Understanding Stocks, Mutual Funds, and ETFs

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Introduction

In the early days of the stock market, it was just that…a market for *stocks*. And while you can still buy individual stocks today, there are many different investment products vying for your attention, including mutual funds, and exchange-traded funds (ETFs). But what is each one exactly and how can you know which is best?

What are stocks?

Even folks with a lot saved for retirement aren't always sure. Many Americans build wealth and save for retirement through their employers. They may be taking advantage of a company 401(k) or have been awarded company stock as part of their compensation. Either way, they don't spend much time thinking about their investment options, because it's simply not required in order to start investing. So, many Americans may have heard of different investment types, or asset classes as they are also known, without really knowing how they differ, or what the pros and cons of each type are.

When you buy stock, you are purchasing partial ownership in a company. So, how do stocks work? When you buy a company's stock, you buy a share in that company. And the more shares you buy, the more of the company you own. Generally speaking, stocks can be held for as short or long a time as you wish, but many experts recommend holding onto your shares for longer-term if you anticipate their value will rise over time.

For example, let's say ACME Corporation – which makes roadrunner traps – sells their stock for $50 per share. You invest $5000 into the company, which means you now own 100 shares. Now, fast forward five years. ACME's business has grown, investors like what they see, which consequently puts their stock in higher demand. As a result, the stock price is now $75 per share. Because you own equity in the company, you benefit from its growth, too – and your investment is now worth $2,500 more, for a total of $7,500.

There are over 3,500 publicly-traded companies, from household names like Apple and Pepsi to smaller companies that you've probably never heard of.

There are two main ways to make money with stocks. One is by the stock appreciating in price. The other way that stock investors make money is by receiving investor dividends. A dividend is a regular payment that a company will pay its stockholders. Most stocks follow a quarterly dividend payout schedule. Many investors prefer dividend-paying stocks because they can provide a steady stream of passive income, separate from the stock's overall price performance.

What are the Pros and Cons of Investing in Stocks?
Every investment has its strengths and weaknesses, and stocks are no exception. The single biggest benefit to investing in stocks is that, historically, they outperform most types of investments over the long term. Because stocks represent partial ownership in a business, finding a strong company that performs well over the course of years and decades can be a powerful way to save for the future. Additionally, stocks are a fairly liquid investment. That means it can potentially be easier to both buy and sell them whenever you need cash. But these pros are just one side of a double-edged sword. With the possibility of a higher return comes added risk. While the stock market has historically risen over the long-term, individual stock prices can be extremely volatile, climbing and falling daily, sometimes dramatically. For example, if a company underperforms relative to its expectations, the stock price can go down. Sometimes, companies can even fail altogether, and it's possible for investors to lose everything they put in. As the saying goes, risk nothing, gain nothing — but it's equally true that if you risk too much, you can leave with less. Furthermore, to actually realize any gains you've made, you must sell your stock, which can trigger a significant tax bill.

If you would like to talk with us about our dividend strategy, you can reach us at 1-800-277-0025

What are Mutual Funds?

Mutual funds are one of the oldest and most common ways that people invest. Here's how the Securities and Exchange Commission (SEC) defines mutual funds: A mutual fund is a company that pools money from many investors and invests the money in securities such as stocks, bonds, and short-term debt. The combined holdings of the mutual fund are known as its portfolio. Investors buy shares in mutual funds. Each share represents an investor's part ownership in the fund and the income it generates. Mutual funds can be either actively managed or passively managed. But regardless which umbrella the fund falls under, many investors flock to mutual funds because they offer several potential benefits:

1) Simplification. Mutual funds can simplify the process of investing because instead of devoting time to researching dozens – or even hundreds – of individual companies to invest in, the fund does it for you. It is important to note that you or your financial advisor should still research which fund is right for you.
2) Diversification. Mutual funds often invest in a wide range of companies and industries to meet the funds stated objective. This could lower your overall risk. This means that if one company/industry does poorly, you may not experience the same kind of loss you would if you invested all your money in that company or industry.

There are potential issues with mutual funds, though. For example, sometimes, it can be difficult to understand what or how the fund actually invests. And mutual funds can differ drastically depending on their objectives, investing style, time horizon, and other factors. Mutual funds are required by law to provide a prospectus to investors that explains how the fund works, but if you don't know what you're looking at, this information may confuse more than enlighten. This is why it's important to do your homework.

Mutual funds can also sometimes come with more expenses than other funds, too. They might include management fees, purchase fees, redemption fees and tax costs. These expenses can eat into your returns, and lowering your overall profit. And mutual funds may not be a great choice if immediate liquidity is a high priority. All mutual fund trades run at the end of day. So, for example, if you wanted to sell a mutual fund at the beginning of the day, hoping to avoid what you think the market will do, you will still get the end of day price.

What are Exchanged Traded Funds (or ETFs)

After John Bogle introduced the first index fund in 1975, it didn't take long for investors to recognize their many advantages. Exchange-Traded Funds, ETFs as they are often called, can be actively managed. More often, however, they track the companies in a specific index, just like an index fund. Otherwise, ETFs differ from mutual funds in a few ways. For one thing, the shares each investor has in an ETF can be traded on the open market. That means you can buy or sell your shares in an ETF just like you would an individual stock. You can't do that with regular mutual- or index funds. That's a big advantage for investors who value flexibility and liquidity. Most ETFs also come with lower expenses than mutual funds. And, ETFs fully disclose all holdings held. This makes it easier to see exactly what you are investing in. It also makes it easier to see where you have overlap. But of course, nothing's perfect. Since ETFs can be traded like common stock, that might lead to trading too often. You may find yourself paying more than you anticipated in trading fees. Then, too, some ETFs are thinly traded, meaning there's just not a lot of activity between buyers and sellers. This could make it difficult to sell your shares.

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Q&A - Mutual Funds and ETF's

What's the difference between owning a no-load mutual fund and an ETF?

In a no-load mutual fund, generally you are buying directly from the fund company. In an ETF, you are buying the fund over a stock exchange just like you would buy a share of stock.

Can I own an ETF in my IRA and if so why?

Absolutely. In fact, many people have a good amount of flows from ETFs into retirement accounts.

Exchange-traded funds present varied advantages to investors, including generally being lower-cost, transparent and providing access to a wide range of parts of the investment landscape. We think investors find that attractive for their retirement accounts, as well as for their general investment accounts.

Are there any tax advantages to owning ETFs versus mutual funds or individual stocks?

Versus mutual funds, I think, historically, exchange-traded funds compare favorably. ETFs tend to be very tax efficient. They tend not to make, generally speaking, the level of taxable distribution that actively managed mutual funds make.

What are the dangers in owning ETFs?

Each ETF, like each investment, has its potential risk and rewards. ETFs are a delivery vehicle for a particular investment strategy, so it’s imperative that the investor or his financial adviser understands the exchange-traded-fund structure but also the particular investment strategy that it is seeking to deliver.

There is a wide spectrum of strategies that ETFs follow. Exchange-traded funds can go from a basic S&P 500 large-cap index strategy to emerging market debt to various sectors like health care to commodities like gold or currency to very conservative investments like we introduced last year. For example, one thing that ETFs have done for investors is to democratize the access to different slices and parts of the economic landscape.

Why are there so many ETFs? It seems so confusing.

To put things in perspective, there are probably six or seven times as many mutual funds as exchange-traded funds. So think of ETFs like tools in a toolbox. Some ETFs are basic tools that you might use every day. A large-cap index might be equivalent to a flat-head screwdriver that you use on a regular basis.

Then there are a variety of other ETFs that investors might use on a special case where they want to get that certain exposure to that part of the market. They think that interest rates are generally going to go up and they want to try to protect their bond investments, and they might try to hedge the effect that rising interest rates might have on their bond portfolio.

Then there are ETFs that most investors would never use but more sophisticated investors find useful. Just like when you go to Home Depot, there are some tools that a basic do-it-yourselfer would use. But there are other tools that more-sophisticated contractors would use.

So there’s a large variety of ETFs for a variety of investors to be used in a variety of ways.

How many ETF s should the average investor own to be properly diversified?

Many investors are giving up trying to pick the stock or the active manager who will outperform the index. Because study after study shows that active managers don't beat passively managed portfolios, you see more portfolios composed of assets with building blocks of ETFs.

There's no magic number of ETFs to achieve the appropriate level of diversification for all investors. That evaluation is a fact-and-circumstances analysis based on the objective of a particular investor, their risk profile and lots of other factors.

It would be surprising to see a well-diversified portfolio with less than four or five exchange-traded funds. One element that we see increasingly being a slice of a well-diversified portfolio is alternative investments. These are investments that are other than what is traditionally long-only equities and fixed income and cash.

More and more smart people look at investments and think by adding these alternative investments, investors can reduce the risk in a portfolio and smooth out the ride.

ETFs have grown rapidly over the past 10 years. Do you foresee ETFs supplanting traditional mutual funds in the future?

Time will tell. But what I will say is, in terms of a vehicle to deliver passive or index strategy, I think the handwriting is on the wall. Exchange-traded funds have virtually won that contest.

I think the harder question is whether exchange-traded funds that offer an actively managed strategy are going to be able to deliver that sort of strategy and to compete mano a mano with mutual funds. So far, few ETFs that are actively managed have been successful.

Have ETFs helped investors become more successful?

ETFs are the most important investment vehicle developed in 50 years.

ETFs have come along during an inflection point in how investors look at investing. What we see investors wanting is a realistic return while trying to reduce the volatility of ups and downs in their portfolio. Many studies have shown that it's much more important as to what parts of the market, what slices of the economic landscape are in your portfolio than what particular companies are represented.

The issue a lot of investors run in to is if they have just one or two companies in their portfolio representing a sector, they are subject to the particular success or lack of success of that company.

On the other hand, if you have a well-diversified portfolio representing a sector, like an ETF that holds 20, 30, 40 companies, you are not subject nearly as much to the success of a company. You are essentially buying that market, and if that part of the market does well, you do well. Generally speaking, if you put together different parts of a market and different slices of the economy, the more diversified you are and the less vulnerable your portfolio will be.

Some have criticized the ETF industry of proliferation, or too many products and too many similar products. How do you counter that criticism?

Like in many areas, whether it's cars or groceries, the more selection that a consumer has, generally speaking, the better off they are. In terms of exchange-traded funds, the more ETFs out there, the more tailored portfolios can be to suit the needs of a particular investor.

But it's always important that an investor understand what a particular ETF is designed to accomplish. In the ETF marketplace, like any marketplace, the products investors don't find useful tend not to gather assets and tend not to be successful and don't survive in the long run. Those that tend to be successful tend to gather assets and tend to be around when investors need them.

Do you think that investors have a good understanding how leveraged ETFs differ from ETFs that seek to match plain-vanilla, market-cap-weighted indexes?

There is a wide spectrum of ETFs offered. They include equity ETFs in African countries to rare-metal offerings like palladium to products that we offer called geared ETFs. They provide magnified or inverse — some people call it "short" — exposure to a wide variety of parts of the market. These ETFs, like many other ETFs, are designed primarily for educated investors and professional investors. They are not for mom-and-pop investors.

If today you believe a large part of the market, large-cap stocks or silver or bonds, are going to go down in price and you want to try to hedge your portfolio, protect it, this is a way to consider doing that. It's important to understand that the objective of these funds is to produce a daily result and the performance over different periods may be different.

What risks does the ETF industry face?

The number one challenge is investor education. ETFs differ in important aspects from mutual funds. If you don't feel like you understand what you are investing in after doing your homework, don't invest in it. Or hire a financial professional to help you.

Why are investors flocking to ETFs?

First, many investors are giving up on buying individual stocks and pieces of fixed income, and they want to buy a broadly diversified piece of the market. The move to passive investing has been like a tsunami. Investors see that investing in an active manager frequently gets them not-as-good returns, and they pay more for it.

Since the market crises of ’08 and ’09, investors are more and more suspicious of investments that are black boxes where you don’t know what your portfolio manager is doing. They want liquidity so they can come in and out of the investments. And they see that lower costs of management over the long term can have a dramatic effect on their portfolios. ETFs answer all those concerns.

Since the financial crisis, many average investors remain hesitant to take on risk. What is your message to them?

That’s a serious concern of ours. We may lose a whole generation or two of investors who effectively, like the Great Depression kids, just want to put their money under a mattress. That would be a shame. Over the long run, it’s our belief that investors who continue to be in the market and well-diversified portfolios that include alternatives will end up better off than someone who simply puts money in a mattress.

What are “alternative investments”?

What many smart people are saying, and some big investment houses are also saying, is that most investors who have a decent-sized portfolio should have a slice of alternative investments.

Let me give you an example. You may have heard of private equity. Most investors have a hard time accessing investments in private companies, especially obtaining a diversified exposure to private companies.. So you don’t have to have a $250,000 investment to get exposure to private equity to further diversify your portfolio.

Another example is something called “hedge fund replication.” What does that mean? This ETF seeks to duplicate the risk-return profile characteristics of a very broad range of hedge funds. Again, this fund is not for someone who wants to buy it to go up to the moon in performance, but it’s designed to produce a diversified performance of hedge funds in order to reduce the risk in a portfolio.

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How can you know which option is right for you?

There is no one-size-fits-all answer. Only the option that is best for **you**, based on your wants, your needs, your nature. This might seem like a no-brainer, but it's critical because, as an investor, you will often hear the media say otherwise. You will hear people claim that stocks are better than bonds, or bonds are safer than stocks. Or that ETFs are always better than mutual funds (or vice versa). But the truth just isn't that simple. So I have six questions for you to consider the answer to. Who, What, When, Where, Why, and How.

1) Who am I? Are you cautious by nature or a risk-taker? Are you a family-oriented person, or more of a lone wolf? An adventurer or a caretaker? Someone with a few simple wants, or big, bold dreams? Or – as many people tend to be – are you a mixture of all these things?
2) What kind of lifestyle do I want? Simple or extravagant? Always trying new things, or staying in your comfort zone? One focuses on work and personal accomplishment, or one focused on family and community? Or again – and I can't stress this too much – a mixture of these things, depending on what stage you're at in life?
3) When will I most need money? Do you need it soon because you're buying a new home or starting a new business? Or do you need it later when you're about to retire?
4) Where do I see myself in ten years? Or twenty? Life is all about change and growth. That means you need to ensure you're investing for long-term growth to reach your long-term goals.
5) Why do I need to invest? To help send your kids to college? To retire? To see the world? To give to charitable causes? To feel like you always have a safety net?
6) How will I pay for retirement? This is key. Because, regardless of your other goals, there's probably going to come a time when you want to stop working. But you can't just pick a day to not show up at work. Retirement

creates a massive lifestyle change, one that will be quite upsetting to your finances if you don't prepare for it.

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