Investment Funds: What They Are, How They Differ and Why You Should Know

Saturday's With Jim

By Jim Pursley
President and CIO, Gaia Capital Management, Inc.
www.gaiacapital.com
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Dear Friends,

Why invest in funds of securities rather than the securities themselves? Investors can buy shares of individual companies through their issued stocks and company debt through their issued bonds. Suppose that the stocks or the bonds of a company become relatively worthless by the underlying issuer's bankruptcy. The investor may have lost everything s/he invested. To mitigate the "business risk" inherent in one company or a few of them, professionally managed funds were created. These funds offer diversification through holding the securities of dozens or even hundreds of company and government securities as fund charters mandate. The fund investor gets instant diversification to reduce business risk, the buying power of a larger portfolio and professional management of their invested money. Fund investors experience less volatility of their account balance than if they held the shares of just one or a few securities and, potentially, higher returns due to the better informed and disciplined nature of the professional money manager.

Evolution of the Fund Industry

The first mutual fund, so called because the fund is owned by its investors/shareholders, was established in 1893 in the U.S. It resembled stocks more than the funds we know today. Called closed end because their money for investment is raised all at once through an Initial Public Offering, these funds sell like stocks on an exchange. Few new shares are created and usually none redeemed; the portfolio is relatively fixed in size. These funds can sell at premiums or discounts to their net asset value (NAV), the dollar value of one share, because there is no mechanism for arbitraging the market price with the portfolio NAV except through investor buying and selling. More buying pressure causes market prices to rise and vice versa. We own a few of the 600 closed end funds (CEFs) that still exist today.

Problems with the CEF Structure

As more people wanted to invest in the 1920's, they found the CEF structure limiting, as their new money just drove up share premiums (which eventually fell back to NAV or below as markets lost their lustre in 1929-30). Inaccurate pricing (exploitable by people like us who look for CEFs selling at discounts to NAV) also caused investor dissatisfaction with the CEF model. The CEF had become so popular that they ceased to function efficiently.

Open Ended Mutual Funds

The first mutual fund, the Massachusetts Investors Trust, was created in 1924 and still exists today in one of the MFS (Massachusetts Financial Services) family of mutual funds. Open ended mutual funds are so called because as money is either deposited or withdrawn they create or retire shares. Thus shares always sell at the NAV, computed at the end of the business day by dividing the portfolio value by the number of shares issued. Mutual funds became super popular as the investment of choice by the army of new baby boomer investors in the 1980’s and the 1990’s. For the first time, mutual funds became household names. But, like their CEF brethren, their popularity (or at least the popularity of the best known of them) began to dent their appeal – and their performance.

Unlike CEFs where the number of shareholders and portfolio capital are relatively constant, open ended mutual fund capital (money available to invest) expands and contracts with new money share creation and withdrawn money share diminution, sometimes with performance consequences. New money must be put to work, sometimes at unattractive prices, and withdrawn money can hurt fund performance if securities must be sold to meet redemptions. Popularity ruined the open ended mutual fund (or at least those which had become so large as to approximate the market as a whole) because investment performance became less exceptional. Low cost passively managed index funds, drawing inspiration from the “efficient markets hypothesis” developed by Markiewitz et al. in the 1970’s, began to cut into the higher cost of open ended actively managed mutual funds. Some investors began to conclude that active management as it had existed since the creation of the CEF did not justify its fees. The index fund business began to take off in the first decade of the 2000’s, but not so much in the wrapper of the open ended mutual fund as it had been known for some 75 years.

The Exchange Traded Fund

The first exchange traded fund, or ETF, was created by State Street Bank in 1993 when it issued the S&P Depositary Receipts, the first of the company’s SPYDER ETFs. With the advent of the Internet, trading on exchanges became cheaper and easier to do – replacing a commissioned broker with a mouse click. Low cost brokerage trading really took off with the Internet bubble of 1998-2000. ETFs, like their earlier cousins the CEFs, are sold on an exchange and brokerages, not ETF fund companies, do shareholder accounting and reporting. Though open ended because they create and redeem shares as deposits and withdrawals are made, ETFs use an arbitrage system to maintain the market price close to the NAV price. Large investors buy or sell “creation units” of ETFs in lots of roughly $50 million dollars. It is these “arbitrageurs” who actually make the issuances and redemptions, though the shareholders are actually registered with the fund. The owners of creation units make a profit on the difference between the buying price and the selling price, or the spread, of the ETF shares. Stocks and bonds are sold with spreads, too. So long as there is enough liquidity for shares to be created or redeemed, the ETF functions smoothly, as intended. Most ETFs are not actively managed, fulfilling two of the “efficient market” believers’ dreams. Not only can shareholders own low cost indexes, but they don’t pay the administrative freight which open ended funds charge in their management fees.

ETFs are more tax-efficient than are most actively managed mutual funds. The ETF sponsor can choose to provide appreciated shares when arbitrageurs (called market makers) buy shares in creation units, thus washing the capital gains shareholders would have paid if the funds had sold them to preserve profits.

Which fund type is better for us? All three, of course. We like buying CEFs at a discount, secure in the knowledge that our shares won't bloat when they get popular. Instead, our shares will rise to a premium where we will probably sell with profits and dividends gained. We are more committed to exchange traded funds, using mutual funds where expenses are low and no equivalent exchange traded fund exists. We also use them for smaller accounts where ETF commissions would be prohibitive relative to the size of the trade order. ETFs give us super low cost access to areas of the markets where active managers have trouble outperforming and offer us funds to invest in very small targeted areas of markets where other types of mutual funds would find cost-prohibitive. Indeed, some large institutional investors buy targeted ETFs instead of individual securities.

As independent stewards of your money, we like the ability to hold the securities which best fit our needs. We love the choice we have between fund types.

Why is it important to know on a general level some salient characteristics of investments we use for you? We believe that having a general picture of our investment process (how we select securities and manage what we hold), our tools (the securities we use) and a general idea of the investing process facilitates your understanding about your investment account with us.

Thank you for entrusting us with a portion of your wealth.

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