Investments: How Is Your Fund Money Managed?

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There are many options for buying a group of securities as a product. The most popular ones are mutual funds, segregated funds and exchange traded funds. What they have in common is that these products are an easy way to buy a group of securities at once instead of buying each one individually. The fund can also proportion the securities so you the individual investor does not have to. There are advantages and disadvantages to any product and these will be explored further in this article.

When Would You Choose These Products?

One selling feature for mutual funds is that they allow you to access markets and securities that you could not access on your own. An extension to this argument is that you can access certain markets, but it is too much work and it is too time consuming and expensive to do on your own. If you were interested in buying Japanese stocks as an example, you would not be able to do this yourself because the trading accounts in Canada do not support the processing for Japanese trades. You could buy American stocks and Canadian stocks directly, but not overseas securities. You can a Japanese mutual fund instead, and this would contain the Japanese stocks as a group and you could at least have some form of Japanese investment.

A second example is that you want to buy all of the stocks of the S&P 500 index. For you to do this on your own, you would need to buy 500 individual securities and proportion them so that they are well represented to form a portfolio. If you have $1000 to invest, this would not be possible because you could not afford to buy 500 separate stocks. If you had $100,000 to invest, you would have an average cost of $200 per stock. This technically would be possible, but it would be time-consuming and expensive. Even at $10 per trade, you would be spending $5000 to set up the portfolio and more money to change the weightings if you wanted to resemble the index each quarter. This would amount to about 5% of your investment account which is very high. If you had a million dollars to invest, this would equate to a cost of $2000 per stock. The $5000 fee would still be there, but it would be a smaller piece of the whole picture, or 0.5% of the portfolio. If you were changing securities every 3 months, this trading fee could creep up to 1 % or 1.5% of your initial investment each year. You would also have to watch 500 securities and do 500 trades at a time, which may take days each year for each sequence. Many people do not have the time or the skill to carry this out. Purchasing a fund that holds all the 500 securities could accomplish the same thing more easily.

A third example is buying a bond index. Since each bond would cost $1000 minimum to buy, and there are thousands of bonds out there, you simply would not be able to replicate the index.

As a last example, some markets are available, but you need either a large opening balance, a certain type of account or special access to even be able to start trading. Examples of this scenario are buying commodities, futures, derivatives or hedge funds. You may have an idea what direction a certain market will go, but you would not be able to take advantage of it. With these products, you can do it for a fairly easily and for a cheap price.

As these products evolved, there became two major ways of building a portfolio – the active method and the passive method. The active method is when the person running the fund deliberately picks securities to maximize return in a certain market. It was later possible to use a passive method of running a fund, which is essentially imitating an average or index instead of choosing securities.

Active Versus Passive Investing

Active investing is when someone (a portfolio manager) picks the stocks that are in the fund and decides how much of each one to hold (the ***weighting***). This portfolio manager would also monitor the portfolio and decide when a security should be sold off, or have its weighting increased or decreased. Since there is ongoing research, meetings and analysis that must be done to build and monitor this portfolio, this fund manager would have research analysts and administrative personnel to help run the fund.

Passive investing has the same business setup as active investing, but rather than someone deciding what securities to buy or how much of each one to buy, the portfolio manager would copy a benchmark. A ***benchmark*** is a collection of securities which the fund is compared against to see how well it is doing; a typical version of a benchmark is an index. Since everything in investing is about how much money you can make and how much risk it takes to make that money, every fund out there is trying to compare to the other funds of the same type to see who can make the most money. Comparisons in general are done only for returns, but the risk aspect should also be considered. The risk portion of the equation is handled by looking at what type of securities the fund holds and how specialized the fund is.

Risk Scale

The risk priority generally speaking from lowest to highest in terms of asset class are cash, bonds, preferred shares, foreign bonds, equities, foreign equities, small companies, commodities, hedge funds and derivatives. If you want to look at risk as a number, most companies use ***standard deviation*** of returns with respect to the average to compare between two funds. This number does not capture all kinds of risk – it is used as a guide to make approximations about risk. Derivatives can characterize all kinds of risk or be used to mitigate risk using the same securities. The first rule of thumb is to compare the funds that have the same underlying securities with the same weighting of each kind. This will insure that your risk grouping will be in the similar ballpark between two products. If you see some security that you don't understand, make sure you know how it works before you assess its risk. Mistakes here can lead to decisions based on wrong information, which means you can lose money.

Is Active Investing Better Than Passive Investing?

This is a raging debate in the investment community and the classic answer of "it depends" is relevant here. What does it depend on? The most important element in deciding which method is better is the hardest element to define – manager skill. It is like comparing athletes. Everyone knows a star athlete when they see one – they can read the plays better than the average player, they are instrumental in motivating the team, and they seem to go the extra mile when it comes to their sport. These superstars are also relatively rare, and it is not known how long they will be superior at what they do. The same idea holds true for portfolio managers. There are some exceptional ones, but a large percentage of them are average and some of them are below average. How do you know who will be the best? You actually don't know and there is no way to know because "the best" depends on many intangible and unpredictable factors. How long will a good athlete's performance last? Will this years' most valuable player be next years' MVP? The same idea can be applied to portfolio managers. What do people do when they don't know something? They guess using odds and statistics, and hope that on average, everything will be worthwhile.

Active Managers Ranking Depends on Their Distribution

This is a simplified way of dissecting the dynamics of active managers as a group to understand that probabilities are important in assessing a fund manager. In a classroom with 20 students, there will always be an average of about 70% for the group according to statistics theory. The students are considered equal in terms of their ability to perform in the classroom, so an equal number of people will be above and below the average of the group in terms of numbers. This is not always true but this example is kept simple for better understanding. In the investment world, if you have 20 managers in a certain market, the default average will be 50% success, where success is beating the benchmark return. Why 50% and not 70%? A key rule of investing is the idea of a "zero sum game". For every dollar made on an investment by one manager, there will be a dollar lost by another manager. This is because all managers will buy and sell from each other in a given market if they make up most of the investment money available, which is usually true. Another way of saying this is that if 10 managers make a collective profit of $50,000 in a year as a group, there will be another 10 managers who lose $50,000 collectively in that year. The assumption here is that the dollars gained or lost are evenly distributed among all of the managers. This is generally not true also, which means that you will not always get the same number of managers winning or losing each and every year.

The other complication is that the entire stock market will rise by inflation on average each year, which means that the number of dollars gained will typically be more than the numbers of dollars lost each year simply because more dollars are added to the market each year. This can be remedied by taking returns after inflation, but because inflation is an average over longer periods of time, this becomes more complicated than it appears.

The last factor to mention in this example is the cost of doing the investing. The $50,000 gained and lost referred to above assumes that managing the money is free. This is not realistic as companies who invest money need to pay employees, overhead, advertising expenses and so on in order to generate these investment results. Since all of the companies are paying these costs, the collective gain would be smaller and the collective loss would be larger for the above situation. As an example, if each manager had costs of $1000 per year to invest the money, the average gain would drop from $50,000 collectively over 10 managers, or $5,000 gain per manager down to $4,000 gain per manager. The collective gain would now be $40,000. On the losing side, the average loss would grow from $50,000 collectively over 10 managers, or $5,000 per manager up to $6,000 per manager. The collective loss would now be $60,000. If the results are always evenly distributed, this would not make much difference in terms of the number of managers who are above and below the average. Since the even distribution is not always present in the real world, this skewing of the results would tend to create more managers below the average than above the average. If it is stated that passive investing (which is represented by the average) is usually better than active investing, this is the simplified analysis of why this is the case. If the assumptions of distribution are dropped, the number of managers can vary each year above and below the average for the group, but over time the idea that most managers do not beat the average will come up consistently. (4)(5)(6)

The Birth Of The Index Fund and Exchange Traded Fund (ETF)

So if the average is difficult to beat for most managers, can I just buy the average? The short answer is that you cannot buy the average directly: It is a calculation that is used to measure results. You can imitate the index or benchmark, but you will have to incur costs to do this which means you will not have the same returns as the index. You can get returns that are pretty close to the benchmark with ETFs or index funds. An ETF stands for exchange traded fund. It will trade like a stock in that it can be bought or sold at any time. More importantly, an ETF is a vehicle that can imitate a stock index, a bond index or any other index that is out there. This allows you to buy the measuring stick of the markets without having to pay a lot of money. An index fund does the same thing, but it tends to be more expensive than an ETF, and it operates like a mutual fund which means the trading procedures are slightly different. An ETF can be bought and sold like a stock in real time during the day when the markets are open. Mutual funds will obtain a price once a day and you will get that price when you put the order in. The trading fees will exist for an ETF but not a mutual fund as the Management Expense Ratio will cover the trading costs.

How Do I Know If A Fund Is Active or Passive?

You would need to know how the fund manager operates the fund. Some clues to finding this out are more quickly are given next. If the fund manager is intentionally trying to pick securities according to some beliefs that they have about the market, this is active management. If the fund description has phrases such as “manager skill,” than it is actively managed. Another clue is to look at the return history. If returns vary versus the index by different amounts each year, then the fund is actively managed. Lastly, the fees may be expensive and have sales loads.

If the name of the fund says “Index” or “Index fund” there is a good chance that the fund is passively managed. If the name of the fund says “ETF” this could be a passive fund, but you need to make sure of this because some ETFs are actually active funds, but they are managed actively in a certain way. Most of the passively managed ETFs are provided by BMO, iShares, Claymore, Vanguard and Horizons in Canada and Powershares, iShares, Vanguard and SPDR (or Standard and Poors) and others if the holdings are from the U.S. Most of the other companies would have actively managed funds only with the exception of the index funds which are offered by many institutions. If the fund description states that the fund is trying to “imitate” the performance of an index or benchmark, then this implies that it is copying the index and this is passively managed. From the return perspective, passively managed funds will be very close to the index that they claim to imitate, but slightly less due to fees each year. The amount that the returns are less than the index will be close to identical each year unless there are currency conversions or variances in cost which may come from currency fluctuations or hedging that the fund may do. Passive funds typically do not have sales loads as they are geared toward people who invest for themselves.

There are some funds that try to mix active and passive management. These funds can be assumed to be actively managed, although their results will be closer to the benchmark than most of the other funds, so this is something to consider if the variation from the index is a factor. By understanding how the fund operates and what is involved in generating the returns, you will have a better idea whether a fund offers good value or if they are delivering on their objective. This knowledge will also make it easier to compare products when choosing where to invest your money.

Sources:

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