of all securities as distributed by the fund. Unlike a mutual fund, however, when the investor sells, he does so to a third-party purchaser, just as he would when selling a stock; the contract of sale is not with the ETF. Another difference between ETFs and mutual funds is that ETFs trade continuously and therefore have their NAV calculated at moment-in-time rather than on a daily basis, allowing investors to move much more quickly to consolidate a competitive advantage. The key weakness of a daily NAV is that NAV is calculated at the time an exchange closes. A mutual fund that trades on the New York Stock Exchange but tracks securities on the London Stock Exchange will still be trading in New York five hours after daily NAV has "frozen" in London. The value of the mutual fund may change while the underpinning value of the securities may not. Moment-in-time (or intraday) NAV eliminates this problem.

ETFs are typically more transparent than mutual funds, which might disclose invested securities only on an annual basis. Discretion over when to buy and sell might also lead to better tax and capital gains planning. Again, ETFs represent a significant cost saving to the investor on mutual funds. One of the most well-known ETF providers, Vanguard Group, shocked the investment world in the latter half of 2018 by being the first provider to offer

commission-free ETFs.

ETF owners can face a couple of problems when they sell their shares. As noted above, illiquidity (an inability to sell the asset) is one of the key drawbacks of an ETF, as some ETFs may have a narrow pool of available buyers. ETF performance statistics from 2017 show that market growth, not ETF inflow, dominated total industry growth, hinting to issues with them being thinly traded on the market. Settlement date requirements also have the result that ETFs are not considered closed until two or three days after a transaction, meaning funds invested are not immediately available for reinvestment. In this scenario an investor selling his shares in an ETF to another investor will experience a two- or three-day delay before receiving the funds in his bank account; that is several days in which those funds will neither be available nor generating income.

So-called "robo-advisors" have played a transformative role in the proliferation of ETFs. Robo-advisors are expected to manage $2.2 trillion in assets by 2020. First introduced in the midst of the financial crisis in 2008, robo-advising tailors the allocation of an individual's portfolio allocation according to the individual's wishes—but does so automatically, and not through an individual advisor's choices. Because the investments are automated, it is a good fit for the ETF model, which also relies on automated investment according to certain indices.

Robo-advising is commonly a cheaper alternative to human-managed accounts. Two robo-advisors, Betterment and Wealthfront, dominate the market, and they are popular among first-time investors. Their average annual fee is 0.5 percent, as opposed to an average annual fee of about 1 percent with active investments. Additionally, because robo-advisors invest in ETFs, the minimum assets required for investment is far lower. Betterment requires no minimum deposit, and Wealthfront requires $500—both a long way from Vanguard's $10,000 minimum for most index funds.

Conclusions

Funds of various kinds have provided investors the opportunity to invest in a diversity of securities at a lower cost. The market for funds has produced two evolutions of the original "mutual fund": an index fund, which passively tracks an index, and an exchange-traded fund, which is traded like an individual stock but typically tracks an index. Index funds and ETFs are the core products in the prominent rise of automated investing and robo-advising—a movement that undermines the traditional model of investment businesses by offering the opportunity to invest at a much lower cost.