<u>Funds and ETFs Demystified</u>

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Mutual funds offer investors a diversified portfolio of stocks and/or bonds and cash. The benefit to an investor is the ability to profit from this diversification without having to purchase the individual underlying securities. Instead, this can be done quickly with a nominal investment in a mutual fund. When looking to purchase mutual funds, an investor is often overwhelmed by both the many options and the confusing terminology. Closed-end funds (CEFs), Open-end funds, Exchange-traded funds (ETFs) - what are the differences? To help facilitate informed investment decisions, here are the basics:

Definitions and Differences

Open-end Funds – These are the most common ways to invest in mutual funds. It is estimated that close to 44% of US households owned open-end mutual funds in 2012. The mutual fund company aggregates money from investors on a continual basis. A portfolio manager can then invest in industry sectors and stocks/bonds on a scale that would not be practical for the individual with a limited portfolio. Shares in the funds are bought and sold at the end of each trading day based on the value of the fund's net asset value or NAV. The NAV is determined by taking the market value of the fund and dividing by the number of shares outstanding. The share number changes each day as old investors exit and new investors enter. There is no secondary market for open-end fund shares. Purchases and redemptions are made directly to the fund manager who stands ready to buy and sell shares every day at the market closing price. Liquidity is almost instantaneous as funds will settle the next day.

Closed-end Funds – This product has a very long history, having been introduced in the late 19th century. This type of fund has a fixed number of shares that are traded on an exchange, between investors. As such, NAV is only part of the pricing determinant as supply and demand come into play. It is common to see closed-end funds trading at a large premium or discount to NAV based on market demand. For a fund that issues a small number of shares and becomes widely sought after either based on performance or market perception, a premium is possible. The exchange traded mechanism also allows this instrument to be bought and sold during the course of the trading day. Closed-end funds tend to be more actively managed, and often employ leverage to generate higher yields. Trade settlement is three business days.

Exchange Traded Funds – ETFs are a relatively new financial product, having been launched about 20 years ago. This type of instrument also trades on a live exchange, but the price tends to track more closely with the NAV than with closed-end funds. That is because the product is more transparent, set up more like an index and passively managed. ETFs also have an innovative structure where shares are created and retired on an active basis by large companies.

ETFs allow an investor to sell short, buy on margin, purchase very small amounts and provide settlement in three business days.

Management Styles & Strategies

Mutual funds employ many management styles, the most common being indexed, actively-managed, lifecycle/target dated, balanced and tax-managed. Index funds are developed to track an underlying index such as the S&P 500 and are very low cost. Actively managed funds utilize a portfolio manager's research and expertise, resulting in higher fees and frequently more portfolio turnover. Lifecycle/Target date funds employ a mix of stocks and bonds, usually by investing in other mutual funds. These are used when an investor is trying to reduce risk and become more conservative over time, commonly tied to an event such as retirement or college tuition payments. Lifestyle funds also invest in a mix of stock and bond funds but the mix doesn't change over time. They are marketed to an investor's particular risk tolerance of conservative, moderate or aggressive. Balanced funds offer a set equity/fixed income allocation, typically in the 60%/40% range. Finally, tax-managed funds are designed to limit turnover and thus distributions in order to keep the tax man at bay.

Costs

ETFs and open-ended mutual funds have some of the lowest cost structures out there given the "indexed" and passive nature of their management. Fee ranges on ETF's and index funds should be below 25 basis points, while actively traded ETFs and managed funds may have fees exceeding 1%. The actively traded fee premium is tied to a manager analyzing and trading securities to maximize returns. Commissions and loads should also be taken into consideration, especially if an investor is purchasing small amounts on a regular basis. With many no-load, open-end mutual funds, there are no fees on purchases, which is appealing to dollar-cost averaging investors. Closed-end and ETFs often charge a brokerage commission for each purchase or sale, independent of the amount of the investment.

Premium/Discount

Closed-end funds are often traded at a substantial discount to NAV, possibly greater than 10%. This appeals to certain investors who feel they can profit in several ways. Not only do closed-end funds generate an attractive yield, but they can also offer upside profit potential should the discount to NAV disappear as the fund's price appreciates. However, this strategy should be used selectively and an investor needs to do his homework before purchasing.

Yield

Some closed end-funds have enjoyed a recent rally due to their high dividend yields. Many closed-end funds invest in municipal and corporate debt, using leverage to boost returns of as high as 15%. Although this is attractive, especially now as investors search for yield and dividends, these high yields often reflect higher risk. Leverage cuts both ways and with a softening economy, and or rising interest rates, can spell trouble. However, buying the closed-end funds at a substantial discount can help mitigate the risk.

Taxes

A large percentage of closed-end funds invest heavily in bonds and preferred stocks as a way of boosting yield. This yield translates to ordinary income and will be taxed as such. Index funds and ETFs are the big winners in terms of minimizing taxes, as managers do not need to constantly buy and sell securities unless a component of the underlying index has changed.

How to Choose

Investors need to focus on their objectives. Are you embarking on a monthly savings plan with small purchases of the fund, or are you prepared to invest a large lump sum? Prioritize what you want in terms of diversification, yield, liquidity and safety. As with any investment, watch expenses, do research on the fund performance, manager and trading history. Although we still believe owning individual stocks gives an investor the ability to create his own mutual fund portfolio with more control and lower costs, the use of funds is appropriate in specific instances.