Strategic Investment Vehicles

Direct Investments

Direct investments take many forms. They may be private investments, limited partnerships, such as hedge funds, and venture capital. They all have the common characteristic—an investment placed directly with the beneficiary of the investments. Usually, the minimum investment is quite high, and the requirements for qualified investments may be difficult for many to meet. We will discuss alternative investments such as hedge funds below.

Mutual Funds

A mutual fund is a pool of many investors' assets. They are highly regulated by the SEC. Mutual funds buy and sell stocks, bonds, or other securities for their investors. Funds are priced to investors based on the aggregate price of their holdings at the end of each trading day. Investors do not actually own the stocks or bonds, but, rather, they own shares in the Fund. Any earnings the fund realizes on its investment portfolio, after the expenses of managing the fund are subtracted, are paid out to the fund's shareholders (see our session on "Investment Types" for more details).

Understanding Mutual Funds: Open Ended vs. Closed Ended

As we Discuss elsewhere, there are two basic types of funds; open-end or closed-end mutual funds. Open-end mutual funds sell as many shares as investors want to buy, and redeem any shares investors want to sell. They are priced daily at a "Net Asset Value" (NAV), which is the value of the securities less liabilities divided by the number of the shares outstanding. Both numbers change daily. Sometimes open-end funds are closed to new investors when the funds become too large to be managed effectively – though current shareholders can continue to invest money. Closed-end funds trade like stocks, on an exchange; with shares changing hands among existing investors rather than being redeemed by the fund. There are usually only a fixed number of shares available, and new investors can't get in except by buying on the open market.

All mutual funds (open and closed) have the following three features in common:

1. An investment objective that states what the fund's goals are.
2. A professional manager or managers who run the fund.
3. Pricing based on the value of the underlying securities.

Investment styles can vary widely among funds, just like among securities as we discussed in that session. In general, mutual funds fall into four main categories:

1. Stock funds, also called equity funds, invest primarily in stocks.
2. Bond funds invest primarily in corporate or government bonds.
3. Balanced funds that invest in both stocks and bonds.
4. Money market funds make short-term investments to keep their share value fixed at $1 a share.

Mutual funds are further categorized according to their style and philosophy, in order that they may be compared equally among their peers. For instance:

-Value- Growth- -Core- -Long Term Bond- Short Term Bond-

International Rating agencies such as Morningstar and Brokerage Firms grade and further categorize funds (see below). Most funds diversify their holdings by buying a wide variety of securities within their category. A typical stock fund, for example, might own stock in 80 or more companies. The benefit of this diversification is that losses from some investments may be offset — or even outweighed — by gains on others. The downside is that a big gain in any one security will have a small impact on the fund value. For this reason, investors favor mutual funds as a conservative method of being in the market.

However, don't be too quick to believe in categories. Not all mutual funds within a particular style are created equal. You must do a good amount of independent research, both before buying a fund and for the duration of the account to make sure you get what you pay for.

Risks of Mutual Funds

Some funds are riskier that others by the very nature of what they buy and sell. Remember the old saying: the greater the returns, the greater the likelihood that the risk level will be higher. Another risk of mutual funds is that the people that produced the past investment successes may not be the same people doing the investing today. Hence, the importance of due diligence (the research process mentioned above).

Another risk is that because most funds are required to distribute their gains, losses and income to all investors as of a certain date at the end of the year, it is possible for investors to be charged with capital gains or income, when, in fact, the value of the fund they bought has lost money since they bought it. Finally, since investors do not actually own the securities in the fund, they have no right to vole on corporate issues of the underlying securities.

Index Funds

Index funds are baskets of all the securities in a particular index — such as the Standard & Poor's 500-stock Index or the Wilshire 5000 Index (which includes all of the stocks traded on U.S. markets.) The objective of index funds is to replicate the returns represented by the respective index.

Index funds are popular because they are an easy way to invest in the market, and are typically inexpensive. However, investors expecting to match an index return need to understand that an index fund is guaranteed to underperform the index, once fees and any costs are deducted. That does not mean that index funds are not appropriate for investors—they may be good investments for many clients. An effective method of using index funds may be to complement an active managed account, or to diversify other holdings of the client.

Also, because index funds do not buy and sell investments as often as actively managed funds, they likely will pay out fewer capital gains distributions, making them somewhat tax-efficient. But, because most indexes are weighted, giving more emphasis to the largest or highest priced securities, a few components of the index can have a larger effect on the performance of the fund.

Not all index funds are equal. Some funds based on the same index may have higher fees, making their returns lower than others.

ETFs

Exchange Traded Funds (ETFs) are investments that track like index funds but can be traded like stocks. Unlike index funds they do not hold every security in an index, they hold a "representative" sampling of those securities. Accordingly, ETF returns can vary from provider to provider. A well-known ETF is the Standard and Poor Depositary Receipt or SPDR (pronounced "Spider"), which tracks the S&P 500. However, ETFs have been created which replicate virtually every major index. Some other well-known ETFs include Diamonds, which track the DOW; Triple Qs, which track the NASDAQ 100; Vipers, which track various Vanguard Index funds and iShares, provided by Barclay's, which track a variety of domestic, international, and global indices. ETFs provide an easy and inexpensive way to reduce risk and increase diversification in a portfolio. The risks are low, however, the return may not be high enough to justify investment. They are generally appropriate as a balancing strategy in an otherwise complete and diversified portfolio (for example, 50% stocks, 40% bonds, 10% ETFs).

Exchange-traded funds are bought and sold through brokerage firms and traded on stock exchanges. Their prices change constantly throughout the trading day, unlike open-end funds whose prices are set only once, at the end of the day.

While similar to their index fund counterparts, there are some additional characteristics specific to ETFs that you should be aware of, including:

- They consistently underperform the Index and their comparable index fund.
- They generally are not as quickly rebalanced when a change occurs.
- They are generally cheaper than traditional funds.
- They can be found on various exchanges: AMEX, CBOE, NYSE, and others.
- They can increase and decrease the number of shares outstanding.
- They can be traded.
- They can track an entire market segment, or a portion thereof.

Investors use ETFs Because:

- ETFs are a good tool for portfolio diversification, they can be used in Core/ Satellite Portfolio Construction. An ETF adds diversification cheaply if an Active Manager is the Core investment.
- They can be used as a component of the following strategies:
  - Sector rotation strategy
  - Arbitrage strategy
  - Hedging and defensive strategies (they can be sold short)
  - Market-neutral strategies
- They also can be used to maintain equity exposure when changing Managers, by shifting assets short term into ETFs until the manager change is effective.
- As an asset allocation component they can be used to rebalance, increase or decrease exposure in any area or sector.

However, a late 2010 survey of clients say most do not understand ETFs and don’t use them because they are too complicated. Investors who don't have exchange-traded funds in their portfolios usually have not purchased ETF shares because they “don't know what they are”.

According to new research from Mintel Comperemedia, about 64% of investors claimed ignorance about ETFs — that is, they either lack any knowledge of the investments or they don't understand how ETFs work. Another 15% of investors said they don't own ETFs because they are “too complicated,” the online survey of 2,000 adult investors found. “Investors are still quite unfamiliar with ETFs,” said Susan Menke, a vice president and behavioral economist at Mintel Comperemedia.

Of people who do invest in ETFs, half said they do so for the diversification that the investments offer. About 63% of ETF investors said they own more now than they did three years ago and 59% said they plan to increase their ETF investments over the next year. Younger people and those with higher incomes are more likely to include ETFs in their portfolios, the research shows. More older respondents said they don't own ETFs because their advisers didn't recommend them.

Nearly half of the investors, who completed the surveys in September, said they learned about ETFs from an adviser. About 63% said they received their knowledge of ETFs from the Internet. Great--I’m sure the information they get from the product pushers is unbiased.

One reason that investors don’t understand ETFs is that ETFs are not commonly offered within retirement plans, such as 401(k)s or individual retirement accounts, which is where many people make their investment choices.

Another reason is that financial advisors aren’t up to speed on ETFs either. “With all the new products coming out, advisers feel a little nervous about some of the more exotic ones out there,” Menke said, such as new ETFs that are actively managed. However, Menke points out that Adviser interest in ETFs is increasing and many say they plan to start recommending that clients use them, citing adviser surveys completed in the last few months. In addition to educating the public, obviously, we need to do a better job in education the advisor world. The Mintel research shows that investors who own ETFs look to their advisers for ideas on ETFs more than they do for other types of investment ideas.

At $2 Trillion in ETFs, we better ramp up our educational efforts now!