Investing in Mutual Funds, ETFs, and Real Estate

Chapter 13

Learning Goals

LG1 Describe the basic features and operating characteristics of mutual funds and exchange traded funds.

LG2 Differentiate between open- and closed-end mutual funds as well as exchange traded funds, and discuss the various types of fund loads and charges.

LG3 Discuss the types of funds available to investors and the different kinds of investor services offered by mutual funds and exchange traded funds.

LG4 Gain an understanding of the variables that should be considered when selecting funds for investment purposes.

LG5 Identify the sources of return and calculate the rate of return earned on an investment in a mutual fund, as well as evaluate the performance of an exchange traded fund.

LG6 Understand the role that real estate plays in a diversified investment portfolio, along with the basics of investing in real estate, either directly or indirectly.

How Will This Affect Me?

Having a financial plan, and being aware that diversification is crucial is a great start to the task of investment planning. The next step is figuring out how to implement your plan by deciding what to invest in. For most people, diversification is best achieved using mutual funds and exchange traded funds (ETFs). This chapter describes the key characteristics of each type of fund, sorts through the various options you have, shows how to calculate rates of return and evaluate performance, and explains how to choose among funds. The essential elements of investing in real estate and its role in diversifying your overall investment portfolio are also covered. After reading this chapter, you should be in a good position to invest in mutual funds, ETFs, and real estate in a way that will help you achieve your financial objectives.

Financial Facts or Fantasies?

- When a mutual fund is open-ended, it means there's no limit on the returns an investor can realize.
- Online and phone switching are services that enable you to move money from one fund to another, so long as you stay within the same family of funds.
- While exchange traded funds (ETFs) offer many of the benefits of mutual funds, they have tax-timing disadvantages not present with otherwise comparable mutual funds.
- In many types of real estate investments, appreciation in the value of the property affects return more than annual rental income.
- A real estate investment trust (REIT) is a popular form of limited partnership that enables individuals to invest directly in income-producing property.

Some Basics

- A **mutual fund** is a financial services organization that receives money from its shareholders and invests those funds on their behalf in a diversified portfolio of securities.
- **Exchange traded fund (ETF):** An investment company whose shares trade on stock exchanges; unlike mutual funds, ETF shares can be bought or sold (or sold short) throughout the day. ETFs are usually structured as an index fund that's set up to match the performance of a certain market segment. Like a mutual fund, allows investor to achieve diversification with professional management of funds.

Mutual Fund Concept

- There are many mutual funds; 8,000 by 2014 with total investments of $15.9 TRILLION. There are more mutual funds in existence today than there are stocks listed on all the stock exchanges in the United States.
- Professional money managers select stocks and mange portfolios
- Dividends, interest, and capital gains earned by mutual funds are passed through to the investors who are subject to taxes on the income even though they have not received the funds.

Why invest in Mutual Funds?

- Pooled diversification: A process whereby investors buy into a diversified portfolio of securities for the collective benefit of individual investors.
- Financial Returns: Investors hope the mutual fund will achieve higher returns than they can generate on their own.
- Convenience: Easy to purchase mutual funds and the fund handles all of the tax reporting and record keeping.
- BUT Investor has no control over buying or selling of securities

Sample Returns by Mutual Funds – 2011-15

as of May, 2015

Fund Type	1 year returns	3 year returns	5 year returns
Consumer defensive	12.74%	16.51%	15.97%
Health	40.62	33.25	25.80
Consumer cyclical	16.10	20.64	18.45
Technology	20.14	19.71	15.94
Real Estate	12.72	12.04	14.12
Utilities	6.32	13.68	13.83
Industrials	7.50	20.67	16.26
Natural resources	-13.40	3.20	4.29
Equity energy	-18.81	5.57	4.92
Communications	7.15	15.14	13.24
Financial	10.27	19.40	11.48

How Mutual Funds are Organized and Run

- Each mutual fund is a separate organization owned by shareholders but controlled by fund managers
- Management Company runs daily operation
- Investment advisor overseas portfolio
- Distributor sells fund shares
- Custodian safeguards fund's assets
- Transfer agent executes transactions and maintains shareholder records
- All may be affiliated companies, such as Fidelity

Mutual funds more Basics

- Open-End Investment Companies commonly called Mutual Funds, shares are purchased from and sold back to company
- New Shares issued as money flows in
- Net Asset Value (NAV) is quoted price
- Closed-End Investment Companies
- Have fixed number of shares
- Trading between investors in market
- Shares are listed and trade at a discount or premium to NAV

Net Asset Value (NAV)

- Total market value of all securities held in fund's portfolio less liabilities, divided by number of shares outstanding
- Will fluctuate in value as underlying shares of stock owned by the fund go up or down.
- Only determined at the end of the trading day
- This is the quoted price for the next day of trading

Exchange-Traded Funds (ETFs)

- Typically structured as an index fund
  - SPDR S&P 500 ETF (SPY) tracks the S&P 500 index
  - SPDR Dow Jones Industrial Average ETF (DIA) tracks the DJIA
  - PowerShares QQQ Trust ,Ser 1(QQQ) tracks the Nasdaq 100 index
- Traded on listed exchanges like closed-end funds
- Number of shares change like open-end funds
- Like stock, may be traded throughout the day

Fees

- Low-loads funds: commission (2 or 3%) charged when purchased [front-end loads]
- Some charge redemption fee (back-end load)
- Per SEC, maximum total amount of fees is 8.5%
- No-load funds do not charge a front-end transaction fee
- 12b-1 Fees: annual fee to offset promotion and selling expenses. May be 1 percent of total assets under management

Fees

- Management Fees is the cost to hire professional manager to run the fund's portfolio of investments. Annual fee that ranges from less than 0.5% to 4% of assets under management. The fee is usually unrelated to the performance of the funds. Good or bad, the manager is paid.
- Impact of fees: Reduces the return on your investment

Sample Mutual Fund Quotes See Exhibit 13.4

Fund	Symbol	NAV	Change	YTD % return	3-year % chg
CorePis p	ACCQX	10.87	-0.01	0.9	2.2
EmgMktA t	AEMMX	9.31	0.04	11.9	9.6
Growth p	TCRAX	29.68	…	5.7	16.7
p Distribution costs apply, 12b-1	r Redemption charge may apply	t Both p and r apply			

Types of Funds

- Growth, Aggressive Growth, Growth-and-Income
- Value, Balanced, Bond, Equity-Income
- Money Market Mutual, Index, Sector
- Socially Responsible
- International
- Asset Allocation – spreads investments over all types of securities

Bond Funds

- Government bonds
- Mortgage-backed bonds
- High-grade Corporate bonds [rated BBB or better]
- High-yield Corporate bond [junk bonds]
- Convertible bond
- Municipal bond
- Intermediate-term bond

Services offered

- Automatic Investment Plans: An automatic savings program that enables an investor to channel a set amount of money systematically into a given mutual fund. In many cases, it can be a payroll deduction form your paycheck. Or, it can be transferred from a checking account.
- Automatic Reinvestment Plans: A plan that gives share owners the option of electing to have dividends and capital gains distributions reinvested in additional fund shares. Supports earning interest-on-interest.
- Systematic withdrawal plans gives current income to owner.

Services offered

- Conversion Privileges: Allows investor to switch from one mutual fund to another within the family of funds. For example, you could move from Fidelity Growth Fund to Fidelity Growth and Income Fund without withdrawal fees. For tax purposes, this is a sale and purchase. Thus, gains on sale may be taxed.
- Retirement Plans: Mutual Funds offer IRAs and other retirement accounts that are tax deferred. The fund handles all of the administrative details.

Selecting Your Mutual Fund or ETF

- Decide which fund you want to buy by assessing your investment plan and needs
- Consider you investment objectives
- What is your intended use of the fund, how long will you hold the fund
- What services are important to you

Choosing between Mutual Fund or ETF

- ETFs have narrow focus [a single sector, or index]; mutual invest in many different stocks
- Tax management, ETFs trade less than the average actively managed mutual fund
- Costs, ETFs have lower costs than mutual funds
- ETFs are often the better for investors using discount brokers, for those investing a large sum of money, and for those with a long-term horizon.

Fund Performance

- Returns consist of: Dividend Income, Capital gains distributions, and change in fund's share price
- Past performance does not guarantee future returns, but recent past is a predictor of future.
- Change in value includes realized and unrealized gains, that is it includes gains on stock that has not been sold.
- Tax efficiency of fund is indicated by the reported realized capital gains

Exhibit 13.9 is a Summary of Mutual Fund Performance

- Focuses on three types of information:
- Income from investment operations
- Distributions from fund
  - Beginning NAV plus income less distributions equals Ending NAV
- Returns and ratios

Performance of ETFs

- Primary reason for investing ETFs is to invest in the index. The major performance criteria is how well the ETF matches the performance of the index it is tracking. Primary statistic is the R-square. The closer to 100, the better the correlation between the ETF and the index.
- The example in Exhibit 13.10 reports a R-squared of 71.10 which is acceptable.

Investing in Real Estate

- Provides diversification rather than only holding stocks and bonds
- Less volatility than stocks
- Does not move in tandem with stocks

Basic Considerations

- Cash Flow and tax impact
  - Depreciation is a non-cash expense that is deductible for tax purposes
  - Passive investment, thus passive losses limited to passive income
  - Appreciation in value deferred until realized or sold
- Use leverage to increase return, that is borrow money to finance part of purchase
- Need to know market you are investing in

Investing in Income Property

- Commercial property
  - Office buildings, industrial space, warehouses, retail space, hotels
  - Have long term leases
  - Rent may include a portion of revenue renter has
- Residential property
  - Homes, apartments, condos, small duplexes

Other Ways to Invest in Real Estate

- Real Estate Investment Trusts (REITs)
- Closed-end investment companies hold real estate
- Offer diverse, marketable way to invest in real estate
  - Equity REITs invest in properties
  - Mortgage REITs invest in mortgages
  - Hybrid REITs invest in both
- Real Estate Limited Partnerships (LLCs)
- Limited liability partnerships tend to invest in local properties