INTEGER WEALTH GLOBAL

Investment Funds 101 – A Summary Narrative

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Investment Funds – Why investing in funds is a smart way to grow your money

Investment funds are an alternative to making direct investments in stocks, bonds, or other asset classes. There are several advantages to investing in funds, as well as one or two drawbacks. Here we explore the most common types of funds and the pros and cons of investing in them.

What is Stock, What are Shares and What Are Bonds.?

To begin with here are the definitions for each:

- **Stocks (Equities):**
  - **Definition:** Stocks, also known as equities, represent ownership in a specific company. When you buy stocks, you become a shareholder and hold a portion of that company.
  - **Ownership:** Owning common stock entitles you to receive dividends (a share of the company's profits) and allows you to vote at shareholder meetings.
  - **Risk and Reward:** Stocks offer the greatest potential for growth but come with significant risk. Stock prices can fluctuate significantly, leading to potential gains or losses.
  - **Examples:** You can buy stocks of well-known companies like Apple (AAPL), Tesla (TSLA), or Intel (INTC) on various stock exchanges.

- **Shares:**
  - **Definition:** Shares are individual units of ownership in a company. Each share represents a fractional interest in the company's total equity.
  - **Common vs. Preferred Shares:**
    - Common Shares: These represent regular ownership and come with voting rights and potential dividends.
    - Preferred Shares: Preferred shareholders don't have voting rights but receive dividend payments before common shareholders do. In case of bankruptcy, preferred stockholders have priority.
  - Trading: Shares are bought and sold on stock exchanges.

- **Bonds (Debt Securities):**
  - **Definition:** Bonds are debt securities issued by corporations or governments. When you buy a bond, you're essentially lending money to the issuer.

- **Issuer:** The company or organization issuing the bond acts as a borrower.
- **Interest Payments:** In exchange for lending money, the issuer promises to pay you a fixed rate of interest (coupon) on top of the bond's principal.
- **Types of Bonds:**
  - **Corporate Bonds:** Issued by private and public companies.
  - **Municipal Bonds:** Issued by states, cities, and counties.
  - **Government Bonds:** Issued by national governments.
  - **Risk and Return:** Bonds are generally considered safer than stocks but offer lower potential returns. They provide fixed income over time.

- **In Summary:**
  - Stocks represent ownership in a company and offer growth potential but come with higher risk.
  - Shares are individual units of stock ownership.
  - Bonds are debt securities where you lend money to an issuer in exchange for fixed interest payments.
  - Securities refer to a broad category of tradable financial instruments that represent ownership or debt in an entity (such as a company or government).

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1. What are investment funds.?

There are many different types of investment funds, each with their own unique characteristics. The feature they do share is that investment funds always pool capital from multiple investors, and the capital is managed according to a predetermined set of objectives.

There are several immediate advantages to pooling capital in this way. Firstly, it allows for the buying and selling of investments to be the responsibility of a fund manager with a specific skill set. Secondly, it is cost effective to spread the costs associated with managing the fund across multiple investors, and finally, larger funds can be more effectively diversified.

Certain types of funds are also beneficial to the economy of a country. They can be structured to encourage and incentivise savings. This in turn provides capital to fund economic growth and job creation. Investment funds are defined along several criteria. These include a fund's legal structure, the asset classes it invests in, its objectives, and the investment strategy it follows.

2. Important Investment Fund Terms

Before we discuss the different types of investment funds, it may be worthwhile highlighting some of the important terms used to describe funds.

- **Open end funds and close end funds**
  Open end funds are structured so that capital can be invested or redeemed at any time. Typically, an investor can invest or redeem capital on a daily basis, though for some funds the period can be monthly, quarterly or annually.
  A closed end fund is typically listed like a share, with a fixed number of shares. Investors can only invest or redeem capital by buying shares from another investor or selling their shares to another investor.

- **Unitised funds**
  Unitisation of an investment fund simplifies the process of accounting for the value and performance of each individual investor's share of a fund. It simplifies an investor's holdings down to units, a buy price and a sell price. Unitisations is common for investments funds for retail investors. (Retail investors, also known as individual investors, are non-professional market participants who buy and sell securities for their own personal accounts.)

- **Active and Passive Management**
  Active management of a fund implies that buying and selling decisions are made on a regular basis when economic conditions or the outlook for underlying instruments change. A passively managed fund simply mirrors an index, with minor adjustments being made at specific intervals.

- **Index Funds**
  An index fund is a type of investment vehicle, either a mutual fund or an exchange-traded fund (ETF), designed to closely replicate the performance of a specific financial market index. Index funds are passively managed funds that track an index. The legal and fee structure of each index fund can vary, however.

- **Net Asset Value (NAV)**
  The Net Asset Value, or NAV, of a fund is the value of all assets held by the fund at a given time. This is usually reported on a 'per-unit' or 'per-share' basis. The NAV of a fund is the price at which units of an open-ended fund are bought and sold. The unit price of a closed end fund is determined by supply and demand, however the price usually trades close to the NAV.

3. How Do Investment Funds Work.?

Investment funds are typically operated by a group of companies, each with specific functions, such as the Integer Wealth Group of companies. A management company will be responsible for administration and marketing, while a fund management company will be responsible for the actual investment decisions. A third company is often responsible for safe custody of assets. Dividing the responsibilities like this reduces the opportunity to fraud and allows for the investment management company to be changed if necessary.

Each fund has a legal structure which determines the rules that govern the fund, as well as tax and legal liabilities. Certain legal structures are specifically designed with retail investors in mind. These funds offer greater levels of transparency and protection for investors.

Legal structures are in turn governed by the jurisdiction in which they are enforced. A fund's mandate sets out its goals and any limitations on what securities the fund can own. The mandate will typically also outline a set of rules in place to manage risk.

The process of investing or withdrawing capital varies from one type of fund to the next. In most cases an account must first be opened. After this, investors can transfer capital to a bank account linked to the fund.
The fund manager buys and sells securities to ensure the cash balance remains below a certain percentage. The remainder of the portfolio is constantly adjusted to keep it in line with the intended investment strategy.

When an investment is redeemed (capital is withdrawn), capital is paid from the fund's cash balance to the investor. If there is insufficient cash to cover the withdrawal, the fund manager will sell securities to raise cash.

4. What are the Different Types of Investment Funds.?

The following are the types of funds most investors are likely to encounter.

- **Mutual funds**
  Mutual funds have traditionally been the most popular form of investment fund for individual investors, though ETF's have become more popular in recent years. Mutual funds are sometimes known as unit trusts or collective investment schemes. They are open ended and unitised, which allows investors to buy or sell units at the NAV each day.

  Some mutual funds are index funds that are managed passively. However, the majority of mutual funds are actively managed. Many of these funds have underperformed their benchmarks over the past two decades. This has led to one of the today's most common investing myths, being the idea that active investing is dead. Market conditions have not favoured active investment strategies over the past decade. However, it is likely that active investing, and by association mutual funds, will regain some popularity in the future.

- **Exchange traded funds (ETF's)**
  ETFs are publicly listed investment vehicles and are managed using passive investing strategies. ETFs track well known indexes like the S&P 500 and FTSE 100, as well as custom index designed to achieve specific objectives.

  Exchange traded funds are close end funds and units are bought and sold like any other listed shares. Units are not exchanged at the NAV of each unit, but at a price determined by supply and demand. New fund shares can be created when demand increases or cancelled when there is too much supply.

  ETF investing is relatively new, with the first fund only being launched in 1993. However, ETF's have gained popularity due to the lower fees and the fact that most mutual funds have failed to meet their benchmark.

- **Hedge funds**
  Hedge funds are investment funds with more flexible mandates than ETF's or mutual funds. Hedge funds are often able to use leverage, derivatives and short selling strategies to generate profits in any type of market environment. Unlike most equity funds, hedge funds can generate positive returns during bear markets as well as from short term price movements.

  There are several types of hedge funds, all employing different strategies and asset classes, and with different objectives. For the most part, hedge funds are designed to reduce volatility and portfolio risk.

  Hedge funds have historically only been available to large funds and very wealthy investors, but they are increasingly being made accessible for retail investors.

  These funds often use innovative investment strategies to generate real returns with low correlation to equity indices. The fund strategies employ artificial intelligence to analyse user generated data and new sources in real time. This data is used to assess market sentiment and generate trading ideas.

  Definitions:
  Leverage: This involves using borrowed funds to enhance the impact of an investment.
  It allows investors to control larger positions than their own capital would allow.

  Derivatives: A derivative is a financial contract whose value depends on an underlying asset, group of assets, or benchmark. These contracts are set between two or more parties and can be traded on an exchange or over the counter (OTC).
  Derivative Underlying Assets: Derivatives derive their value from various underlying assets, including:
    - **Stocks:** Equity derivatives.
    - **Bonds:** Fixed income derivatives.
    - **Commodities:** Agricultural products, metals, energy, etc.
    - **Currencies:** Foreign exchange derivatives.
    - **Interest Rates:** Interest rate derivatives.
    - **Market Indexes:** Derivatives based on stock market indices.
    - **Cryptocurrencies:** Emerging derivatives related to digital assets.
    - **Purpose and Use:**
      - Hedging: Derivatives can be used to hedge against risk. For example, a company might use futures contracts to protect against adverse price movements.
      - Speculation: Traders use derivatives to speculate on the directional movement of an underlying asset. This involves assuming risk with the expectation of commensurate reward.

- **Investment trusts**
  Investment trusts are similar to ETF's in that they are publicly listed trusts, however they do not track indexes. In most cases investment trusts focus on a specific strategy or sector.

These funds were more popular before mutual funds and ETF’s came about. They still exist in certain industries where the structure is beneficial.

- **REIT’s**
  REIT’s, or ‘R*eal Estate Investment Trusts’*, are investment trusts that invest in real estate. In most countries, REIT’s are a specific type of entity with their own limitations and tax obligations. REIT’s pay dividends and are regarded as an alternative to bonds or preference shares.

- **Private equity and venture capital funds**
  Private equity funds invest in established companies that are not publicly traded. Venture capital funds invest in newer, private companies that may not yet be profitable. Most of these funds are only available to high-net-worth investors and institutions. Increasingly, private market funds are being made available to retail investors through *fund of fund* structures.

- **Pension funds and retirement plans**
  Pension and retirement funds come in various forms around the world. They have one or two notable characteristics. Firstly, many are sponsored or administered by companies for employees. Typically, the employer and the employee make monthly contributions.

  The other notable characteristic is that taxes are often deferred within a retirement plan. This means income and gains are not taxed, and tax is only paid when withdrawals are made during retirement. This allows the fund’s assets to compound tax free until retirement.

- **Alternative Investment Funds**
  An AIF is an acronym for 'Alternative Investment Fund', a form of managed fund. It is a collective fund that invests in assets outside Bonds, equities, and cash. For the benefit of investors, it collects funds from investors and invests them in different categories of assets. It makes investments into Venture Capital, Private Equity, Hedge Funds, Managed Futures and other financial instruments.

  Generally, high-net-worth people, institutions and organisations engage with AIF's since they require a large initial investment.

  Key points to consider are:
  - Alternative Investment Funds (AIF’s) are vehicles for diversifying investments by accessing a variety of asset classes.
  - AIF’s allow investors to access unique investment opportunities and compete with larger institutional investors.
  - AIF’s provide increased liquidity compared to traditional investments, as well as greater flexibility in terms of structuring and managing investments.
  - AIF’s can also help investors manage risk by spreading out their investments across different asset types and geographies.
  - By investing in AIF’s, investors can access a wide range of financial products and services that would otherwise be unavailable to them through standard investments.

- AIF’s can offer investors the potential for higher returns due to the variety of investment opportunities that they provide.

Fund-of-funds and umbrella funds - Are they the same.?

A fund of funds (FOF) and an umbrella fund are not the same, but they are both investment strategies that involve other funds:

- **Fund of funds**
  An FOF is an investment strategy that invests in a portfolio of other funds, rather than directly in securities like stocks or bonds.
- **Umbrella fund**
  An umbrella fund is an investment fund that contains multiple sub-funds, each with its own investment strategy and investors.

Differentials	Fund of funds	Umbrella fund
Investment Strategy:	Invests in a portfolio of other funds	Contains multiple sub-funds, each with its own investment strategy
Typical Investments:	Mutual funds, hedge funds, private equity funds, or real estate funds	Stocks, bonds, or commodities

Note: Umbrella funds are often easier to administer than traditional funds because they share a legal entity and management team. This makes it easier for investors to switch between sub-funds, which can be beneficial if you want to change your investment strategy.

5. Investment Funds vs. Direct Investments

There are several points to consider when deciding between direct investments and a fund.

- **Fees**
  The fees charged by a fund can make a large difference to their ultimate performance. In the past, management fees were high and long-term investors could benefit from managing their own portfolios. However the fees charged by many ETFs are so low that the benefit of managing your own portfolio is now marginal. Generally, funds with expense ratios below 0.3% are hard to beat in terms of costs.

- **Diversification and Portfolio Size**
  It is easier and cheaper to achieve diversification with funds than individual securities. However, this also means that a fund or a portfolio of funds is unlikely to benefit meaningfully from the performance of any individual stocks.

- **Skills and Time**
  Perhaps most important is the fact that most investors don't have the skills or time to manage a portfolio made up entirely of individual securities. In most cases investors benefit most from a mix of investment funds and individual securities.

6. Characteristics of a Good Investment Fund

Just as it is impossible to predict the future it is also impossible to know how well a fund will perform in the future. However, there are a few attributes that can tilt the odds of selecting a good investment. Active funds should have a good track record over the long term and especially under a range of differing market conditions. If a fund has a shorter track record, the fund manager's track record should be studied.
The best funds have a long-term focus and capture major investment themes while avoiding short term fads. Fees should be in line with similar funds.

Passive funds should track indexes with a fairly large eco system, such as the S&P 500 and FTSE 100 do. For most investors, index funds should be broad based and not sector specific. An expense ratio below 0.3% is preferable, and there should also be good liquidity.

7. Pros and Cons of Investment Funds

The most important advantage of investment funds is the diversification they offer easily and cheaply. Individual funds are already diversified, but funds invested in different asset classes can also be used to achieve broad asset allocation.
In most countries there are tax advantages to investing in certain types of funds. If you earn capital gains on direct investment you will probably have to pay tax on those gains when you sell the shares.

When underlying investments within investment funds are sold, there is no tax liability. Capital gains tax may be due when the fund is sold, but capital can compound more efficiently within the fund before it is sold.

Good fund managers are more adept than most individual investors at navigating challenging periods in the market. Experienced fund managers are often able to spot the investment warning signs that precede bear markets. Historically the downside of funds was the high fees that were charged.

Management fees are a lot lower than they used to be and this is less of disadvantage nowadays. In the place of fees though, is the large number of funds available these days. This can make it challenging to find the most suitable funds to achieve investment goals.

The other disadvantage is the fact that funds are unlikely to earn the higher returns of a concentrated and actively managed portfolio. Successful funds tend to attract large amounts of capital which then acts as a drag on performance. On the other hand, the smaller funds that may outperform are far riskier and difficult to pick.

8. Investment Portfolio – What is it.?

An investment portfolio is a collection of financial assets owned by an individual or an entity. It represents a diversified mix of investments, each chosen with specific objectives in mind. Here are the key points about investment portfolios:

- **Composition**:
    - An investment portfolio typically includes various asset classes, such as:
        - **Stocks**: Represent ownership in companies (equity securities).
        - **Bonds**: Debt securities issued by corporations or governments.
        - **Mutual Funds and ETFs**: Pooled investments managed by professionals.
        - **Real Estate**: Properties or real estate investment trusts (REITs).
        - **Cash and Cash Equivalents**: Short-term, low-risk instruments like money market funds.
        - **Alternative Investments**: Examples include private equity, hedge funds, and commodities.

- **Diversification**:
    - Diversification is a key concept in portfolio management.
    - By spreading investments across different asset classes, investors aim to reduce risk.
    - Diversified portfolios can potentially provide more stable returns over time.

- **Risk and Return**:
    - Portfolios balance risk and return based on an individual's goals and risk tolerance.
    - Some assets (like stocks) offer higher potential returns but come with greater volatility.
    - Others (like bonds) provide stability but may yield lower returns.

- **Customization**:
    - Each investor's portfolio is unique, reflecting their financial situation, investment horizon, and preferences.
    - Portfolios can be conservative, aggressive, or balanced, depending on the investor's objectives.

- **Management**:
    - Investors can manage their portfolios independently or seek professional help.
    - Financial advisors, wealth managers, or robo-advisors assist in constructing and adjusting portfolios.

Remember that an investment portfolio is a dynamic entity—it evolves over time as financial goals change, market conditions fluctuate, and new opportunities arise.

Investment funds are very useful tools for building an investment portfolio, and to achieve long term goals. However, they are not the only solution and are probably best used alongside a few direct investments.