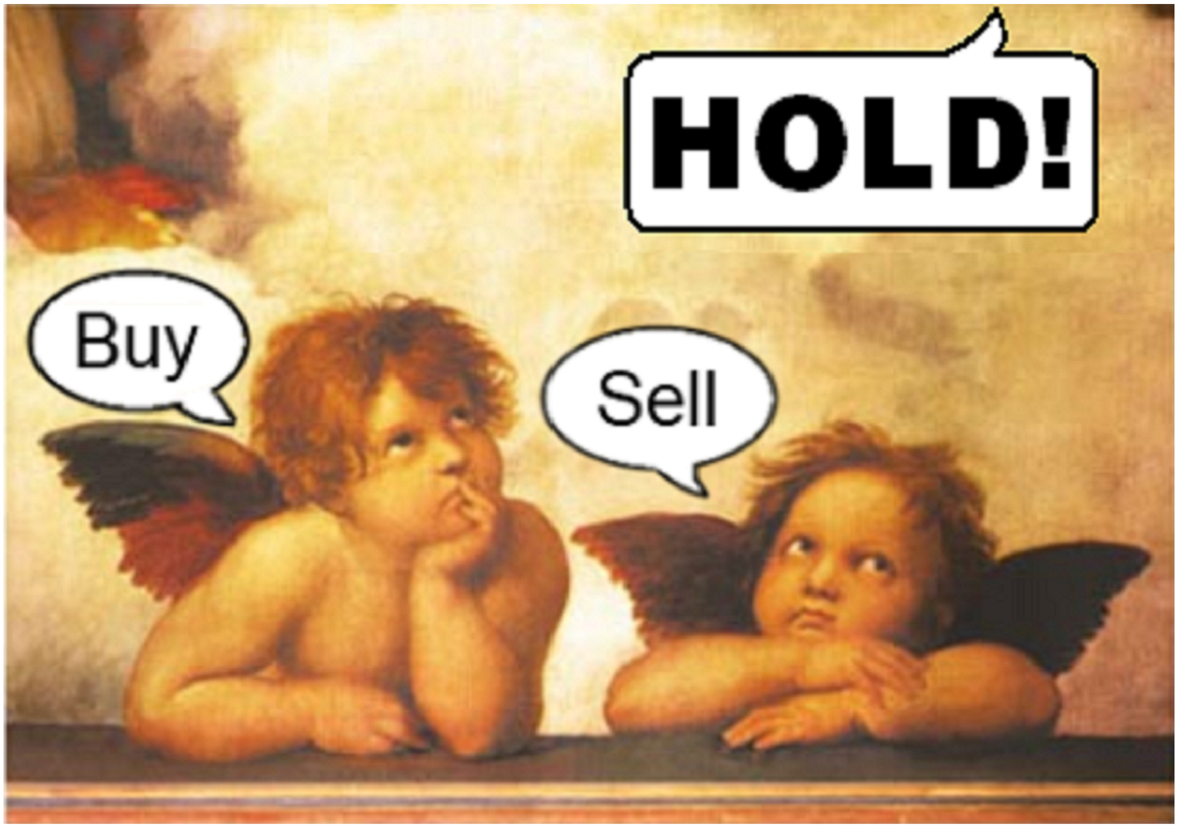


# *Introduction to Investments:*

## *A Free Manual for Building Wealth*

*The companion textbook for*
*Introduction to Investments*
*Southwestern Community College*
*Chula Vista, California*

*Frank Paiano*

# Table of Contents

# Foreword: OER, Open Educational Resources - *This Book is Free to Read*

*"An author is a fool who, not content with having bored those who have lived with him, insists on boring future generations." – Montesquieu*

This book is written as an Open Educational Resource (OER). It is licensed under the Creative Commons Attribution-NonCommercial-ShareAlike 4.0 International License. This means you can read it for free. If anyone is trying to get you to pay for this book, they are scam artists. If you have already paid the scam artists for this book, contact your credit card company and tell them you have been scammed and you want your money back. If you want to use this material for anything else other than for your own education, please read the above Creative Commons license agreement carefully. If you want to collaborate on this textbook as we keep it updated in the future, please contact me directly, especially if you are much smarter than I am. (We are setting the bar fairly low here, Folks.) We desperately need graphic artists and data experts. If you are a Technical Analysis expert, please contact us immediately! If you would like to translate this text to another language, please contact us immediately! We would love to have this become a group effort, especially for those teaching Introduction to Investments at the middle, high, and adult school, community college, and even university levels.

Okay, so why write a book about investing when there are already many great books about investing available? That's a great question. The reason is a bit complicated. Nothing is perfect and that includes the world of academia. I have taught BUS-123, Introduction to Investments, at Southwestern Community College for almost 20 years now and have been a Registered Representative, also known as a Stockbroker, since 1998. I have been investing for far longer than that. If it were up to me, I would use The Intelligent Investor by Benjamin Graham as our college textbook at Southwestern. It is the definitive work on investing written by none other than the teacher and mentor of Warren Buffett, the famed investor. But always remember our academia motto: If it makes sense, we don't do it. The Intelligent Investor is not a college-level textbook. It does not come from a college-level textbook publisher. A college-level textbook must cost at least US$340 for a book that is usually worth about US$29.95. In reality, The Intelligent Investor is far more rigorous than any college-level Introduction to Investments textbooks we have come across.

This is where Open Educational Resources (OER) comes in. Under their auspices, we can write a college-level textbook and have it blessed and kissed by the Academic Powers-That-Be. The reality is that this textbook is really just a restatement of the BUS-123, Introduction to Investments, class website. Websites also can not be used as college-level textbooks even though, in my humble opinion and the opinion of many of our students, our website is also far superior to any college-level Introduction to Investments textbooks available. Again, if it makes sense, we don't do it. So there! That is why we are writing this book.

The other reason is that, as the French philosopher, Montesquieu, points out above, I am very much looking forward to boring those who are living with me and all future generations to come.

# Preface: Welcome to Introduction to Investments

*"It is a gloomy moment in history. Never has the future seemed so dark and incalculable. The United States is beset with racial, industrial and commercial chaos, drifting we know not where. Of our troubles, no one can see the end."*

You have heard the predictions. The End of the World is Nigh! Doom and Gloom Await the Human Race! Global warming! Climate change! Rising sea levels! Pollution! Totalitarianism! Nuclear annihilation! Economic inequality! Earthquakes! Fires! Droughts! Tsunamis! Pestilence! Disco returning! Pretty scary stuff, eh? All you have to do is turn on the tele and watch the talking heads on Skunk News, ah, wait, Weasel News, no, I know, Fox News! When you ask people when they believe this quote was said or written, they will often say, "Great Depression," or, "World War II," or maybe even, "9/11," or "2008." This famous quote is actually from Harper's Weekly, the nation's oldest magazine. It was written in 1847. (A few sources claim it was actually 1857. So here is your first research assignment. See if you can definitely find the actual date. Have fun!)

Did the United States face tremendous problems in the 1840's and 1850's? Yes, indeed it did. The nation was about to tear itself apart over the issue of slavery, our original sin. Do we have tremendous problems now? Yes, indeed we do. The nation is still tearing itself apart over issues similar to those fought during the Civil War along with a host of other problems we are facing, locally, nationally and globally. However, so far, equating serious with fatal has been a bad choice. In fact, the last 200 years have been the most prosperous years in the history of recorded civilization. The last 100 years, the last 50 years, the last 20 years, all of these have seen the global standard of living rise to levels never before seen by humankind. According to some sources, the global middle class reached over 50% in 2018 and is predicted to swell to over 5.5 billion people by 2030. Of course, there is much, much more that we need to do to bring all the people in the world into the global middle class so they have access to food, clothing, and shelter.

So what does this mean for those of us who want to become prudent, long-term oriented, successful investors? It means that the news is good! As hundreds of millions of people enter the global middle class for the first time, they want many of the same things that we in the West have taken for granted for a hundred years. They want clean water, healthy food, safe housing, shoes, toothpaste, diapers, electronics, entertainment, bicycles, scooters, cars, etc. This will create many new and tremendous opportunities for companies to profit from this rise in the standard of living and for us investors who want to partake in that success.

Oh, by the way, you won't see this is very good news on the nightly disasters, oops!, I mean, the nightly news. That is why it is a good idea to resolve to never again get your news from television. Start reading. You know what I am talking about, newspapers, magazines, books, libraries. You can download and read books, articles, and the news on your mobile phone. It's cool, really. You will feel better. And you will live longer, too. Trust me.

So are you ready to learn how to partake in the future success of the human race? We hope so. We will do our best to make you prudent, long-term oriented, successful investors. We want you to become the best investors the world has ever seen and become very wealthy! We also will do our best to make this class the best class you have ever taken! (I know. I know. This all sounds a bit over the top but it is sincere.) We want to emphasize that you don't need any previous investment experience. In fact, the less exposure to the talking heads in the media or the latest get rich quick schemes or your brother-in-law, the self-proclaimed investment expert, the better. So let's get started with chapter 1. We start with a very simple question: What is an investment?

# Chapter 1 - Introduction, Overview, and Risk versus Return

*"In investing money, the amount of interest you want should depend upon on whether you want to eat well or sleep well."*

*-- J. Kenfield Morley*

## Objectives

In this chapter and in the chapter 1 Canvas module and class website, you will

- Be introduced to the definition of an investment and the basic characteristics of investments – We start from the very beginning! What is an investment?
- Review the major asset investment alternatives – An Overview of the Investment Universe
- Explore the relationship of risk and return
- Identify the differences between an investor and a speculator/trader
- Concentrate and investigate short term "cash" investment alternatives – A Place to Park Your Money
- Discuss aspects of short term "cash" investments with your fellow students

By the end of this chapter and the Canvas module or class website, you should be able to

- Given a typical investment, identify its characteristics including the cash flow (income) and capital gains (growth) components, and identify the advantages and disadvantages of the investment
- In a brief two- to three-sentence description, succinctly describe the major investment alternatives including stocks, bonds, mutual funds, and short term "cash' investments
- Express the historical relationship of risk and return (Do you want to eat well or do you want to sleep well?)
- Research short term "cash" investment alternatives including demand deposit accounts such as savings accounts, Certificates of Deposits, money market accounts and money market mutual funds, and Treasury Bills
- Describe institutional short term investment alternatives such as corporate paper and bankers acceptance notes
- Optionally, calculate the future values of a lump sum principal investment and a series of investments

Don't worry if any or all of this sounds scary now. We will learn all these terms and concepts in good time. They really are not as hard as they sound. Again, not for the last time, we want you to remember that this is an Introduction to Investments class. You need no prior investment experience nor training.

# What Is an Investment?

*"Investing is simple ... but it ain't easy!"* -- Warren Buffett

Welcome to Introduction to Investments. Do you want to be a successful investor? You can. You do not need any prior investment experience to take this class. You don't have to be a genius or a technology whiz. There is no advanced math, only simple arithmetic that any 99¢ calculator can perform, add, subtraction, division, and multiplication. The concepts, techniques, and skills, while extensive at times, are not difficult. The research is relatively easy but beware as it can become habit forming. As the famed investor, Mr. Warren Buffett, has been quoted as saying, "Investing is simple … but it ain't easy." What? Why? How? Mr. Buffett is referring to the fact that there are two parts to the world of investments. The simple part is the intellectual part, the cognitive part. Read, listen, watch, and study the material, spend some time doing the research, do the assignments, and you should find that the concepts, techniques, and skills are actually very straightforward. The "ain't easy" part is the emotional part of investing. We will spend a great deal of time doing our best to help you learn techniques, tricks, and tips that should help you succeed with the emotional part, but again, as Mr. Buffett says, "it ain't easy!"

*"Do you want to eat well or do you want to sleep well?"*

Mr. J. Kenfield Morley encapsulates our predicament perfectly. "Do you want to eat well or do you want to sleep well?" If we may be so bold as to suggest a better rendition of this timeless advice, we would ask Mr. Morley to substitute the word reward for his choice of the word interest. Interest is just one type of investment reward; there are others. Nevertheless, the meaning shines through brilliantly. As we are introduced to the many investment choices, we are going to see that some of the choices will help us eat well. Some others will allow us to sleep well. However, there aren't any choices that can do both. Take heart! We will learn some techniques that should allow us to eat reasonably well and sleep reasonably well but as we will say over and over and over again, "There ain't no guarantees!"

## Investing versus Speculating/Trading

Investing and speculating/trading are two different endeavors.

We are going to introduce a distinction here that will run through our journey together. Do you want to be an investor or do you want to be a speculator, also known as a trader? Becoming an investor is something that we can definitely help you with. You will learn the most important and popular investment alternatives. You will learn the types of rewards we can expect from each and the levels of risks that we will have to accept to receive these rewards. We will also cover some important techniques and skills to help us deal with these risks. We will learn that building wealth through investments is a long-term process; it does not happen overnight. We can help you become a prudent, long-term investor. However, if you want to become a speculator or a trader and earn tremendous amounts of money quickly,  then we are sorry to say that you will be very disappointed in this class. We are not able to help you to become a speculator or trader. Our sincerest apologies.

So let's get started. We start from the very beginning with a simple question:

What is an investment? There are many definitions available. Here is the definition we will use in our class:

> *An investment is any vehicle into which resources can be placed with the expectation that it will generate positive income, or that its value will be preserved or increased, or both.*

For the vast majority of us, the resources placed will be dollars, typically from our work-related income. There are many investment vehicles and, as mentioned, we will cover the most popular alternatives. We see that there are a few goals that we might seek with regard to our investments. One goal is to generate positive income, also known as cash flow. Another goal is to increase the value of our investment, also known as capital appreciation. At the very least, we want to preserve the value of our investments. Lastly, we could also seek both goals of cash flow and capital appreciation. As we introduce each investment alternative, we will discuss the goals associated with the alternative and the risks that each investment alternative carries.

Here is another important definition that revisits our distinction of being an investor or a speculator/trader:

> *"An investment operation is one which, upon thorough analysis, promises safety of principal and a satisfactory return. Operations not meeting these requirements are speculative." – Benjamin Graham*

This definition, Dear Readers, is very near and dear to Your Humble Author's heart. This quote is from The Intelligent Investor, written by Mr. Benjamin Graham. Mr. Graham was Mr. Warren Buffett's teacher and mentor. Eventually you will want to read The Intelligent Investor. (Don't read it as your first book! There are better books to read as your first book on investing. Please see the Bibliography for which books you should read first.) We will return again and again to this definition. If nothing else, we want you to understand the difference between prudent investing for the long term and speculating/trading in the short term.

Mr. Buffett is famous for boiling down Mr. Graham's concepts into very simple sayings. To illustrate this concept, Mr. Buffett famously said, "Rule #1: Don't lose money. Rule #2: Never forget Rule #1." Although we will see that investment values bounce up and down all the time, if you do your research and choose prudent, long-term investments that have done well over time and should continue to do well into the future – and you don't panic when the markets fall – you won't lose money in the long term. You won't be a speculator/trader. You will be an investor.

## Investment Characteristics and Attributes

As you work through the material in this introductory chapter, remember that this is an Introduction to Investments class. Don't worry about all the jargon and buzzwords and proclamations and sexy graphics and silly antics that you may have heard or seen from the talking heads on the financial media outlets.

Please forget anything and everything your brother-in-law, the self-appointed Expert-On-All-Things-Including-How-To-Invest, told you at the Thanksgiving dinner table. What follows is a list of general characteristics and attributes about investments. Study these terms, write them down, print the chapter 1 Study Guide, and watch and listen to the first lecture presentation for chapter 1 on the website or Canvas. This is all you need to learn and know for now.

## Securities, Property, and Personal Investments

There are three broad categories of investments: securities, property, and personal. According to Wikipedia, a "security is a tradable financial asset." Investopedia goes into more detail and defines a "security as a fungible, negotiable financial instrument that holds some type of monetary value." The fancy words fungible and negotiable mean that the security can be traded and its value can be negotiated. Another popular definition of security is "an investment that represents debt or ownership or the legal right to acquire or sell an ownership interest." This last definition introduces the three main categories of securities that we will detail later. The word security is an unfortunate term. Many people don't have a clear picture of what is meant by the word security. Our class used to be titled, "Investments and Securities." Students would think, "I'm not an Administration of Justice major. I don't need to take this class." No, not that type of security! For now, please understand that a security is a financial asset that can be traded and whose value changes over time.

Investments in property are sometimes referred to as hard assets or tangible assets. They include gold and other precious metals, art and other collectibles such as cars, commodities such basic foodstuffs and materials, and real estate. We will discuss property investments toward the end of our journey together. They are important options but for the vast majority of us, securities are the best choice for prudent, long-term investments. This class concentrates on securities.

Personal investments are endeavors we undertake to better ourselves. Examples include education, training, and travel. Many say that their personal investments such as college or traveling the world were often the best investments they ever made.

## Primary Assets versus Derivative Assets

Investments fall into either primary or derivative assets. For the vast majority of our time together, we will be covering primary assets. Primary assets fall into two categories: debt and equity. Debt investments are investments where we are lending our money to someone else. Examples of these include bonds and savings accounts. Debt investors are loaners. Equity investments are investments where we have full or partial ownership of the entity. We are owners. Examples include stocks, real estate, and partnerships

Derivatives are securities that derive their value from other assets. Examples of derivatives are options and futures. With derivatives, you can make a whole lot of money quickly and then lose a whole lot of money quickly. In fact, you can lose the whole value of your derivative investment overnight. Many in the industry do not categorize derivatives as investing. According to Mr. Graham's definition above, derivatives would certainly be regarded as speculative. As we will see, in the investment world, "speculative" is a euphemism for the word "gambling." We will discuss options and futures in detail at the very end of our journey together. Before we impress upon you just how dangerous these speculations are, if anyone tries to entice you with riches beyond your wildest dreams trading in options or futures, please tell them you are waiting until the end of the Introduction to Investments class, before you make a decision one way or the other. (Spoiler alert: Stay away from derivatives of all forms! They are hazardous to your financial well-being.)

## Direct Investments versus Indirect Investments

Direct investments are investments for which you have control of the underlying investment assets. Your name is on the title or the account. You are in control of the asset. Examples of these types of investments include stocks, bonds, real estate, and hard assets. With an indirect investment, someone else is making the decision about what underlying investment will be chosen. You may have some input into the decision but more often than not, you have no control of what assets will be chosen. Examples of these investments are mutual funds, limited partnerships, and Real Estate Investment Trusts (REITs). With indirect investments, you choose the mutual fund or limited partnership or REIT, and the manager or general partner chooses the underlying investments in stocks or bonds or real estate.

## Investment Domesticity

Domesticity describes the location of an investment. There are three categories: domestic, global, and international. The first category is easy; a domestic investment is domiciled inside the United States. There is a subtle but important distinction with regard to the second two categories. A global investment means that it could be based anywhere in the world; an international investment is based outside the United States. Please pay attention to this important difference. International investments are also often called foreign investment or overseas investments.

Until the 1970's, the differences between these categories were important. However, as globalization has evolved since the 1980's, the differences have become much less pronounced. Greg Ireland, a successful mutual fund manager with over 35 years of experience once said, "The world is a very small place economically." The influential magazine Forbes reported that, "Sixty-five percent (by value) of the parts in the Ford Mustang come from the U.S. and Canada. Ninety percent of the parts in the Toyota Sienna – which is built in Indiana – come from the U.S. and Canada." Which is the more American car, a Ford Mustang or a Toyota Sienna?

In the presentation, we list seventeen well-known companies and ask, "Which are domestic and which are foreign?" (Spoiler alert: They are all foreign.) In the United States, the issue of globalization has spilled into the political arena and elicited much controversy. At times, this controversy has taken the form of anger, fear, and loathing. This is unfortunate from our viewpoint as investors. Nothing is perfect and that includes our efforts to globalize the economy. However, on balance, globalization has been a tremendous positive for investors around the world and has helped bring hundreds of millions of people out of poverty and into the global middle class. The tricky part is ensuring that all enjoy the benefits of the expansion of the global economy.

Next in the presentation, we list the top 18 countries according to per capita gross domestic product. We then ask a simple question: Which country had the best average annual return between 1973 and 2013? (No spoiler here! Please watch or listen to the presentations on the class website or Canvas.) The world is indeed a very small place economically these days.

## Time Horizon

One of the most important, if not the most important, characteristic that we must decide upon before we make an investment decision is our time horizon, also known as our time frame. When will we need to use the funds from our investment? Here are some popular guidelines:

| Time Frame | Financial Industry | Life Insurance Industry |
|---|---|---|
| Short Term | Up to a year or so | 1 to 3 years |
| Intermediate Term | 2 to 5 years | 3 to 5, 6, or even 7 years |
| Long Term | More than 5 years | More than 7 years |

Before you make an investment, we must know our time frame. As we will learn, our time frame will dictate what types of investment we can and can not use.

Liquidity – A measure of the ability to quickly and easily turn your investment into cash.

## Liquidity

No, not how much beer we need for the weekend! Liquidity refers to how easily your investment can be turned into cash. Liquid investments are easily and quickly converted into cash. There is a ready market to purchase the investment and change of ownership happens quickly. Examples include stocks and mutual funds. Go online or call your broker. You will have your money very quickly, usually within a day or two. Illiquid investments are the exact opposite. The market for the investment is small or the change of ownership happens slowly, or both. It usually takes some time – sometimes much time – to convert your investment into cash. The poster child for illiquid investments is real estate. Real estate usually takes at least two or three or more months to sell. Other examples of illiquid investments include limited partnerships, fine art, and collectibles.

## Risk versus Return

Do you want to eat well or do you want to sleep well? In the investment world, risk is the chance that your actual investment returns will differ from your expected return from the investment. Wait a minute! That is not the typical definition of risk. When most people think of risk, they think of the possibility of suffering harm or loss. They think of danger. When they think of risk with regard to investing, they think of losing their investment. They think of losing all their money. Instead, in the investment world, when we endeavor to measure risk, we calculate the probability that what we receive from our investment will not match what we expect from our investment. It is an imperfect measurement but it can help us to keep a long-term perspective and can even help us to take advantage of the risks inherent in an investment.

In general, the higher the expectation of investment returns, the higher the risk level we will have to accept. There is no way to negate this relationship. If we want high returns, we are going to have to accept high risk. Here are two risk versus return spectrums

| | Post 2008 Global Financial Crisis | Pre 2008 Global Financial Crisis |
|---|---|---|
| Low Risk | 1% to 3% or less | 3% to 5% |
| Moderate Risk | 3% to 5% | 5% to 8% |
| High Risk | 6% to 10% | 8% to 12% |
| Speculative Risk | Greater than 10% | Greater than 12% |

We will use the Post 2008 Global Financial Crisis risk versus reward spectrum in our class. Please note that speculation is not considered investing by many in the industry, Your Humble Author included. As mentioned, we are going to do our best to help you learn how to handle the ups and downs of moderate to high risk investments and at the same time, generate reasonably moderate to high returns over the long term. We want you to eat reasonably well and sleep reasonably well!

It's time for some checking for comprehension. In the presentation, we list six examples of investments. We want you to ascribe the various characteristics and attributes we covered to the six investments. Again, only concern yourself with what we have covered so far. Relax and have fun. Give my regards to Uncle Harry!

# An Overview of the Investment Universe

Let's become casually acquainted with the major investment asset classes. We will dispense with all the tedious details. Concern yourself with just what we cover here. Don't fret. There will be plenty of time later on to learn the many intricacies of these investments. As we introduce each investment asset class, we will also touch on the risk and return that we can expect from each.

## Equity Securities, Also Known as Common Stocks, Stocks

In the investment world, equity refers to ownership. Equity securities, also known as common stocks, represent partial ownership in corporations. Most people just use the term stocks. The term stocks is a bit unfortunate. Your Humble Author prefers to refer to them as companies or better yet, businesses.

You are investing in a business. Why invest in a business? When all goes well, businesses grow and earn money. This creates two great opportunities for investors. When the business grows, your partial ownership of the business should also grow. That's capital appreciation, also known as capital gains. Also, the business can optionally distribute earnings to you in the form of dividends. (You can think of dividends like interest payments but they are legally two different forms of payments.) We invest in businesses for potential capital appreciation and potential dividends. We invest for growth and income.

Note that we said, "When all goes well." Obviously, all doesn't always go well in this wicked world of ours, does it? Both capital appreciation and dividends are optional and are not guaranteed. Therefore, we find that stocks are high risk investments. We say that stocks are volatile. Stocks exhibit high volatility. Volatility is a euphemism for, "I lost a whole lotta' money!" You might ask someone how that stock he or she bought is doing and they may sheepishly say, "Oh, it's been volatile." That means they bought it for $11.88 and sold it for 30¢. Do you know anyone who bought a stock for $11.88 and sold it for 30¢? I do. I have known him all my life. He's kinda' of a goofy guy who teaches Introduction to Investments at Southwestern … Look, it was a really good company and they were going to strike it rich making artificial blood and well, um, it just didn't turn out the way it was supposed to. Ahem. Stocks are volatile. Stocks are risky. In fact, to paraphrase Professor Burton Malkiel from his famous book, A Random Walk Down Wall Street discussed in our Bibliography, the 2008 definition of stocks is, "Stocks are equity investment instruments designed to lose value."

However, if we can learn to stomach the volatility that comes along with stock investing, history tells us that we can reasonably expect to receive the best investment returns available from the most popular investment alternatives. We like to say that stocks have an average annual return of 8%, 9%, or even 10% over the long term. The problem is that they almost never return 8% or 9% or 10% in any given year. The returns vary substantially, up and down. For this reason, when we want to invest in stocks, we must think long term. We must give our stock investment enough time to reward us with 8% or 9% or 10% annually. As Warren Buffett is quoted as saying, "If you aren't thinking about owning a stock for ten years, don't even think about owning it for ten minutes." Stocks are long term investments.

Disclaimers: The real estate fans are most likely jumping up and down and screaming that real estate has given investors better returns than stocks. Calm down and please accept my apologies. In one sense, they are correct. In another, they are not. The problem is how we measure investment returns and how different investments are typically purchased. We will deal with this thorny issue later on. Some stock fans might also be screaming saying that 8%, 9%, 10% is too low. Stocks have done better. This is actually true. Stocks as a whole have done better than 10% over the last 100 years and some stocks have done a whole lot better. However, some have done a whole lot worse. We prefer to keep new investors' expectations muted, especially since there are long periods of time where stocks have done a whole lot worse than 8%, 9%, or 10%. Finally, a scant few stocks can be considered moderate risk and moderate return vehicles. In the presentation for the previous section – You have watched it already, right? – we discussed Nestlé, the world's largest food company. Companies such as Nestle can be categorized as moderate risk and moderate return investments.

## Fixed-Income Securities, Also Known as Bonds

Fixed-income securities are typically referred to as bonds. Bonds are long-term loans to corporations, state and local municipalities, and the Federal government. When you invest in a bond, you get to play the part of a bank. You lend your money to one of these entities. In return, they promise to repay the principal – the money you lent them – and along the way, they will pay you interest. Most people pay their debts to the banks. Likewise, most corporations and state and local governments also pay their debts. The United States Treasury has always paid its debts. Hence, we find that bonds are far less risky than stocks. And subsequently, we find the long term return from bonds is far less than stocks. (Are you starting to see a pattern here, Dear Students?) What can we expect from bonds? Interestingly, the returns since the Global Financial Crisis of 2008 have been less than they were for many decades before the Global Financial Crisis. Investors used to be accustomed to receiving 4% to 8% from their bond investments. At the time of this writing, many bonds are paying 1% to 3%. Today, greater than 4% is unusual but not uncommon.

At first, it may seem a bit odd that the value of a loan could vary. However, remember that bonds are securities and bond prices change in the marketplace every day just like stocks. As mentioned, though, the volatility with regard to bonds is much less than what stocks exhibit. Yet there are times when the prices of bonds can fall hard, too. To repeat, it will typically be far less than stocks but it can still sting. For example, when some stocks lost well over 50% during the Global Financial Crisis of the late 2000's, many bonds lost between 10% and 20%. We again paraphrase Professor Malkiel by saying the 2008 definition of bonds is, "Bonds are fixed-rate investment instruments designed to lose value."

## Short term Investments, Also Known as "Cash" – A Place to Park Your Money

Short term investments are often referred to as "cash." We usually see cash put in quotes because these investments are not dollar bills that we stuff under our mattresses. Many of these short term instruments are tradable securities so again, their prices do change. However, they are vehicles that are typically guaranteed by some governmental organization. And if they are not guaranteed, they are pretty darned close. If you have been paying attention, you should be able to guess correctly that since these choices have very low risk, these investments will not give us much reward. Therefore, we say that short term investments are a place to park your money. You aren't going to lose your money, but you also aren't going to make much money. That is why we call them short term investments. If we need the money in the short term, we don't want to place our funds into the stock market. Even the bond market might be too risky for us. We need to park our money into a short term investment so that in three, six, or nine months, we know it will not have lost 10%, 20%, or more of its value. At the end of this introductory chapter, we will cover short term investments in detail. Our 2008 Definition? "Short term investments are instruments designed to accept what remains of investors' money after they have given up on stocks and bonds."

## Mutual Funds, Also Known as Investment Companies – Investments for the Masses

Unless you live on a deserted island or somehow effectively have shut out all forms of mass media, you no doubt have been subjected to advertisements for mutual funds. There is a valid reason for this. Mutual funds are investments for the masses. Just as most of us workaday individuals don't build our own cars, make our own shoes, or grow our own food, most people will not dedicate the time to learn how to invest. (This is most unfortunate. Everyone should take Introduction to Investments. I am not biased, of course.) And education is just the beginning! They then need to spend many hours doing the necessary research to identify, choose, and monitor their individual stock and bond investments. You, Dear Readers, are going to make this a fun and profitable labor of love. Many other people are either not interested, too nervous or frightened, or just simply too busy living their lives. This is where mutual funds come into the picture.

The legal term for a mutual fund is an investment company. Now doesn't that name make more sense? The term investment company tells you what the mutual fund does for you. You need a car? You go to a car company. You need shoes? You go to a shoe company. You need investments? You go to an investment company! Mutual funds / investment companies are companies that pool investors' money and invest in a diversified portfolio of securities, typically stocks or bonds or a combination of stocks and bonds. Investors receive two valuable benefits, diversification and professional money management. Because of the size of the typical mutual fund, they are not limited to 10 or 20 stocks or bonds as is common with an individual investor. More than 20 stocks and an individual investor often becomes overwhelmed with the necessary research to simply keep track of their holdings. A typical mutual fund will hold 100 or 200 securities. Some hold many more.

So how does the mutual fund keep from becoming overwhelmed? The mutual fund is managed by professional money managers, the second major benefit of investing in mutual funds. The mutual fund portfolio managers are highly skilled and very well-paid professionals whose day-to-day job is to identify, choose, and then monitor the diversified portfolio of investments in the mutual fund. As we shall see, it is not an easy job and there is some controversy over whether these individuals are actually worth the high salaries they demand. We will explore this debate in our chapter dedicated to mutual funds.

Because of these two valuable benefits, diversification and professional money management, mutual funds have become extremely popular. Also adding to their popularity are the countless employer-sponsored retirement programs such as 401(k) and 403(b) plans. Mutual funds are the dominant investment choice for employer-sponsored retirement programs. Almost half of all American households own mutual funds. In our next chapter, because of their importance as investments for the masses, we will spend a great deal of time on mutual funds.

What kinds of risks and returns can we expect from mutual funds? Mutual funds will exhibit risks and returns similar to their underlying investments. There are many mutual funds that fall into the short term investment category. These are called money market funds. Low risk, low return. However, most mutual funds are dedicated to stocks or bonds or both and they will exhibit the same risk versus return characteristics of stocks and bonds. Hence, what is their 2008 definition? "Yeah, them too." 2008 was a very difficult year for everyone.

## Hybrid Securities – Preferred Stocks and Convertible Securities

Hybrid securities are designed to offer the stability of fixed-income investments (bonds) with the opportunity for capital growth of equity investments (stocks). With these investments, we are trying to get the best of both worlds. The pesky fly in the ointment with this approach is that along with the advantages of both stocks and bonds, you also get the disadvantages of both stocks and bonds. So, we get the best of both worlds … and we get the worst of both worlds.

Other annoying flies buzzing around the hybrid security worlds are the names of the major types of hybrid securities. The two major examples of hybrid investments are preferred stock and convertible securities. Don't they sound enticing? Wouldn't you really rather have "preferred stock" instead of just "common stock?" Well, actually, no, you and I and most individual investors don't really want preferred stock. They are typically owned by corporations. Plus anything that has to do with convertibles must be cool, right? You know, driving down the highway in your convertible car with the wind blowing through your hair? Well, convertible securities are nowhere near as sexy as that, as we shall see. For now, all you need to know is that hybrid securities are an attempt to combine the advantages of stocks and bonds together but also combine the disadvantages of stocks and bonds. We will postpone discussing these oddities until much later in our class. By the way, they constitute a very small part of the investment universe.

## Other Investment Alternatives – Real Estate, Physical Assets

Not everyone wants to invest in just stocks or bonds or mutual funds. For them, they may want to dabble in the world of real estate or try their hand at precious metals, art, collectibles, cars, or even enter the high-stakes world of commodities. Suffice to say, these investments are not for everyone. For many people, just scraping together the resources to purchase a home is enough real estate for a lifetime. Also, as we will see, some alternatives such as gold that get a great deal of attention have not necessarily been very good investments over the long term. At the very end of our journey together, we will touch on these alternatives. By the way, none of these choices were spared during the Global Financial Crisis in 2008.

### Derivatives – Options, Futures

Derivative assets are speculative securities that derive their value from an underlying security or asset such as a stock or bond. "What? You are not buying the stock or bond?" No, you are buying a security that depends upon the price movements of a stock or bond. That sounds very confusing. Well, yes it is. Derivatives are very confusing. More importantly, they are immensely risky. You can make 100% in one day … and then lose it all the next day. For this reason, we do not categorize them as investments. They are speculations. (Throughout the class, when you see the words speculative or speculation, simply substitute the word gambling, okay?)

Two major examples of derivatives are options and futures. Actually, to show you how confusing these things really are, their actual names are options contracts and futures contracts. Try saying those names three times fast. For now, this is all you need to know about derivatives: Derivatives derive their value from another asset, two major examples of derivatives are options and futures, and derivatives are extremely dangerous. In 2008, the derivative speculators did not feel so all alone. Usually, they are the only ones who are proud to have only lost 30%.

We have completed our Overview of the Investment Universe. Once again, we remind you that, for now, the material in this chapter is all you need to study and learn with regard to the investment alternatives discussed above. As you may have gathered by now, in this class, we will emphasize stocks, bonds, short term investments, and mutual funds. For the vast majority of us retail investors, these are the most popular and most important financial investment options. It is now time for us to delve deeply into the Eternal Struggle of Investing, Risk versus Return. But before we do that, we want you to review the investment alternatives we have just covered. Please make sure you watch the presentation on the class website or Canvas. There is a comprehension checking exercise at the very end of the presentation. Also, work through the Security Types Handout. Memorize this document for the first exam. (Hint, hint. Wink, wink. Nudge, nudge.)

## Risk versus Return – The Eternal Struggle of Investing

Here it is, Dear Readers! This is the entire class in one presentation! Do you want to eat well or do you want to sleep well? By now, you should be seeing that there is a pattern in the world of investments. The more return you want from your investments, the more risk you will have to accept. In the previous section, we saw that stocks have given us the best returns over time but have also subjected us to the most risk. Bonds are less risky but give us less return. Short term investments are risk-free or pretty darned close but they pay very little, currently almost nothing. Mutual funds will more or less reflect the underlying assets that they invest in. In the corresponding presentation on risk versus return, you will see how these various investment asset classes have done over very long periods of time. We see that stocks are the stars! Bonds are a distant second. And short term investments have barely kept up with inflation and currently are losing to inflation.

It is no accident that stocks and bonds have produced better returns than short term investments. If that were not the case, why would investors assume the higher risks of stocks and bonds? The answer is they would not. If short term guaranteed (or pretty darned close to being guaranteed) investments returned the same as stocks or bonds, investors would prefer those short term guaranteed investments. They would choose an investment for which there is no chance of losing money and they would be happy to accept the risk-free rate of return on their money. In theory, there is no investment with absolute zero risk. However, short term United States Treasury bills come as close to absolute zero risk as you can get in this world. Therefore, when investors want to know what the current risk-free rate of return is, they often look at the interest rate that three-month United States Treasury Bills are currently paying. (We will cover Treasury Bills in more detail in our next section dedicated to short term investments.)

To make prudent investment decisions, we investors need to know what the risk premium is for our potential investors. The risk premium is the reward for bearing risk. It is the extra return on a risky asset over the risk-free rate of return. As we would expect, the risk premium for stocks is the highest at over 8%. The risk premium for bonds is a bit less than 3%. These may not sound like much but over time, the effects of the higher returns are enormous as we saw in the graphics in the presentation. We find that investment returns are very easy to measure. How much did you start with? How much did you end with? How long did it take you to earn this amount? That's your return.

## Variance and Standard Deviation – Two Imperfect Measures of Risk

Investment risk, on the other hand, is much more difficult to measure. The reality is that risk is impossible to measure and predict. There is no measurement that accurately reflects the amount of risk that investors must accept when choosing an investment. That does not stop us from trying, though. Each year, the investment community measures the average annual return and the amount of variance from the average return. Using statistics, the resulting measures of risk are called variance and standard deviation. By far, the most popular measure of risk is standard deviation. Standard deviation is the measure we will use for our class.

I already know what you are thinking. "Aye, this is math! I need to drop this class!" Relax. Please don't drop the class. We don't do any variance or standard deviation calculations. We leave those calculations for your statistics class. We just do a quick library or Internet search and the investment community readily and happily gives us the results. Please. Don't drop the class.

It is important to understand what the variance and its more popular and important companion, standard deviation, can tell us about a potential investment. In general, the higher the variance and standard deviation, the riskier the investment. The higher the variance and standard deviation, the more the investment return will deviate from the average annual return of that investment. In other words, we said that stocks can give us an average annual return of 8%, 9% or even 10% over the long term but we also know that in any one year, the probability is very high that we won't get 8% or 9% or 10%. We might get +17% in one year, -9% the next year, +22% after that, and then -4%. With stocks, the variances and deviations from the annual returns are extreme. A high standard deviation means the volatility is high. The investment is risky.

Please make sure that you have reviewed the graphics and the statistics in the presentation before continuing. There you will see that stocks are similar to Henry Longfellow's little girl with the little curl right in the middle of her forehead. When she was good, she was very, very good, but when she was bad, she was horrid. "Minus 20% in 2001, minus 30% in 2002, minus 40% in 2008!? No way! Not for me! I ain't gettin' involved in investing," is how some people react. Relax. Calm down. We are going to learn how to use this volatility to our advantage. We can make volatility our friend, not our enemy.

The lessons from history are that if we want high average annual returns, we are going to have to accept high risk and high volatility. There are going to be times when we lose money. There will be market downturns, corrections, crashes, etc. It is inevitable. As famed investor Peter Lynch says, "A stock market decline is as routine as a January blizzard in Colorado. If you're prepared, it can't hurt you. A decline is a great opportunity to pick up the bargains left behind by investors who are fleeing the storm in panic." The good news is that history also tells us, so far, the global economy and the stock markets around the world have always come back from those snowstorms.

Please note that there are charlatans and grifters and con artists aplenty in the shadows of the investment industry. They will brazenly – and illegally, by the way – tell you that they can guarantee, for example, a 12% risk-free average annual rate of return. They are lying, pure and simple. There is no such thing as a 12%, risk-free rate of return. It's a blue unicorn, a flying panda; it simply does not exist. Some crooks might even make claims of 300% or 3,000%. Check the website or Canvas for some examples. Or better yet, just type "100% return in 3 days using options" into any Internet search engine and see how many sharks want to separate you from your money.

## Investing versus Speculating/Trading – Revisited

"But isn't someone doing it? Aren't there people who make tremendous rates of returns?" you may rightly ask. The answer is yes. There are individuals who make tremendous rates of return. But those people are not prudent, long term investors like us. They are speculators, also known as traders. Being a speculator/trader can be very profitable but it is also very stressful and perilous.

Furthermore, you are up against the best in the world. Here is a quote from one of the famed speculators of the early 20th century, Jesse Livermore.

*"The speculator is not an investor. His object is not to secure a steady return on his money at a good rate of interest, but to profit by either a rise or a fall in the price of whatever he may be speculating in." – Jesse Livermore*

So do you want to be an investor or a speculator/trader? As we mentioned at the beginning, we can help you learn how to become a patient, prudent, successful long term investor. We cannot help you learn how to become a successful short term speculator. Sorry. We can't do it ourselves; how could we possibly teach anyone else to do it? If we have not convinced you yet to renounce any dreams you may have had of making riches quickly day trading surrounded by two computers and four monitors while simultaneously on the phone with two different companies, please take some time to listen to the story of John Gutfreund and John Meriweather from the book Liar's Poker by the accomplished investment author Michael Lewis. You never, ever want to play Liar's Poker with John Meriweather, let alone try to outtrade him.

It's really very simple. When the task is immensely difficult and the competition is ferocious, as it is in speculating/trading or in sports or the arts, for that matter, it is only natural that a select few will rise to the top. Can you throw or hit a fastball at 98 miles per hour? If you successfully can hit a fastball at 98 miles per hour three times out of ten tries, you can snag yourself a contract for tens of millions of dollars each year. Can you dunk a basketball? Can you sing the lead part in a five-act opera? Can you write or direct or act in a movie with a $100+ million dollar budget? Can you hit a tiny white ball 350 yards down the fairway in just three shots? The average person can't accomplish any of these. But that does not mean there aren't people who can't. There are. Are you going to compete with them in their venue? I think not.

One of the best observations ever about investing versus speculating/trading was made by John Bogle, the founder of the Vanguard Group mutual fund company. He was interviewed by Steve Forbes, the Editor-in-Chief of Forbes magazine, back in 2009. The interview used to be available on the magazine's website but was taken down long ago. I contacted them and begged them to make it available again. I never got a response. So, please, Dear Folks at Forbes, if you are reading this, please make it available again and I promise to delete the following passage from this text.

*"Well, the first thing you have to think about is, and this is an issue that I've almost never heard discussed, Steve, and that's the first question you have to ask yourself is: Am I an investor, or am I a speculator? An investor is a person who owns business and holds it forever and enjoys the returns that U.S. businesses, and to some extent global businesses, have earned since the beginning of time. They have capital, they earn a return on their capital and that capital grows over time. It's not complicated. That's the business of investing.*

*Speculation is betting on price. I think I can buy this for 10 and sell it for 12* *or 14 or 20 or 100. Speculation has no place in the portfolio or the kit of the typical investor. Speculation leads you the wrong way. It allows you to put your emotion first, whereas investment gets emotions out of the picture. You own these businesses, they're still sound, if the market doesn't think they're worth as much as they were, well, pity, the market doesn't know everything." – John "Jack" Bogle, Founder and former CEO of the Vanguard Group*

When the video was still available, we would show this segment in the face-to-face class and I would call out, "We do, Mr. Bogle! We emphasize the distinction between investors and speculators/traders in our Introduction to Investments class!" The entire interview is over 30 minutes and highly informative and enterprising. Let's hope Forbes resurrects it.

## Observations about the End of the World

Some readers will ask, "Well, what if stock prices all go to zero? What if the economy and the stock market don't come back?" This is a very probing question. It speaks to our justifiable fears about investing, especially in stocks. Let's rephrase the question: What if the world ends? The truth is someday the world is going to end. There are numerous scenarios. For example, we know that in about 1 or 2 billion years, the sun will expand and swallow Mercury and Venus and maybe even the Earth. However, it won't need to swallow the Earth for our world to end. By the time it gets to Venus, temperatures on the Earth will be hot enough to melt tin and lead and copper. Thankfully, we have a long time to prepare for this scenario. But what about all the other disasters looming on our horizon? Global warming, climate change, income inequality, rising sea levels, pandemics, tsunamis, earthquakes, fires, floods, disco returning!

As we said at the beginning, there will always be proclamations of doom and gloom, especially from charlatans ready to sell you their sure-fire method for surviving the end times. Don't listen to them! If the world does end, if our technologically-based civilization cracks and falls and dissolves into a pool of tears, if there is no food at the grocery store, no gas at the gas station, no clothes at the mall, the cell phones aren't working, the utility companies are not pumping out electricity or natural gas, the trash isn't being picked up, the sewers are clogged, the hospitals, schools, fire departments, police stations, banks are all boarded up, etc., your stock portfolio will be the last thought on your mind. You will be digging for beetle grubs and boiling bark for dinner. Let's meet at the beach. You bring the marshmallows. I'll bring the vodka. We can get drunk and watch the world burn.

Take heart, Dear Students! This scenario is not going to happen! Failure is not an option! As I have already told you, Your Humble Author is firmly convinced that the next 20, 30, 50 years are going to be the most prosperous years in the history of our civilization. There is no doubt that we have tremendous hurdles to overcome, some might say they are insurmountable. But never underestimate the innovative power of our species. Just look at what we did with Covid in 2020. A vaccine usually takes at least 4 years and often up to 10 years to develop. Multiple groups around the world created safe and effective vaccines in a matter of months! We will overcome climate change. We will phase out fossil fuels. We will have driverless cars and some will be able to fly. We will cure cancer. We will colonize Mars. We will have universal language translators. We will have domestic robots. We will see the day when close to 100% of the citizens of our world are connected to the Internet. Economically, I am very confident of this and more. (Politically, I am very scared. But that discussion is for another class in another department. Thank goodness this isn't Kindergarten where all the disciplines are taught in the same classroom. Go take up our political woes with your Political Science professor.)

## So What Is a Realistic Rate of Return for Me?

After you have taken this course, you will have a strong foundation of the most popular types of securities investments: stocks, bonds, "cash," and mutual funds. You will also know what levels of returns and what levels of risks you should reasonably expect to receive. And if you are a patient, long-term investor, I believe it is realistic to expect 8% to 10%. I am certainly working on it myself. So far, so good. Of course, as we will reiterate time and time again, there are no guarantees.

You are now most likely thinking, "But is 8% or 9% or 10% good enough for me?" It turns out the answer to this question is a resounding, "Yes!" There are some caveats we need to add, though. If you start early, if you invest patiently and consistently, if you do not get cocky or greedy, if you do not chase after every "Next Big Thing" that comes along, and most importantly, you do not panic when the market swoons, as it inevitably will do from time to time, then – unless the world ends – we believe it is entirely reasonable and realistic to expect 8% or 9% or 10% over the long term. As mentioned, some investors have done better. The trick is to take advantage of the time value of money, also known as the compound annual return or the compound annual growth rate.

The time value of money is the amount to which a sum you invest now will increase based on a specified rate of return and time period. Calculating amounts into the future is called compounding. The result is the future value of money. Future value can be computed for a single amount, also known as a lump sum, a principal, or a single payment. Future value can also be determined for a series of deposits, also known as a stream of investments or an annuity. (In our class, we usually don't use the term annuity because an annuity is also an insurance product. We discuss annuity insurance products at the end of the class. We do not have kind words for them.)

There is a future value handout available on the class website and Canvas. We leave the calculations to you as an optional exercise. Quite possibly you have already taken our  Financial Planning and Money Management class at Southwestern. We spend a good deal of time learning future value calculations in Financial Planning and Money Management. At the very least, please review the answer key and listen to the commentary to see the kinds of wealth that one can reasonably build over the working careers. The news is good!

The future value calculations allow us to move from the present into the future. Later on, when we learn how to assign valuations to stocks and bonds, we will use the inverse of future value, present value, to move from the future back to the present. ("Huh? What?" Relax. Study what is in this chapter. We have a long road ahead of us.)

So are you ready to start your journey to become a prudent, long term investor? Are you excited? I know I am! Well, before we do get to the good stuff, we are going to take a small detour. We will now revisit short term investments, vehicles that we use if we need the money in three, six, or nine months or even a year or two, depending upon the importance of the uses for the short term funds. Short term investments aren't very exciting. They aren't supposed to be. We don't want excitement with money that we need in the short term. We want certainty.

# Short Term Investments Revisited – A Place to Park Your Money

To review, short term investments are vehicles that we use when we need the money to be safe because we are going to be using it soon. For example, we are setting aside our financial aid for living expenses for the coming semester. We are building a down payment fund for a car or house. Hence, we often say that short term investments are a place to park your money. We don't want the value to decrease. We don't want to lose the money. We want the money to be there when we need it. For this reason, short term investments are typically guaranteed or pretty darned close. Short term investments are also very liquid; we can get our money very quickly, usually within a day. Some even allow us to write a check. These are the advantages and benefits of short term investments.

What are the disadvantages of short term investments? As we have seen, the returns from short term investments are very low. Low risk? Low return! In fact, as of this writing, many short term investments are paying almost nothing and have been paying miniscule amounts since the 2008 Global Financial Crisis. Short term interest rates started to climb very slowly starting in 2015 and were actually approaching respectable amounts in 2019 as the economy was finally shaking off the lingering effects of the economic devastation a decade earlier. And then Covid-19 hit and short term rates again fell close to zero. (Darned, stupid microbe!)

## Stated Rate of Interest versus Discount Basis

As we explore the various short term investment alternatives, we will see that some offer the stated rate of interest method of paying interest and some offer the discount basis method. The stated rate of interest is the method that we are already familiar with if we have ever opened a savings account. The bank will tell us that they will pay us 1% on our money. If we deposit $100, after one year, we will earn 1% of $100 or $1. This is very straightforward.

The discount basis is a bit trickier. This method of earning interest entails purchasing the security at a price below its redemption value, also known as the par value, maturity value, or face value. The difference between the purchase price and redemption value is the interest earned. Since the securities are negotiable, the value of the investment grows as it approaches its maturity date. We say the interest “accrues” on the short term investment. On the date of maturity, the current owner of the security receives the maturity value. An example: You purchase a security now for $4,800 that will be redeemed for $5,000 in ten months. Your interest would be $200. If you were to sell the security in five months, – one half the time until maturity – the value would likely have accrued to $4,900. One half of the $200 would be $100 of interest and that would be added to the price of the security.

## Risks of Short Term Investments

“Risks of short term investments!? Wait a minute! You told me that these investments were risk-free!” Yes, short term investments are risk-free with regard to the loss of principal, also known as the risk of default. We are not going to lose our money. However, there are other risks when investing. There is the risk that we may lose purchasing power. Over time, short term investments have barely kept up with inflation. Currently, they are losing to inflation. There is also the risk of lost opportunity cost. Opportunity cost is a rather nebulous concept that you would discuss in detail in your ECON 101 class. It is real, though. Whenever we make a choice, we must think about the opportunities that we forego by making that choice. What else could we have done with our money? If we choose short term investments for money that we won’t need for the long term, we will almost certainly have done much worse than by carefully researching and choosing prudent, long term investments. You first saw this in the graphics discussing the returns of stocks versus bonds versus short term investments in the previous presentation and we will see examples of this throughout the semester.

Sadly, you will sometimes come across individuals who have placed all their investable savings into short term “cash” investments. This is usually money that they are saving for long term goals such as retirement. These people need to take Introduction to Investments! In time, Dear Readers, you will be the Investment Gurus for your friends, family, and co-workers. You will gently but firmly educate and guide them in choosing prudent, long term oriented investments that will clobber the meager returns they were getting from their short term investments. You will speak with authority. They will thank you profusely. We will be proud of you. You may even decide that you want to pursue a career in the investment services industry.

That’s just the first of many pep talks. Stay tuned for more because the industry needs you. For now, it is time to run through the various types of short term investments. Don’t do this before bed time … unless you are prone to insomnia.

Again, these choices are not very exciting but then again, they are not meant to be exciting. They are meant to ensure safety of principal. With short term money, boring is good.

## Demand Deposit Accounts

Demand deposit accounts are offered by commercial banks and credit unions. The name comes from the fact that depositors can withdraw the funds at any time; the funds are available upon demand, although there are sometimes certain restrictions such as when you want to withdraw a large amount of money in cash. Demand deposit accounts at banks and credit unions have a very important benefit: They are typically guaranteed by an agency of the Federal government. You may have heard of the Federal Deposit Insurance Corporation (FDIC) or the National Credit Union Administration (NCUA). Your money is safe. Practically all banks and credit unions belong to these entities. If you are unsure if your bank or credit union belongs, just ask. For each account at each bank or credit union, you are currently insured up to $250,000. If you have more than $250,000, you can simply distribute that amount into separate banks or credit unions. (If you have more than $250,000 and this is not short term money, you need to take Introduction to Investments and learn where to allocate your investable assets more effectively and prudently for long term growth of capital and income. Excuse me? You have heard this before. My apologies but it bears repeating. The opportunity cost of keeping long term money in short term investments is very high.)

Common examples of demand deposit accounts are checking accounts and savings accounts at banks and share-draft accounts and share accounts at credit unions. Those of you who use credit unions have probably never heard of share-draft or share accounts. That is because no one at the credit union uses those terms; they just use the same terms that the banks use, checking and savings. Even though there are legal differences, as far as we retail customers are concerned, there are no differences. They both work the same way. For many years, the regulators would not allow checking accounts to pay interest. For this reason, banks and credit unions offered Negotiable Order of Withdrawal (NOW) accounts. Again, no one called them that; they just called them checking accounts that paid interest. That restriction was removed in 2010 so now, NOW accounts are not as popular as they once were. (And no, that is not a double word typo.) Lastly, banks and credit can offer money market accounts, also known as money market demand accounts. Money market accounts typically pay more than checking and savings accounts. These accounts are very similar to the money market mutual funds. In fact, the banks and credit unions simply copied the concept from the mutual fund industry. The main difference between money market accounts and money market mutual funds is that the money market accounts at banks and credit unions have the same guarantee as other demand deposit accounts; money market mutual funds at mutual fund companies do not have this guarantee. We will discuss money market mutual funds a bit later on.

We mentioned that there may be some restrictions on your ability to withdraw your funds upon demand. An example of this would be if you were to walk into your neighborhood bank and ask to withdraw the entire $187,000 in your savings account – in cash! The bank would most likely ask you to wait until tomorrow because they simply don't keep that much cash on hand. (There's over $250,000 in the ATM next door, though. Shows you how safe and secure the banks believe their ATMs are.) The bank would also contact the FBI and report a "suspicious transaction." This is courtesy of the Patriot Act, hurried through Congress within a month after the attacks on the World Trade Towers on September 11th, 2001. Some people will tell you that a deposit or withdrawal of $5,000 or $10,000 triggers the "suspicious transaction." This is not true. There is no specific dollar amount. The bank or credit union must determine what is a "suspicious transaction," depending upon the circumstances. Kinda' creepy, huh? The FBI will check up on you for carrying around your own money.

## Certificates of Deposits (CDs)

Certificates of Deposits (CDs) are also offered by banks and credit unions and have the same guarantees as demand deposit accounts, namely the $250,000 deposit insurance guarantee. Unlike demand deposit accounts, though, CDs are time deposit accounts, also known as term deposits. They have a maturity date. You agree to keep your money on deposit for a certain time, anywhere from seven days to several years. Typically, the longer the time period, the higher the rate of interest a CD investor will receive. The rate of return is usually better than demand deposit accounts such as savings accounts or money market accounts. What are the disadvantages? If you need to withdraw the money before the maturity date, there will be a penalty. Also, your rate of return is fixed and typically does not change. If interest rates rise, your CD will not rise with them. For this reason, many banks and credit unions offer Bump-Up CDs. If interest rates have risen, the Bump-Up CD allows an investor to "bump up" their initial interest to the current interest rate. CD investors need to be aware of the rollover or renewal provision of some CDs. Some banks or credit unions will automatically renew your CD at the end of the time period. The bank or credit union is required to notify you of the upcoming renewal. You typically have the option of requesting that the funds be automatically deposited into your savings or checking account. It definitely pays to shop around for the best CD interest rates. CD rates vary widely and as long as your bank or credit union belongs to the FDIC or NCUA, you can do business with institutions in the United States and its territories and have the same guarantee of principal.

Some brokerage firms and some banks offer Brokered CDs. The brokerage firm has invested a great deal of money with a bank and that generates more income than a typical retail investor will receive. The brokerage firm then can offer these higher rates to their customers. Also, unlike typical CDs, they can be bought and sold on the open market as are other securities. An investor does not have to wait until the maturity to receive their principal. The downside is that Brokered CDs are not FDIC-insured. For this reason, it is important to ensure that Brokered CD investors deal with a reputable brokerage firm.

## Money Market Mutual Funds

Money market mutual funds are short term investments offered by mutual fund companies. Recall that a mutual fund is a company that pools the capital of a large number of investors. A money market mutual fund uses their investors' capital to invest exclusively in short term securities. They are also known as mutual money funds, or more simply and more typically, money markets. Because they are offered by mutual fund companies and not banks or credit unions, they do not have the same protections that money market accounts at banks and credit unions have, namely the $250,000 principal protection guarantee. However, in practice, they are considered essentially as safe as their counterparts at banks and credit unions. Why? There is a long history of the government and the industry doing their parts to ensure that money market clients do not lose a penny! In practice, that is exactly what can happen. Your money money fund can "break the buck." When that happens, the whole world sits up and takes notice. Just type "breaking the buck" into any Internet search engine and see how many millions of results you get. There are tremendous forces allied against any money market ever breaking the buck.

Money markets are very versatile and popular. Virtually every mutual fund company offers one or sometimes several different types of money market funds. Many money markets allow you to write checks, although in practice, most investors simply link their money market funds to their checking and savings accounts at their banks and credit unions and electronically withdraw funds as needed. Money markets allow you to easily exchange funds to and from your stock and bond mutual funds at your mutual fund company. Money market funds typically pay interest rates higher than checking and savings accounts and only a bit less than CDs. However, unlike CDs, the interest rates on money market funds change daily. Therefore, if interest rates rise, your money market interest rate will rise with them. There is much to like about money market mutual funds.

## Series EE, HH, and I Savings Bonds

Savings bonds are short term investments that are offered by the United States Treasury. The Treasury currently offers both Series EE and Series I savings bonds. The Series HH bonds were discontinued in 2004 and will all mature and disappear by 2024. The Series EE savings bonds use the discount basis of accruing interest. In other words, for example, you might buy a Series EE savings bond for $50 and it will pay its maturity value of $100 in 20 years. Currently, though, Series EE bonds purchased online electronically are purchased at face value and earn interest in the stated rate of interest manner. Savings bonds are exempt from state income taxes. (We will discuss more about the tax relationship of the Federal government and the state and local governments later in the class.) If you use the proceeds from your savings bond for qualified higher education expenses, then the interest is also exempt from Federal income taxes.

The "I" in Series I savings bonds stands for Inflation. Series I bonds were introduced in 1998 to cater to those investors worried about inflation. Like Series EE savings bonds, Series I bonds do come with a fixed rate of return but that rate of return is far less than other types of short term investments, including Series EE bonds. Instead, Series I bonds add an inflation-adjusted interest amount every six months that varies with the rate of inflation. Hence, Series I bonds are guaranteed to keep pace with inflation. Series I bonds are very popular with those who are worried about inflation returning.

The yearly purchase limits are currently $10,000 for Series EE bonds Series I bonds. For decades, United States savings bonds were popular gifts to newborns. Grandparents and aunts and uncles would buy them at their local bank for the new arrival to the family. The bonds would be tucked away in a drawer somewhere and promptly forgotten about until the parents passed away and the adult kids and adult grandkids were tasked with clearing everything out of the house. The Treasury has done away with paper savings bonds for Series EE bonds and are phasing out paper savings bonds for Series I bonds. All bonds are now available for purchase and safekeeping at www.TreasuryDirect.gov. TreasuryDirect.gov is the subject of one of your chapter 1 assignments.

## Treasury Bills

Treasury Bills are short term investments that are also offered by the United States Treasury. They are often informally referred to as T-Bills. T-Bills all have maturities that are less than one year. The most typical periods are one month (4-week), three months (13-week), and six months (26-week), although two months (8-week) and twelve months (52-week) are also available.  Treasury Bills are often considered the safest of all investments. As mentioned, when the investment community wants to report the current risk-free rate of return, they often use the rate for three month Treasury Bills.

T-Bills are usually sold in $1,000 increments and use the discount basis method for paying interest. For example, you may purchase a six-month $1,000 Treasury Bill for $990 that will mature at $1,000. The $10 difference would be your interest received. Along the way to the six month maturity date, because these are securities, you could sell your Treasury Bill, again, at a discount to the $1,000 maturity value. As the date of maturity becomes nearer, your Treasury Bill will increase in value. The price would depend upon the prevailing market rates but any volatility would be close to zero. Remember, Treasury Bills are very safe. At the date of maturity, the T-Bill would be worth the full $1,000.

Like the Series EE and I savings bonds, interest from Treasury Bonds is tax-exempt at the state and local level. Unlike Series EE and I savings, though, the interest is not tax-exempt if used for the qualified higher education expenses.

Also like the Series EE and I savings bonds, Treasury Bills are available for purchase at www.TreasuryDirect.gov. TreasuryDirect.gov offers you and me, the common retail investors, the same prices as the big boys and girls on Wall Street. It is a very well done website and, as mentioned, the subject of one of your chapter 1 assignments. The Mexican government has a website very similar to TreasuryDirect.gov. It is called Cetes Directo. Your Humble Author had the good fortune to meet the project manager. He acknowledged that they essentially copied TreasuryDirect.gov verbatim. We love to complain when our government screws up. Hence, we should rightly praise them when they do something well. Thanks, United States Treasury!

## Commercial Paper and Banker's Acceptance Notes

Commercial paper investments are short term, unsecured promissory notes (IOUs) issued by corporations with very high credit standings. Corporations typically use these vehicles when they need a very short term loan for payroll or maybe for the large purchase of goods in anticipation of a coming increase in business activity such as major retailers preparing for the Christmas surge. Instead of going to a bank, the corporation can go to the investment community and get a much better rate than the bank would charge. Like Treasury Bills, commercial paper investments use the discount basis and are sold at a discount to their maturity face value and have short term maturity periods of one, three, six, and nine months. Unlike Treasury Bills, commercial paper investments are typically denominated in $100,000 increments and commercial paper dealers normally want you to buy many of them at one time. Hence, they are usually purchased by financial institutions such as life insurance companies and pension funds. Money market mutual funds are also eager buyers of commercial paper. You and I are not going to buy commercial paper except indirectly through our investments in money markets. (If you are indeed in the market for commercial paper and can afford multiples of $100,000 denominations, then congratulations but I have a sneaking suspicion that you have your own private broker.)

Banker's acceptance notes are cousins to commercial paper investments. They, too, are sold at a discount, are tradable securities, are typically denominated in $100,000 increments, and mature quickly. Banker's acceptance notes usually mature in 90 days but the maturity date can be up to 180 days. They are often used to facilitate domestic and international trade for companies that do not have the prestige and financial wherewithal to issue their own commercial paper in the marketplace. The company petitions the bank for help and the bank issues the acceptance notes which the company can sell on the open market. The company then uses the proceeds to facilitate the trade. The company must pay the bank the face value at the maturity date so that ultimate holders of the notes can be paid. If the company defaults, the bank must make good on the notes.

By keeping the maturity periods to less than one year, the issuers of corporate paper and banker's acceptance notes are not required to register their securities with the Securities and Exchange Commission. This helps keep the fees associated with these short term investments low.

## Which Short Term Investment Is Right for Me?

We have explored the various short term investment alternatives. It is time for you to answer the question, "Which short term investment is right for me?" Everyone is different and so that question can only be answered by you. Here are our observations: Because of their costs, commercial paper and banker's acceptance notes are usually only suitable for institutional investors. Savings bonds used to make cute gifts for newborns in paper form but now that they are all electronic, will the proud new parents still coo and awe when the card is opened only to say that their newborn's savings bond is safely tucked away at TreasuryDirect.gov? Many savvy investors purchase Treasury Bills directly from the Treasury at www.TreasuryDirect.gov. Certificates of Deposit are okay for those that are sure that they will not need the money until maturity. In our opinion, their flexibility and ease of use make money market mutual funds and money market deposit accounts the preferred choice of most investors, especially since every bank, credit union, brokerage firm, and mutual fund company offers them. Sadly, many uninformed savers still use a passbook savings account from a bank or credit union. (They have not taken this course yet. Such a shame!)

## Emergency Fund Debate

If you watch the financial media outlets and listen to any of the talking heads with their perfect hair and immaculate dental implants, they will vehemently insist that you have an emergency fund. An emergency fund is essentially a liquid, short term investment in which you place three, six, nine, or even twelve or more months of income. This is a self-insurance program in case of losing your source of income or another costly emergency arises. Some experts, most notably David Chilton, author of The Wealthy Barber, do not agree with this strategy. Of course, no one is advocating that you have $17.87 in your rainy day savings account; some substantial amount socked away for that rainy day is obviously a great benefit to your financial well-being. However, for those still working, assuming you have a marketable skill that would allow you to find gainful employment in a reasonable amount of time, there can be better uses for that money. You can use those funds to pay down expensive debt or increase your monthly retirement or investment contributions. There are exceptions, though. Anyone who works in sales or has their own business or works in a seasonal industry definitely needs a substantial emergency fund. We would be remiss to forget to ask one last thing: You do have proper and adequate insurance, yes? For more about an emergency fund,  takeFinancial Planning and Money Management at Southwestern Community College.

## The Federal Reserve Bank and Short Term Interest Rates

We mentioned that short term interest rates change over time. You may be wondering, "Well, who sets these short term interest rates?" For a more thorough investigation, you will want to take an Introduction to Economics class. The short answer, though, is that the Federal Reserve Bank is responsible for setting short term interest rates in the United States. It is often referred to as the Fed. They are the nation's central bank and are often called the bankers' bank since the banks of our nation use the Fed as their bank. The Fed has major two objectives. They are charged with keeping the nation's economy at full employment while at the same time, keeping inflation under control. These two objectives are often at odds with one another. The Fed has tremendous power and the Chairperson of the Federal Reserve Bank is often called, "the second most powerful person in the nation." The Fed was designed to be independent and not subject to political pressures. That does not stop politicians and other high-profile individuals from criticizing their actions. In fact, many vocal critics even claim that the Federal Reserve Bank is unconstitutional. Suffice to say that no system we humans have ever created is perfect, and that includes the Fed. However, for over 100 years, the Fed has bumbled along and sometimes has executed brilliantly and sometimes has failed miserably. We don't call Economics the "Dismal Science" for nothing.

## Congratulations – You Have Finished Chapter 1 – Introduction, Overview, and Risk versus Return

We told you not to worry, right? It was not that hard, was it? If you are still a bit fuzzy on some topics, that is okay. Go back and read the text and listen and watch the presentations again. Much of the task of learning about investments is just getting past the odd and strange names that we hear all the time on the television but don't really know what they are talking about. Well, now you know more about what they are talking about, don't you?

## Your Feedback, Please

Are you getting an education about investments? We hope so! Our goal is for this class to be one of the few classes that you remember 10 or 20 or more years from now. We hope that you can say to yourself, "Ya' know, that Introduction to Investments class really helped me." Again, enrolled students should comment in the Strength-to-Go-On Bar & Grille Canvas discussion forum. Perhaps you might want to start your own journal to help you organize your learning process. You can use the [Syllabus] menu option in Canvas to jot down everything you do each day in this class. Or just use the [Notes] or [Keep] app on your mobile device. Everyone can, of course, always contact me directly if you have any questions, comments, criticisms, suggestions, complaints, etc.

In our next chapter, we will investigate Mutual Funds, Investments for the Masses. The chances are very high that you will have a job with a company that offers you some kind of employer-sponsored retirement plan. That plan will almost certainly have mutual funds as the investment alternatives. As we will see, there are more mutual funds in the investment universe than visible stars in the night sky. (There are about 2,000 visible stars in the sky. There are approximately 12,000 mutual funds.) Choosing a mutual fund is extremely difficult, especially for those who have had no training or experience whatsoever. You, Dear Students, are going to be the Investment Guru for your family, friends, and fellow co-workers. You Can't Let Them Down! See you in our next chapter.

# Chapter 2 - Mutual Funds: Investments for the Masses

*"Mutual funds will bore you to wealth." -- Industry saying*

## Objectives

In this chapter and in the chapter 2 Canvas module and class website, you will

- Be introduced to the definition of a mutual fund, a.k.a. an investment company, and review the growth of the mutual fund industry
- Investigate major mutual fund share classes and how mutual funds charge their investors for the services of the mutual fund
- Explore the major mutual fund categories from the most riskiest to the least riskiest
- Compare and contrast active versus passive portfolio management of mutual fund assets
- Examine a few mutual fund families and concentrate on a sample mutual fund with decades of investing experience

By the end of this chapter and the Canvas module and class website, you should be able to

- Describe the various components, characteristics, benefits, advantages, and disadvantages of mutual funds
- Identify and describe the various ways in which mutual funds charge their investors for their services and explain the actual costs borne by the investor
- Outline the major mutual fund categories and their risk/return aspect
- Discuss the advantages and disadvantages of active versus passive portfolio management of mutual fund assets
- Identify a sampling of mutual fund families and the services available to mutual fund investors
- Describe the benefits of long-term, prudent, consistent mutual fund investing and the pitfalls of short-term, uniformed, impatient mutual fund investing

Mutual funds are truly Investments for the Masses. The probability is very high that at some time in your future, your employer will offer you an employer-sponsored retirement plan. That plan will almost assuredly have mutual funds as their primary investment vehicles. Your friends and family and co-workers will also likely be investing in mutual funds and they will need your help. As the Investment Guru for your family, friends, and co-workers, you need to know and understand mutual funds thoroughly. That includes the major categories of mutual funds and the ways that investors are charged for mutual fund services. As you will see, both are complicated. Dear Students, study hard and bring honor and glory to Southwestern Community College when you tell them where you learned everything you know!

# Introduction to Mutual Funds

*"Investing is simple ... but it ain't easy!"* -- Warren Buffett

When teaching Introduction to Investments, one is confronted with the thorny problem of where to put mutual funds in the class. There are advantages to having mutual funds taught after stocks and bonds. Since almost all mutual funds rely on stocks and bonds as their underlying investments, it helps to have become acquainted with the ins and outs of stock and bond investments before tackling mutual funds. However, the advantages of teaching mutual funds first are tempting. First, since investing in mutual funds is almost certainly to be in almost everyone's future via individual and employer-sponsored retirement plans, it pays to be introduced to them as soon as possible, especially since for whatever reasons, many students will drop the class within the first few weeks. Also, as we slog through the copious amount of concepts, definitions, attributes, calculations, etc. of stocks and bonds, inevitably several students will decide, "Ya' know, this stuff just ain't for me." That is fine! That is something we hope you will be able to decide for yourself as we progress through the semester. Not everyone will have the time, inclination, aptitude, and most importantly, receive enjoyment from doing the detailed research necessary to identify, choose, and continuously monitor individual stock and bond purchases. If you are one of them, no problem! That's why mutual funds exist! But whether you are an Investment Guru that relies upon mutual funds or one who chooses your own individual stocks and bonds, or both, it is important that you know and understand mutual funds thoroughly. They are in your future. And remember that your friends, family members, and colleagues are counting on you. So let's get started!

*"Do you want to eat well or do you want to sleep well?"*

## What is a Mutual Fund? An Investment Company!

A mutual fund is an investment company that invests its shareholders' money in a diversified portfolio of securities. Investment company is the legal term; mutual fund is the popular term. Mutual funds are one type of investment company; there are others. By far, though, the most popular investment companies are mutual funds. Although the term mutual fund does connote that investors are getting together to invest with one another, the term investment company more accurately describes the work of the mutual fund. The mutual fund will invest on your behalf.

Investing and speculating/trading are two different endeavors.

The mutual fund industry is immense. There are approximately 12,000 mutual funds available in the United States. How could this be? Are there 12,000 different types of breakfast cereals in the grocery stores? Are there 12,000 different types of cars or mobile phones available for purchase? Why and how has the number of mutual funds grown to such an unwieldy number? The mutual fund industry is also very lucrative. The competition is ferocious. As we shall see, the number of categories and numbers of mutual funds has exploded as companies have been competing for business for the past several decades. Also, as mentioned, mutual funds are very popular with employer-sponsored and individual retirement plans. We find that this is the most difficult issue with mutual funds: How do you choose the best mutual fund for you?! The answer:

It ain't easy! However, once you have chosen a mutual fund or maybe two or three mutual funds, your work is done. The rest is up to the mutual fund.

The graphic below is a very rudimentary representation of how mutual funds work. The people in the lower left are we, the Little Folk. We contribute $25 or $50 or $100 or whatever we can comfortably afford per month to the people in the top hats. These individuals are the mutual fund managers, also known as portfolio managers, portfolio counselors, and money managers. The mutual fund managers are highly skilled and well-paid professionals whose job it is to identify, choose, and monitor the underlying investments in the mutual fund. If the mutual fund managers purchase stocks for the mutual fund, it is called a stock mutual fund. If they purchase bonds, it is called a bond mutual fund. If the mutual fund concentrates on the short term "cash" vehicles that we discussed in chapter 1, the mutual fund is called a money market mutual fund, but is usually just referred to as a money market or money market fund. We also can see that a mutual fund that invests in both stocks and bonds is called a balanced mutual fund. This is just the beginning of the many categories and types of mutual funds. There are literally dozens of other categories. We will learn about a dozen as the rest are variations on the categories that we will cover.

Every month, there are millions of us Little Folk giving billions of dollars to the folks in the top hats. They create huge pools of money, hence the term "mutual funds." Because this is their career and their full-time job, the mutual fund managers can afford to identify many choices of their underlying investments. The mutual fund managers don't just purchase 10 or 20 stocks or bonds, which is typical for an individual investor. They purchase 100 or 200 or many hundreds of stocks or bonds. Therefore, we find that the two major advantages of mutual funds over individual stock and bond investments are professional money management and diversification.

Professional money management is sometimes the subject of some controversy. There are some in the industry and the public who question whether or not the mutual fund managers are really worth the high salaries they earn. For now, suffice to say that some are and some aren't. We will discuss this controversy throughout our coverage of mutual funds. However, virtually no one questions the advantage of managing the risks inherent in investing through diversification. Having a wide range of stocks or bonds across the various categories of each will help us eliminate much but not all of the risks of choosing individual stocks and bonds. You have heard the saying, "Don't put all your eggs in one basket." With a mutual fund, you are putting your eggs into hundreds of baskets. There are some who shun and even mock diversification but they are not investors. They are the speculators and traders but they most likely put down this book before reaching the end of chapter 1. Dear Students, for us investors, diversification is a good thing.

## Growth of the Mutual Fund Industry

The mutual fund industry in the United States started in the mid-1920's and by

1940 there were 70 mutual funds. By 1970, the number had grown to 350 and by 1980, it was 600. The exponential growth started in the 1980's and 1990's and by the year 2000, there were over 9,000 mutual funds. This unbridled growth coincided with the great bull market that started in 1982 and ended in March of 2000. Since then the growth has moderated but still, as of December 2021, we have just under 12,000 mutual funds, each with its own investment objective.

Year

Number of Mutual Funds

1940

70

1970

350

1980

600

1990

2,000

2000

9,000

2020

11,817

Source: Investment Company Institute, ici.org

How and why did this aggressive growth occur? As mentioned, the mutual fund industry is very profitable and has engendered tremendous competition. So when one company creates a new category or type of mutual fund, many other companies follow suit. We will do our best to internalize the broadest categories.

Likewise, the growth in the assets of mutual funds and number of investors have been equally stupendous. According to the Investment Company Institute, the trade group for the investment company industry, in 1980, five million Americans owned funds, holding 3% of their household financial assets. As of December 2020, 106.3 million Americans in 60.9 million households owned mutual funds. That is 47.4% of all U. S. households. In the table below, we see that as of December 2002, mutual fund assets totaled $29.6 trillion dollars. That is approximately 23% of the financial assets of United States households. Mutual funds are now the nation's largest financial intermediary, followed by commercial banks and life insurance companies.

Year

Assets ($US trillions)

2007

$13.0 trillion

2008

10.4

2009

12.2

2010

13.1

2011

13.0

2012

14.7

2013

17.1

2014

18.2

2015

18.1

2016

19.2

2017

22.4

2018

21.4

2019

26.0

2020

$29.6 trillion

Source: Investment Company Institute, ici.org

Notice the pronounced dip in 2008. Wait a minute. Didn't the stock market and many stock mutual funds lose over 50% during the Global Financial Crisis? The answer is yes and some lost even more. However, the bond market and bond funds only lost 10% to 15% and the money market mutual funds didn't lose a penny. Hence, the mutual fund industry only saw about a 20% decline in their assets. Also, many stock and bond investors simply moved their assets from stock and bond funds into money market funds when the turmoil hit. Therefore, much of the assets were just shifted around within the industry. (Actually, two money market mutual funds did lose a penny or three in 2008 but again, for those of you interested, type "breaking the buck" into any Internet search engine or contact your local librarian. It's a nail-baiting story for you Rising Investment Gurus.)

After growing fairly slowly throughout the 2010's, take note of the slight dip in 2018. At the end of 2018, the stock market lost almost 20%. Christmas Eve was a seriously down day that year. No doubt, many hapless investors gave up and pulled their money out of their stock mutual funds – only to see tremendous gains in 2019 and 2020. From $21.4 trillion, the industry saw their assets balloon to $26 trillion in 2019 and then $29.6 trillion in 2020. That's trillion with a T. This is typical of stock movements. If 2021 and 2022 are also banner years, we can expect that those ill-fated investors will finally move their money back into stock mutual funds – just in time for the next major downturn. Luckily, you, Dear Students, will not be one of them.

## Advantages and Disadvantages of Mutual Funds

Liquidity – A measure of the ability to quickly and easily turn your investment into cash.

We have already reviewed the two major advantages of mutual funds, professional money management and diversification. As an Investment Guru, you must internalize these two important characteristics of mutual funds. If someone were to call you at 2:00 am in the morning and ask, "What are the two principal advantages of mutual funds for investors?" you should be able to be woken out of deep sleep and answer without hesitation, "professional money management and diversification." With a mutual fund, your investments are diversified instantly. Your $50 monthly contribution buys 20¢ of Nike, 15¢ of Visa, and 25¢ of Home Depot. This diversification provides some reduction of risk that is difficult for an individual investor to obtain on their own. In addition, the professional money managers are working diligently to identify, choose, and monitor the stocks and bonds that populate your mutual fund. They better be working diligently as you are paying them very well to do so.

Another benefit of mutual funds is the initial low outlay of capital. This is a fancy way of saying that you don't need $500 or $5,000 or $50,000 to invest in a mutual fund. You can start with $25 or $50 per month. Until recently, it was not advantageous to buy individual stocks with less than $500 or more. (Technology is changing this but at a hidden cost. More about this movement later on when we get to stocks.) There are some mutual funds that have minimum investment amounts of $1,000 or $5,000 or $25,000. In general, these are more exotic, sometimes called "boutique" funds, catering to very wealthy investors willing and able to sustain large losses. These are normally funds that we retail investors avoid.

The last major benefit of mutual funds is the PITA factor. PITA stands for "pain in the a**." With mutual funds, once you have chosen your one or two or three mutual funds, the PITA factor is extremely low. (This gem comes to us courtesy of David Chilton, the author of The Wealthy Barber. I sure wish I had thought of it. Read The Wealthy Barber!) The exceedingly difficult part of mutual funds is choosing one from the vast universe of 12,000 available funds. However, once that is done, there is really almost nothing for us investors to do except check them over every six or twelve months. Yes, Dear Students, mutual funds are boring. And not for the last time will we emphasize that in the investment world, boring is good.

## Open-end, Closed-end, and Exchange-Traded Funds (ETFs)

There are three major types of mutual funds, open-end mutual funds, closed-end mutual funds, and Exchange-Traded Funds, commonly referred to as ETFs. Please don't ask me why the name is capitalized but it is while the first two are not. Also, sometimes you will see Exchange-Traded Fund with a hyphen and sometimes you will see it without a hyphen. The investment world is full of these types of ambiguities. It is one of the reasons why the general public often throws up its hands and gives up trying to understand investments. That is why you need to study hard, Dear Rising Investment Gurus, to help your family, friends, and colleagues.

By far, the largest number of mutual funds are open-end mutual funds. When people refer to mutual funds without any qualifier, they are invariably referring to open-end mutual funds. An open-end mutual fund is a type of investment company in which investors buy shares from, and sell them back to, the mutual fund itself. There is no limit on the number of shares the fund can issue. Shares are issued and redeemed by the investment company at the request of investors. Investors can buy shares from (purchase) and sell shares to (redeem) the investment company at any time. As of December 2020, there were 9,027 open-end mutual funds totaling $23.896 trillion dollars in assets. They make up approximately 76% of all mutual funds.

The second major fund category consists of closed-end mutual funds. A closed-end mutual fund is a type of investment company that operates with a fixed number of shares outstanding. Shares are issued by an investment company only when the fund is organized. After all original shares are sold you can only purchase shares from another investor. In this way, closed-end mutual funds are bought and sold like stocks and bonds on the open market. The investor will incur brokerage commissions. Closed-end mutual funds are a much smaller part of the mutual fund universe. As of December 2020, there were only 494 closed-end mutual funds holding only $279 billion dollars in assets. That number represents only 4% of the available mutual funds. In recent years, both numbers have been steadily shrinking.

The current underlying worth of any mutual fund is represented by the Net Asset Value (NAV). At the end of every day that the stock market in the United States is open, all mutual funds are required to compute the Net Asset Value of a single share. The mutual fund staff sum the value of the securities in the mutual fund and subtracts any liabilities. The securities are quoted as of 4 pm New York time. The liabilities consist of pending redemptions to be sent to investors, pending purchases of new securities, and any other day-to-day costs of running the mutual fund. The liabilities are typically very low compared to the value of the securities. The result of the value of the securities minus the liabilities is then divided by the number of mutual fund shares. This is the Net Asset Value. This is the number you will see when you investigate your mutual fund. Although it is good to understand what the Net Asset Value represents, there is really no need to perform the calculation for yourself; each day, it is computed for you automatically and all you need to do is run to your nearest Internet-enabled device and ask for it.

Open-end mutual funds are bought or sold at Net Asset Value. Some open-end mutual funds may add a sales commission, also known as sales charge or sales load. If a sales commission is added, the resulting price is called the Maximum Offering Price (MOP) or just the Offering Price. The NAV or MOP is the price that the investor will pay when the fund is purchased. The NAV is the price the investor will receive when the fund is redeemed. Since closed-end mutual funds are bought and sold on the open market, their price usually either reflects a premium or discount to the Net Asset Value. They are very rarely priced at their Net Asset Value. Closed-end funds more often than not will sell at a discount to the Net Asset Value. The investor will pay the current market price when purchasing closed-end mutual funds and receive the current market price when redeeming closed-end mutual funds.

What are the advantages and disadvantages of open-end versus closed-end mutual funds? Open-end mutual funds are much more popular than closed-end mutual funds and therefore offer the investor a much wider range of options. With open-end mutual funds, there are no market forces so the investor does not pay any brokerage commissions and does not have to worry about any supply and demand market forces.

One downside of open-end mutual funds is something that the investor has no control over. Invariably, if an open-end mutual fund becomes very successful, it will become very popular. Floods of new contributions will inundate the fund. At first, this may sound like a great boon to the company. However, too much money flowing into a mutual fund can create serious challenges for the mutual fund managers. They must put this money to use and that can be problematic. Will they choose to purchase more of the same securities that they already have in the portfolio? Will they decide to invest in new securities? Both have their pitfalls. Purchasing more of an existing security that is already in the mutual fund may bump the mutual fund up against the 5% rule. It also could be difficult for the fund to purchase more shares without adversely affecting the price of the security, especially if the security is a smaller issue such as small company stock. Identifying, choosing, and monitoring new securities placing that much burden upon the mutual fund company. Too much diversification can be too much of a good thing. How much resources will the mutual fund company devote to the 250th stock in their portfolio? For this reason, many open-end mutual funds will decide to close the fund. Other mutual funds handle this problem by adding more mutual fund managers, essentially creating multiple portfolios within the overall portfolio. Again, this is an issue that the mutual fund company must handle but it is important for us investors to be aware of.

In addition to the problem of a flood of contributions into the open-end mutual fund, if an open-end mutual fund experiences a flood of withdrawals from the fund, the exact same problem happens in reverse. Now, the mutual fund managers might be forced to sell securities to pay for redemptions. This may occur at precisely the worst time, namely when the market is experiencing a major downturn and ill-informed investors are running for the exits. Or it may occur when a very successful and popular money manager leaves a fund after many years. Both too many contributions and too many withdrawals are uncommon events but they are something that investors need to be aware of.

Closed-end mutual funds have the issue that the investor must pay a broker's commission just as they would when they bought or sold a stock or a bond. (You may be saying to yourself, "My brokerage firm doesn't charge commissions. I am not paying anything for my trades!" Ah, Dear Student, please know that you are being charged, one way or another. We will tackle the industry's current sleight of hand in our next chapter.) Closed-end funds must be bought and sold in the marketplace so the forces of supply and demand are at work. Hence, there is often a premium or, more often than not, a discount to the Net Asset Value. However, one advantage of closed-end funds is that it is much easier for the mutual fund investment advisors to manage the underlying assets. Recall that the number of shares is set when the closed-end mutual fund is established. The closed-end mutual fund managers do not have to worry about a flood of purchases or redemptions as do the open-end mutual fund managers.

A third type of mutual fund has emerged in the past few decades. Exchange-Traded Funds (ETFs) are hybrids of open-end and closed-end mutual funds. Exchange-Traded Funds are open-end mutual funds that have no limit to the number of shares. The mutual fund company issues new shares as needed. However, they trade on the stock exchanges like closed-end mutual funds. Therefore, the investor must purchase the fund using a brokerage account, incurring brokerage transaction fees as would a closed-end mutual fund. Competition and innovation have led some mutual fund companies to find a way to eliminate the brokerage transaction fees. Some mutual fund companies have opened their own brokerage firms and if you purchase their Exchange-Traded Funds through their brokerage firm, they waive the commission.

Exchange-Traded Funds were introduced in the early 1990's. Starting in the 2000's, their popularity began a meteoric rise, as shown in the table below. This has led many in the industry, especially the financial media talking heads doing their best to attract your attention by making profound revelations, to confidently predict that ETFs will supplant all other mutual funds. To steal from Mark Twain, the reports of the death of open-end and closed-end mutual funds are greatly exaggerated. Even given their spectacular growth, ETFs still only account for about 19% of the total number of mutual funds.

Year

Number of Funds

Assets ($US)

2006

359

$423 billion

2007

629

608

2008

743

531

2009

820

777

2010

950

992

2011

1,168

1,048

2012

1,239

1,337

2013

1,332

1,675

2014

1,451

1,974

2015

1,644

2,100

2016

1,774

2,500

2017

1,900

3,401

2018

2,057

3,371

2019

2,175

4,396

2020

2,296

$5,449 billion ($5.449 trillion)

Source: Investment Company Institute, ici.org

There is some confusion surrounding the underlying investments in Exchange-Traded Funds that we will discuss when we discuss the various types of mutual fund strategies and objectives. Furthermore, because of the ability to buy and sell Exchange-Traded Funds throughout the trading day, many speculators and traders have begun to use ETFs as trading vehicles. Many in the industry including John "Jack" Bogle, founder have lamented the use of ETFs as trading vehicles as mutual funds were originally designed to be long term investments.

## Regulation and Organization of Mutual Funds

The mutual fund industry in the United States started in the mid-1920's. The concept was borrowed from the famous Scottish Investment Trust that has been in operation since the 1880's. The idea was to be able to bring professional money management and diversification to the masses. At first, some regulators were very skeptical about these new investment alternatives and states had conflicting rules and regulations. Especially troublesome from the governments' viewpoint was how these entities should be taxed. That all changed with the Investment Company Act of 1940. This legislation is the foundation of the modern mutual fund industry. It

defined a "regulated investment company," also known as a "pass-through" investment vehicle. The mutual fund does not pay taxes on the interest, dividends, and capital gains from the underlying investments. Instead, the mutual fund "passes through" the rewards to the investors and the investors are responsible for any subsequent taxes. (The mutual fund earns its money from the fees charged to the investors and must pay any taxes on those earnings.)

There are several rules, regulations, and guidelines that must be adhered to for a company to qualify as an investment company. The entity must hold almost all its assets as investments in stocks, bonds, and other traditional securities. It has a very limited ability to use derivatives and other risky strategies. Also, the mutual fund may use no more than 5% of its assets when acquiring a particular security. This rule is crucial. By limiting the amount of assets to 5% to any one particular stock or bond, the mutual fund is guaranteed to have at least 20 securities. Obviously, most mutual funds have far more investments in their portfolio but there are some mutual funds that do limit their portfolios to the bare minimum. One such fund was the infamous Janus 20 mutual fund. Where did the name come from? Again, a mutual fund must have at least 20 different stocks, bonds, or other securities. The strategy of the Janus 20 fund was to have a portfolio of only 20 stocks. This anti-diversification strategy works great – if you choose 20 great stocks. Of course, if even one or two of your choices don't work out as expected, it can quickly sour the long term results of a mutual fund. If you investigate the history of the Janus 20 fund, you will find that this is exactly what happened. Janus 20 was a high-flying and very popular mutual fund – until 2008. Janus finally merged the fund into another mutual fund – Janus 40! This is an example of what is called in the industry "burying the evidence." It happens far more often than it should.

Another important provision of the Investment Company Act of 1940 is that mutual funds must create an organization with "checks & balances." This is the exact same concept that is embedded into the Constitution of the United States and is taught in high school Civics and United States History classes. In the case of mutual funds, the idea was to help ensure that the investors' assets would be protected by separating the various tasks among several different entities. In truth, a mutual fund is not just one company; it consists of a group of companies.

The mutual fund is a corporation run by a Board of Directors for the benefit of the investors who are shareholders in the corporation. The Board of Directors is voted in by shareholders and are charged with overseeing the fund operations on behalf of the shareholding investors. In the past, some Boards of Directors were criticized for not exercising the highest standards in fiduciary oversight. This is a fancy way of saying that they were asleep at the wheel. Some Board Members are paid handsomely for their services. Critics contend that this creates a conflict of interest and question whether Board Members would be fearful of jeopardizing their positions by being too critical of the mutual fund management.

By far, the most important component of the mutual fund structure is the Investment Manager, also known as the Management Company or simply the Fund Manager. This is the company that is charged with researching, identifying, choosing, and then monitoring the securities that will populate the mutual fund. Many mutual fund companies use what is sometimes referred to as the "star manager" approach where one individual is responsible for all the final decisions of what investments will be included in the fund. This person is assisted by many research analysts who cover specific sectors and industries such as energy, technology, and health care. Other companies use a committee that must come to a consensus about which securities to buy. An approach that is a hybrid of these two strategies is to have several money managers responsible for the investment decisions. The group does their research as a team but the individual money managers make their own decisions. This approach is gaining popularity as it has some advantages over the "star manager" approach. It allows the portfolio managers to focus on fewer investment choices, ones in which they have the most conviction. It also allows for a smoother transition when a money manager leaves the firm. This is in stark contrast to the problem a "star manager" mutual fund has when their individual retires or joins another firm.

The custodian is the company that actually holds the securities. This company is often a bank or trust company. The investment manager makes the decisions, the custodian company holds the investments. This is done to reduce the risk of any financial misconduct and is part of the "checks and balances" that is built into the mutual fund. As their name suggests, the distributors distribute the shares to the public or to other financial professionals dealers who then deal with their own clients. The transfer agent keeps track of purchase and redemption requests from shareholders, not the most glamorous of tasks in the investment industry but very important, nonetheless. Lastly, the independent public accounting firm certifies the fund's financial operations and reports. They are the watchdog that ensures that the investments are safe and sound and that there is no financial fraud. Normally the independent public accounting firm is one of the Big Four public accounting firms. (Note: In the case of the fraud perpetrated by Bernie Madoff, the accounting firm that he was using was a guy out in Connecticut working who worked out of his garage.)

Why the large diversification of tasks and companies? Mutual funds are highly regulated in order to protect shareholders' investment from fraud and collapse. How often have you heard of a scandal at a mutual fund company? Until 2003, never.

"Wait a minute, Paiano! Did you just say, 'Mutual Fund Scandals?!' You want me to invest in an industry that is plagued with scandal?!" Well, as a matter of fact, yes, I do. I want you to invest in mutual funds. But on the contrary, the industry is not nor has it ever been plagued with scandal. Since 1940, the mutual fund industry has been regulated and for decades escaped any but the slightest hints of impropriety. In 2003, some practices that were not quite illegal but obviously unethical were uncovered. Only a handful of mutual fund companies and people in the firms were affected such as Strong, Janus, Bank of America, Putnam, and Alliance. The vast majority of companies never engaged in any of the shenanigans. Two individuals at Alliance were guilty of these improper actions and the entire company was unfairly tarred and feathered. The worst example was the sad story of Strong Funds where the CEO, Richard Strong, who built the company from scratch, supposedly earned $600,000 in ill-gotten gains. This was a man who was worth a reported $800 million dollars at the time of the ruse. What causes a titan in the industry to risk their most important asset, their good name and reputation, for what to him was essentially pocket change? Mr. Strong was barred from life from the securities industries, paid a $60 million fine, and publicly apologized for his actions. Strong Funds paid $115 million in penalties and $80 million to investors. And unlike most such settlements, the firm admitted wrongdoing and apologized to its investors. The assets of Strong Funds were eventually sold to Wells Fargo and, once again, the evidence was buried.

What were these terrible things that these few rascals were guilty of? We won't get into the gory details of mutual fund late trading and market timing. Although these actions were certainly dishonest and corrupt, the effect upon the average mutual fund investor was essentially unnoticeable. Those who invested heavily in Enron, WorldCom, or Bernie Madoff lost $99,999 on a $100,000 investment. In contrast, the investors of the affected mutual funds typically lost less than a penny on a $100,000 account. The offenders were stealing hundredths of pennies from their fellow mutual fund investors. There just happened to be millions of said fellow mutual fund investors to steal a few hundredths of a penny from every few days or so. Even though the harm was negligible to the typical mutual fund investor, these actions were counter to the honest and principled operation of a mutual fund. Again, only a handful of culprits were guilty. As usual, it is the very few who give all of the hard-working, honest professionals a bad name.

# Fees, Expenses, and Share Classes, Oh, My!

Most mutual fund investors know that they are paying for the services of the mutual fund. However, typically their understanding of how they are being charged is vague at best. My apologies on behalf of our industry because as you will see, we have done our best to make sure that the vast majority of mutual fund investors do not fully understand the costs associated with mutual fund investing. And for the most part, the industry has succeeded. As Rising Investment Gurus, it is your duty to understand thoroughly the fees and expenses of mutual funds. Study this section over and over. Your friends and family and colleagues are depending upon you.

## Annual Operating Expenses

Every mutual fund has annual operating expenses. These expenses are reported as a percentage of the assets under management. Understanding the percentage of assets under management is only the first hurdle for most potential mutual fund investors with regard to expenses. There is much more to understand and internalize about mutual fund fees. Sadly, understanding the costs resulting from the percentage expense of assets under management is also often the last hurdle for puzzled would-be investors. Subsequent explanations of fees and expenses often elicit only glassy-eyed stares. Our intrepid future mutual fund investor then decides quickly to banish from their mind any further thought of the costs of mutual fund investing and to concentrate on the other juicier aspects of mutual funds such as the investment returns touted in the slick marketing material their representative sent them.

This dynamic is unfortunate because understanding the costs as a percentage of assets under management is not difficult once it is explained adequately. For example, if the annual operating expenses are 1% of assets under management, then for every $100 in the account, the mutual fund will charge 1% of $100 or $1 each year to operate the mutual fund. If the assets under management were $1,000, 1% would be $10 yearly. $100,000 would mean an expense of $1,000, and so on. It is typical to see annual operating expenses range from 0.05% or less to up to 2% and sometimes even more. Although the difference between, for example, 0.5% and 2% might seem small at first, the difference in absolute expenses can be substantial, especially when the investment amount becomes considerable.

Mutual funds have up to four annual operating expenses. Normally, the most costly annual operating expense is the management fee. This fee goes to the professional money managers who are identifying, choosing, and monitoring the securities that populate the mutual fund. Management fees range from 0.2% up to 2% yearly. Proper securities research is not inexpensive. If the money managers are doing the serious work necessary to actively manage the underlying choices in the mutual fund, the costs will be significant. As we have discussed, the world is a very small place economically and money managers must have a global outlook. Doing research across the globe is costly and the management fee reflects this cost. However, we shall see an important exception to this rule as we progress through our discussion of fees.

A second annual operating expense is the 12b-1 fee. Where did this comically baffling name come from? The 12b-1 fee's name comes from Rule 12b-1 of the Investment Company Act of 1940. This annual fee is used to defray advertising, servicing, and distribution costs of the fund. Mutual fund companies are required to report what they pay for these costs. Are banks or life insurers, or beverage companies or car companies, for that matter, required to tell the general public what they pay for advertising? No, but according to the Investment Company Act of 1940, mutual funds companies must. Over the past two decades, 12-b fees have gotten a bad reputation because of some abuses which will be discussed soon. The 12-b fees are usually 0.25% but can be as high as 1.0%.

The third category of annual operating expenses are accounting and other expenses. This is a broad category that consists of all the other expenses of operating a mutual fund such as the rent, utilities, communications, and, very importantly, the accounting. This expense ratio is usually less than 0.2%.

A last category of mutual fund annual operating expenses usually only applies to accounts that the IRS has deemed tax-advantaged accounts, also known as tax-qualified accounts. Examples of these are retirement accounts such as Traditional and Roth IRAs, health savings accounts, and educational accounts. With these accounts, the IRS requires the funds to be held by a separate trustee. Unlike the first three expenses, instead of a percentage of assets under management, the trustee typically charges a set fee of between $10 and $35 per year per account. Also unlike the previous three fees which are paid automatically from the proceeds of the account, this fee can be paid separately outside the account by the investor. In practice, very few investors bother to write a check each year for $10 and send it to the mutual fund trustee.

Disclaimer: Because of the intense competition in the mutual fund industry, there are now a few funds that do not charge any annual operating expenses. Fidelity Investments was the first to offer a few of their funds with no annual operating expense. In marketing, this is often referred to as a loss leader. Fidelity is courting new customers with a few free mutual funds and anticipating that once they are loyal clients, Fidelity will be able to sell them other for-pay services. Obviously, no company can exist indefinitely without revenue so we will see if this marketing gambit is successful over the long term for Fidelity. If it is, we can expect other companies to follow Fidelity's lead.

According to the Investment Company Act of 1940, all the previous fees and expenses, along with much other information about the mutual fund, must be reported in the funds' prospectus. No doubt you have heard or seen in advertisements about mutual funds and other types of investments, "Be sure to read this and other important information about the investment in the prospectus." Ha, ha, ha, ha, ha! This is one of our industry's little jokes. No one reads the prospectus. Before the revolution in digital communication, every investor was required to have been given or sent to them the prospectus in writing. Now, as with other online services, you simply, "Click or tap here to acknowledge that you have read the prospectus."

As Rising Investment Gurus, it is important for you to at least slog through one or two prospectuses. (No, the plural of prospectus is sadly not prospecti.) There are various links on the class website and in Canvas for you to follow. The truth is the prospectus can be very useful. If you ever suffer from insomnia, simply start reading a mutual fund prospectus. Your insomnia will be a distant memory. When Your Humble Author was first introduced to mutual funds, the representative gave me the required prospectus in writing along with the marketing material. Although I skimmed quickly through some of the material, I read every page. When I saw her again to discuss the potential investments, I asked for the prospectus of the second mutual fund that she was also thinking of recommending. She looked at me oddly and said, “You read the prospectus?” I replied that I had and was eager to read the other one. She was dumbfounded. This was a woman who had over 20 years experience in the industry at the time and she replied, “I don’t know anyone who has read a prospectus. I’ve never read a prospectus!” At the time, I thought that this was odd since if you are going to trust your money with this company, shouldn’t you know everything you can about them? Since then, I believe that only one of my clients has ever actually read the prospectus. Also in recent years, the Securities and Exchange Commission has allowed the mutual fund companies to issue a summary prospectus which is about ¼ of the size of the full prospectuses. It is still written in such a way to put the average person asleep within one or two pages.

Before the advent of pervasive digital communications, there was a saying in the industry. “The more important the information, the cheaper the paper. The less more the information, the more expensive the paper.” This was a comment on the fact that the prospectuses were printed on drab, inexpensive paper. On the other hand, the slick marketing materials were always printed on luxurious paper in full color.

One operating expense that is often overlooked is the cost related to trading. The trading costs are not required to be reported in the prospectus. So how does one know how much the mutual fund is paying in trading costs. A quick guide is to look at the mutual fund’s turnover ratio. This is a measure of how much of the portfolio “turns over” in one year. If the turnover ratio is 100%, the mutual fund will have bought and sold the entire portfolio in one year. If it is 50%, it will take two years to turn over the portfolio. The higher the turnover ratio, the more trading costs the mutual fund will incur.

What is an optimal turnover ratio for a mutual fund? The answer depends as some mutual funds will have a high turnover ratio simply by the nature of the underlying investments. An example are with money market mutual funds that have short term securities that mature in three, six, or nine months. Therefore, it is typical to see 300% or more turnover in money market mutual funds. However, with stock mutual funds, a high turnover ratio implies that the mutual fund managers are acting more along the lines of speculators and traders instead of investors. We will see when we discuss stock valuations that a turnover ratio of 20% to 30% for stock mutual funds is a respectable turnover ratio. The mutual fund managers are holding onto their stocks for an average of 3 to 5 years. A turnover ratio of 200% or more for a stock mutual fund means the managers are only holding onto their stocks for an average of six months or less.

## Load Funds versus No-load Funds

Along with the annual operating expenses, some mutual funds have a commission. The commission goes by various names including the sales commission, the sales charge and, historically, the sales load. Hence, mutual funds that come with a commission are called load funds. Mutual funds that do not have sales commissions are called no-load funds. During the first few decades of the mutual fund industry, mutual funds were sold by financial representatives such as stockbrokers and came with a sales load. The commission was used to compensate the financial representative along with the fund distributor. Eventually, enterprising new mutual fund companies began to offer no-load mutual funds without commissions that bypassed the financial representatives. The investor would deal directly with the mutual fund company via 800 toll-free phone numbers and then eventually, the Internet and other digital communications. The incessant drumbeat from the financial media will tell you that you should never buy a load fund and should only purchase no-load funds. There are two problems with this. First, along with the sales load, you need to compare the annual operating expenses. Over the long term, a no-load fund with higher annual operating expenses may wind up costing you far more than a load fund with lower annual operating expenses. Secondly, if an investor believes that they need the services of a financial representative, they should be expected to pay for these services. We will see that traditional load fund sales commission can wind up costing orders of magnitude less than the current system that has evolved to replace the traditional sales load.

In addition, as you nose about the financial media, you will invariably see something along these lines, "If you invest $100,000 into a mutual fund with a 5% sales load, at the time you invest, $5,000 will be taken out of your account and used to pay the broker and other distributors that helped get you to choose that investment. If your mutual fund grew by 8% compounded for 50 years, a $5,000 sales load charge would result in you having $234,508 less in wealth." The problem with this assertion is that the writers are assuming that the load fund and the no-load fund will have the exact same investment returns. This would almost always never be the case. No two funds are exactly the same.

How did the investment services industry respond to the challenge of charging clients for their services in the face of no-load funds? The industry introduced various mutual fund share classes. As we work through the next discussions of the various types of share classes, their non-descriptive names, their sales loads and other fees and expenses, we will see yet another reason why mutual fund investors would rather not concentrate on how they are being charged. Again, it is up to you, Dear Rising Investment Gurus, to study these share classes thoroughly and internalize them so that you will be able to help your friends, family, and colleagues make sense of the fees they are paying for their funds.

## Share Classes – Alphabet Soup, Anyone?

The first mutual funds had a front-end sales load. The sales commission was subtracted from the purchases of the mutual fund shares. These mutual funds shares are typically now referred to as Class A shares. They would traditionally have the lowest annual operating expenses. Also, the sales load was reduced as the contributions or the amount of the investment reached certain sales charge breakpoints. For example, the maximum sales load on a mutual fund's A shares may be 5%. However, once the contribution or the amount in the account reaches $25,000, the sales load would be reduced to 4.5%. At $50,000, it might be reduced to 4%, and so on. Typically, once the contributions or the amount in the account reaches $1,000,000, the sales load is waived entirely. (Does this give you an idea of how much the industry simply adores high net worth individuals, often called sophisticated investors or accredited investors?)As no-load funds became more popular, many in the general public soured on the idea of sales commissions. If nothing else, the investment services industry is very good at marketing. For those individuals who did not want to pay a front-end Class A sales load, the industry created Class B shares. Class B shares had a back-end sales load. The investor paid a commission when they sold the shares. Savvy investors would respond, "Ms. Financial Representative, what difference does it make if I pay a front-end load or a back-end load? I don't want to pay any sales commission!" The industry was already one step ahead of them.

"No problem, Mr. and Mrs. John Q. Investor! Our Class B shares have a Contingent Deferred Sales Change (CDSC). You only pay the back-end sales charge if you don't hold on to the shares for 4 years. After that, there is no sales charge." The representative is correct but she and her cohorts were often withholding an important piece of information. The Contingent Deferred Sales Charge does indeed reduce over 4 or 5 or 6 years. The first year, it may be 4%, the second year, 3%, and so on until the back-end sales charge disappears. However, what the sales representative did not divulge – "Ms. Jane Q. Investor, it was all contained in the prospectus that you read!" – is that the Class B shares typically charge higher annual operating expenses over 6 or 8 years. Much of those higher annual operating expenses are going to compensate the advisor and their firm.

Where did the higher annual operating expenses come from? They came from the 12b-1 fees, of course! Class B shares typically had 12b-1 fees that were four times higher than Class A 12b-1 fees. Over time, the Class B shares can wind up costing an investor more than the Class A shares. Plus, there is a point at which the sales charge breakpoint makes the Class A shares a much better deal for the investor than the Class B shares. This and a few other abuses of the Class B shares perpetrated by a number of financial representatives gave the Class B shares a less-than-stellar reputation. Many mutual fund companies have already done away with their Class B shares.

"Mr. Ron Q. Investor, you say you don't want a front-end load nor a back-end load? No problem! We have the shares for you! They are called Broker No-load Funds." The next attempt by the industry to counter the challenges of the no-load funds was the invention of the Class C shares. At the time, many representatives referred to them as Broker No-load Funds. That name is no longer allowed by the regulators. Class C shares have no front-end load and no back-end load except for a typical 1% back-end load that is charged if the investor withdraws the funds within one year. "But you are not going to withdraw your money within a year, right? Mrs. Juana Q. Investor? Mutual funds are a long term investment." However, like the Class B shares, the Class C shares have much higher 12b-1 fees for typically 8 or 10 years and therefore, they, too, can wind up costing far more than the front-load Class A shares. As with the Class B shares, most of those higher 12b-1 fees are used to compensate the client's advisor.

As mentioned, the name Broker No-load Funds is no longer permitted to be used by investment representatives. Why is this? The Securities and Exchange Commission has ruled that Class C shares are a type of load fund. The only difference is that instead of front-end or back-end load, the mutual fund is charging the sales load yearly over time on an amortized basis.

So you go to your broker and you say, "I don't want to pay a front-end load nor a back-end load and I want lower annual expenses." What do you think your broker is going to say? Are you starting to see a pattern here? Can you guess what the first words out of the advisor's mouth will be?

"No problem! For you, we have the new and improved Class F shares! And by the way, we are not your brokers anymore. Oh, no, no, no! We are your wealth managers, your investment advisors, your trusted personal financial consultants. We don't charge commissions anymore!" The Class F shares go by various designations, Class FI, Class I, Advisor Class, and now, clean shares. These shares have no front-end load, no back-end load, typically no 12b-1 fees, and overall, have much lower annual operating expenses than the Class A, B, and C shares. If you are wondering where the funds to compensate the advisor are coming from, then you have been paying attention and are a good candidate for entering our industry as a professional. What has the sales representative left out of the conversation?

With the Class F shares, the advisors and their firms are tacking on an additional annual operating expense separate from the mutual fund expenses. Currently, it is typical for a brokerage firm to add an additional 1% or even 2% on top of the mutual fund annual operating expenses. With this additional charge, over time, the potential fees that a mutual fund investor pays dwarf the fees of the corresponding front-end load Class A shares, especially for those who can take advantage of the sales charge breakpoints available to Class A share investors. However, this is not the investment world of the 1960's. If you seek the services of a personal investment advisor, chances are that they will want to pony up the additional 1% or 2% "wealth management fee."

In addition, the wealth managers normally don't want us, the Little Folk, who are putting $50 or $100 per month away into our Roth IRA. For example, one such firm, Fisher Investments wants you to have at least $500,000. With your $500,000 or more, you get charged 1.25% for the privilege of having them manage your money. According to a report from Investopedia, the average fee as of 2019 was 1.02%. As of this writing, larger firms are experimenting with more automated, less personalized, services and are offering lower annual operating expenses. One example of this is a company called Betterment that offers wealth management services for a fee that is between 0.25% and 0.40% of assets depending upon the size of the account.

The A, B, C, and F/I/FI/Advisor/Clean shares classes are only the beginning. Depending upon the mutual fund company, there may be many more share classes. Take heart. All of them are variations on one of the four share classes described above.

The very last share class consists of no-load funds. The financial media often refers to them as "true" no-load funds. This unofficial designation was meant to distinguish these funds from the so-called "broker no-load" Class C mutual fund shares. (Recall that the SEC now prohibits Class C shares from being called no-load funds.) The debate between load funds in all their many permutations and no-load funds will continue unabated for years to come. Remember that no two mutual funds are the same and some load funds have done better than some no-load funds over significant periods of time. Also recall that if you want the benefits of a financial professional, you should be expected to pay for it. One way is to pay of paying your financial professional is through sales loads, whether through Class A front end shares, Class B back end shares with a contingent deferred sales charge (CDSC), Class C shares with the load spread out of several years, or Class F/I/FI/Advisor/Clean shares with the additional wealth management, also known as the assets under management (AUM) fee.

A last word on paying for professional financial services is needed here. Some financial professionals are "fee-only." This has added yet another option into the debate. Some in the industry argue that fee-only professionals do not have the same potential for a conflict of interest since the professionals are not being paid on commissions. However, there are various types of fee-only professionals and some do indeed earn a commission or an assets under management fee or both. Added to this confusion is that often the fees for fee-only advisors can be more expensive than paying the commissions on Class A front end mutual fund shares.

## Breakpoint Sales Charge Reductions and Contingent Deferred Sales Charges

The sales charge breakpoints for Class A shares are often overlooked as a potential powerful method to lower an investor's costs over time. We will revisit this topic a bit later after looking at the expenses for some example mutual funds. Below is a typical sales breakpoint schedule for Class A shares.

Investment

(either purchased or accumulated)

Sales Charge

Less than $25,000

5.75%

$25,000 but less than $50,000

5.00%

$50,000 but less than $100,000

4.50%

$100,000 but less than $250,000

3.50%

$250,000 but less than $500,000

2.50%

$500,000 but less than $750,000

2.00%

$750,000 but less than $1,000,000

1.50%

$1,000,000 or more

None

As we can see from the table above, as we contribute more or as our account reaches higher levels, the sales charge on future purchases is reduced. Investors can even sign a Statement of Intention with their mutual fund company, agreeing to invest a sufficient amount to qualify for a certain breakpoint. The investor has 13 months to satisfy the statement. This allows the investor to pay fewer dollars of sales commission on their initial investments. For example, an investor might know that they will be able to invest at least $100,000 over the next 13 months. After signing the Statement of Intention, the investor could initially invest $10,000 now and only pay a 3.50% commission instead of the 5.75% maximum commission. If they fail to satisfy the statement of intention and the 13-month period expires, the mutual fund company will charge the commission that was waived.

In the past, some unscrupulous brokers would fail to mention the sales charge breakpoints provision to their clients. As the client reached a breakpoint, the broker would recommend that the client contribute to a different fund. Today, any broker that attempted this breach of fiduciary trust with their clients would have their license revoked as well as be liable for fines and restitution to be paid to the clients. Once again, we apologize on behalf of our industry and once again, it is the few bad apples that give all investment professionals a very bad name. By the way, “breach of fiduciary trust” is the investment industry’s gently ambiguous euphemism for, “fraud and theft.”

As mentioned, the Class B shares typically have a Contingent Deferred Sales Charge that is reduced over time until it disappears entirely. Below is a typical Contingent Deferred Sales Charge schedule. This type of schedule is also common with annuity investments in the insurance industry. However, the annuity schedules often last upwards of 20 years and can start at up to a 20% or 25% back-end fee.

Year of Redemption

Contingent Deferred Sales Charge

1

4.0%

2

3.0%

3

2.0%

4

1.0%

## Fees and Expenses of Several Example Mutual Funds

It is now time to take an in-depth look at the fees and expenses of several sample mutual funds. If you have not done so, please listen and watch the second presentation of chapter 2 in Canvas, on the class website, or on iTunes, YouTube, or 3CMediaSolutions. Stick around for the denouement where we compare not only the fees but the investment results for four different mutual funds and compare them to an industry standard.

Pay special attention to the “checking for comprehension” slides at the end of the presentation. Yes, these terms will be emphasized on the exam. But more importantly, you need to be able to explain the subtle and obtuse differences between the various mutual fund share classes. Last, note that the share classes that we have described above and describe in the presentation are just the major share classes. There are many, many more! Luckily, all the other mutual fund share classes are simply variations on the themes that we cover here. Study and learn these thoroughly. Memorize them.

In the presentation, we see that there is a strong difference in the fees charged by actively-managed mutual funds and passively-managed index mutual funds. The simple reason a passively-managed index mutual fund costs much less than an actively-managed mutual fund is that the passively-managed index mutual fund is doing absolutely no research and is not identifying, choosing, and monitoring the securities that populate the mutual fund. The index fund is simply reading from a list of stocks or bonds and buying them; if the stocks or bonds are not on the list; they don’t buy them. It’s that simple. On the other hand, the actively-managed mutual funds have entire staffs of portfolio managers and research analysts that need to span the globe to identify, choose, and monitor their investments. If done well, this is an expensive undertaking.

There is one exception to the rule about low-cost passively-managed index funds. As your family’s, friends’, and most importantly, your colleagues’ Future Financial Wizard, you must be aware of this exception. Some employer-sponsored plans will try to sneak index funds into the plan with high fees. This is typically done by insurance companies. When that slick financial representative in the three-piece silk suit with a $5,000 watch on his wrist tries to sell you on how wonderful your 401(k) plan is, you are going to ask him, "Why do we have a Nationwide index fund that costs 10 times more than a Vanguard or Fidelity index fund?" He will start to stammer and hem and haw and your colleagues will look at you with awe and admiration. And hopefully, your company will realize what absolute scoundrels these people are. When your colleagues are amazed and ask you how you became a Financial Wizard, don't forget to tell them about Introduction to Investments at Southwestern Community College. You're welcome, by the way.

## Comparison of Commissions versus Assets Under Management (AUM) Fees

In the presentation, we saw how a front-end load fund using Class A shares can cost an investor less in fees and expenses than the other share classes including the financial advisor "wealth management" shares. This difference can become enormous if the potential investor is eligible for the sales charge breakpoints. Later on in the chapter, we will discuss mutual fund illustrations, also called hypothetical illustrations or just hypotheticals. These are examples of the investment returns that mutual funds have produced in the past. We will run hypotheticals for the same mutual fund at the $500,000 sales charge breakpoint, one using Class A shares and paying the front-end load, the other using the Class F shares and charging a typical 1.25% annual wealth management assets under management fee. The differences in the final resulting amounts over 20 and 25 years are eye-opening.

Some investment professionals may cry foul here. We must acknowledge that we are making a major assumption here. We are assuming that the investor has a very long term time horizon and does not plan to move their investments around often. If that is not true, then switching your Class A share investments every one, two, or three years would quickly generate large front-end load fees. We again reiterate that mutual funds should be considered long term investments.

The same investment professionals might be quick to say, "Well, we don't use the mutual fund in the example your class used. We use different investments." If that is the case, then we would need to run hypothetical illustrations of their chosen investments, one with the front end commissions and one with the annual wealth management fee. Again, if the investor has a long term perspective and intends to buy and hold their investments, the commission fee structure will normally be less costly than the annual wealth management fee.

## The Bottom Line on Fees

Fees and expenses are very important, but they certainly do not tell you the whole story about a mutual fund. When comparing mutual funds, you must look at many attributes, not the least of which are the rates of return, preferably over long, statistically significant time periods. Many financial advisors will say that a 10-year period is far more than enough to evaluate mutual funds. However, even 10 years might not be a long enough time period to evaluate your potential mutual funds. There are 10-year periods where some types of mutual funds do very well while others languish. Those times are often followed by a subsequent 10-year where the reverse is true. Look for companies with track records of 20, 30, or even 50 or more years of successful investing. We will do this as an assignment in a later chapter. In our next section, we will try our best to do the impossible. We are going to try to get our arms around the mutual fund industry and identify the major categories of mutual funds. Wish us luck. It’s not easy!

# Categories and Types of Mutual Funds

Many decades ago, there were three types of mutual funds. Some mutual funds invested in stocks, some invested in bonds, and some invested in a balance of stocks and bonds. The mutual funds that invested in stocks were called stock mutual funds. The mutual funds that invested in bonds were called bond mutual funds. And the mutual funds that invested in a blend of stocks and bonds were called balanced mutual funds. Life was simple.

Life ain’t so simple anymore.

What follows is a catalog of the broadest categories of mutual funds. There are many, many more. Study and learn and memorize these major categories and know that all the others are variations on these major themes. You will want to have the mutual fund scramble sheet available to help.

## Stock Mutual Funds

In our discussion of stock mutual funds, we are going to use an analogy that may or may not help you. If it helps, great. If it doesn’t help, our apologies; just ignore it and accept our apologies. We will liken the choices of stock mutual funds to a buffet table and we will start with the riskiest stock mutual funds – the spiciest offerings – and move to the least risky stock mutual funds – the most boring, often ignored, items on the buffet table.

The riskiest stock mutual funds are called aggressive growth funds. These funds seek outsized capital gains by investing primarily in companies that are experiencing the strongest growth in the markets. They also often engage in extensive trading to attempt to offer eye-popping short term results. Although the funds often report excellent returns in some years, as one would expect, they also are the funds that will fall the fastest and furthest when the markets stumble. These funds are the spicy jalapeño and habanero peppers of the mutual fund world. When we visit the buffet table, do we fill our plates with just the spiciest foods? No, most of us put a little bit of spice on our dishes, maybe 10% or even 20%. So it should be with aggressive growth mutual funds.

However, some adventurous folks may decide to fill their plates with the spiciest mutual fund alternatives. Hence, they must also be prepared for the inevitable downturns. Herein lies the danger with aggressive growth funds.

Someone just starting out in the world of investing might take a look at the long term results of the funds in their employer-sponsored 401k plan at work and say, “Look at this! The Getritch, Quik, and Retyre Aggressive Fund has the highest returns of all the choices. That’s what I want!” Does this person understand the risks they are taking? Are they emotionally prepared for the rollercoaster-like plunges that are in their future? Will they pull their money from the fund at the worst possible time, after a 30% or 40% or 50% or more decline?

To make matters worse, there are one or two categories of mutual funds that are riskier than aggressive growth funds. They often have “Ultra” or “Pro” in their names. They use exotic strategies to enhance the positive returns of the fund. As you would expect, those exotic strategies also can enhance the negative returns. Do you remember the Janus 20 fund that only had 20 stocks to decrease the diversification to the least amount allowable by law? Do you also remember that the Janus 20 mutual fund was merged into another mutual fund to bury the evidence of unsatisfactory returns for the investors? Aggressive mutual funds will exhibit severe volatility. And if you remember, volatility is our industry euphemism for, “I lost a whole lotta’ money!”

Our second category consists of growth mutual funds. Like their aggressive growth siblings, growth mutual funds will primarily invest in companies with growth prospects higher than the economy and most all stocks. Unlike their aggressive growth siblings, they typically do not take the same level of risk as their aggressive growth siblings. However, they will still demonstrate strong volatility. They are still spicy! Prudent, long term investors would do well to temper their enthusiasm and limit their allocations of growth mutual funds to 20% to 40% of their overall portfolio.

Here is where it starts to get tricky and you see how complicated categorizing mutual funds can be. A third category of mutual funds consists of capital appreciation funds. Capital appreciation is just a generic term that describes a rise in the value of an investment. Therefore, capital appreciation funds seek long-term growth of capital. They seek to increase the value of your investment. So how does that differ from a growth or aggressive growth fund? The differences are very subtle. Most growth funds and aggressive growth funds will have a provision in their prospectus that states they will invest primarily in growth stocks, usually staying between 80% & 100% invested in these types of companies. Capital appreciation funds can invest in anything they like and anywhere they like. They can invest in slow growing companies or out-of-favor companies if the investment managers deem that there is the opportunity for the value of the company to rise for whatever reason. Another analogy that we may use is that capital appreciation funds paint with a broad brush and can invest in any type of company whereas growth and aggressive growth funds paint with a narrow brush and primarily choose growing companies.

If you refer to the mutual fund scramble sheet, you will see that we show capital appreciation funds wrapping around the aggressive growth and growth funds. They are normally associated with aggressive growth and growth funds but they are technically not the same. In general, they tend to be as risky as growth and aggressive growth funds although not always. The well-known Fidelity Magellan Fund is a capital appreciation fund. It was managed by famed investor Peter Lynch from 1977 to 1990 and returned an astonishing 29% annual yearly return. Mr. Lynch was very good at choosing all types of companies, growth and non-growth, that had capital appreciation potential.

Yet another example of the confusion inherent in the mutual fund industry is the fact that one of the nation's oldest and largest capital appreciation funds is called The Growth Fund of America. If you accosted the fund managers of The Growth Fund of America and asked them how they account for the apparent inconsistency with regard to the name of their fund, they would counter, "Excuse us. The Growth Fund of America was named long before the category of capital appreciation fund emerged in the industry." This is common when researching and investing in mutual funds. The industry can't even decide upon how best to categorize the thousands of funds available.

The next category of stock mutual funds is called growth and income. These funds primarily invest in stocks for growth of capital and income from dividends. Most funds emphasize capital gains while some may emphasize growth of income from dividends. The fund manager may also sometimes own bonds to augment the income when they believe the opportunity for income is lacking from stocks. They are also sometimes referred to as blend funds. We shall see that some in the industry use the term blend fund to designate another category that we will cover later on. To further complicate the categorization of mutual funds, some will refer to growth and income funds as value funds. Referring to the mutual fund scramble sheet, we see that we have wrapped the terms blend and value around the term growth and income. We will discuss the subtle difference and uses of the terms blend and value in the investment world later on.

Where will we find the growth and income funds on our buffet table? These funds are the main entrees. They are the pasta dishes, the meat and potatoes, the lasagna. Most people will have from 50% up to 75% or even 100% of their plate filled with the main entree and so it is with growth and income funds, especially younger adults up into their late 30's. These funds will exhibit less volatility than their riskier brethren described above. However, they often have returns very close or on par with growth and aggressive growth funds. A well-run growth and income stock mutual fund is an excellent choice for what is sometimes called a core mutual fund for your portfolio. None other than Sir John Templeton, founder of The Templeton Funds (now merged with FranklinTempleton), believed that if you were to own just one fund during your working years, it should be a global growth and income stock mutual fund fund.

The last category of stock mutual funds is equity income. Recall that equity is another term for stock and that income from stocks is in the form of dividends. These are mutual funds that primarily are seeking income from stocks. The investment manager can also use bonds to augment the income. Equity income funds are the least riskiest of stock mutual funds. They primarily invest in slow-growing companies that are paying generous dividends. These funds will not participate in the festivities when the markets are rocketing upward. On the other hand, they will typically hold up very well when there is a market downturn or a crash. They are still stock mutual funds; they will go down in a panic but they will not fall anywhere near as far as the stock funds described above.

Would it not be more descriptive to use the term stock dividends funds? We apologize, once again, on behalf of our industry. We often use very confusing, vague, and obtuse terms to describe an investment in place of more common sense descriptions. This is why we need you, Dear Students, to become the Investment Guru for your friends, family, and colleagues. They need your help and guidance!

In our buffet analogy, equity income funds are the oatmeal, the broccoli, the lima beans, the stuff your mother always told you to eat when you were a child. Equity income funds are not exciting but they are very good for us, especially as we enter our late 40', our 50's, and beyond. A 30% decline in an equity income fund is much easier to stomach for middle-aged investors than a 70% decline in an aggressive growth mutual fund. This is exactly what happened during the late 1990's Internet mania when equity income funds lagged the market badly and were derided as stodgy, boring, out-of-touch investments that invested in "Old Economy" companies. In the subsequent Internet meltdown bear market of 2000 to 2002, equity income funds did very well, some even went up as many aggressive growth funds lost 70%, 80%, and even 90% of their value.

We have gone from the most riskiest to the least riskiest stock mutual funds. It is now time to add two other types of categories, market capitalization and domesticity. Market capitalization refers to the size of the companies. We will discuss this concept in detail in our next chapter. There are three broad categories of market capitalization, usually referred to as large-cap, mid-cap, and small-cap. They refer to large companies, mid-sized companies, and small companies. In general, large company stock mutual funds exhibit the least risk while small company stock mutual funds exhibit the most risk. Of course, mid-sized company mutual funds find themselves somewhere in between but are normally closer to their small company cousins with regard to risk.

The domesticity of a mutual fund refers to where the stock investments are based. The three broad categories are domestic, global, and international, also called overseas or foreign. Recall that the term domestic refers to investments that are based in the United States, global refers to investments based anywhere around the world, and international describes investments based outside the United States. Decades ago, the conventional wisdom was that domestic funds were the least riskiest, international funds were the most riskiest, and global funds were somewhere in between. Also recall from our discussion in the first chapter that these distinctions are not as important and pronounced as they once were. The world is indeed a very small place economically these days.

What the industry did is overlay these two types of categories on top of the first type of category. Refer to the mutual fund scramble sheet. In their efforts to be more competitive, a mutual fund company would offer a global, large-cap growth fund or a domestic, small-cap aggressive growth fund. Pick one from column A, one from column B, and one from column C. And of course, if one mutual fund company does it, many others believe they need to follow suit. Do you see how the industry wound up with approximately 12,000 different mutual funds? Ask your statistics professor to help you compute how many permutations there are for all the possible combinations.

Wait! There is more! There are regional stock mutual funds that invest in a certain region of the world such as Latin America, the Nordic countries, Canada, Japan, and the Far East. There are emerging market stock mutual funds that invest in developing countries such as India, Brazil, the Philippines, Russia, and China. There used to be a mutual fund that invested only in companies based in California but that fund seems to have vanished. Upon analysis, this actually was not such an eccentric idea. California by itself ranks as the fifth largest world economy, ahead of India and behind Germany. (If anyone can uncover what happened to this fund, please contact us.)

There are also stock mutual funds that invest in companies based in just a certain sector of the economy such as energy or real estate or wireless communications. These are called sector funds. Both regional mutual funds and sector funds are an attempt to enhance returns by concentrating the portfolio of the investor. Some investors may have some intimate knowledge of the region or the sector of the economy. If that is so, then, just like the aggressive growth funds, placing 10% or maybe even up to 20% of your portfolio may be a decent choice providing you are aware of the risks. However, we investors use mutual funds to diversify, not concentrate, our portfolios. Regional and sector funds should generally be avoided by prudent, long term oriented investors.

One last category of stock mutual funds consists of mutual funds that use market timing as their primary strategy. We will discuss market timing as a strategy in our next chapter on stocks. Suffice to say that only speculators and traders should ever consider market timing. Prudent, long term oriented investors should never mention market timing in polite company.

We have spanned the world of stock mutual funds. It is time to turn our attention to bond mutual funds.

## Bond Mutual Funds

Bond mutual funds primarily invest in fixed-income bond securities. Recall that bonds are essentially loans to corporations, state and local municipalities, and the Federal government. Bond investors lend their money to the bond issuer, the corporation, the state or local municipality, or the Federal government. In return, the bond issuer agrees to pay interest to the bond investor and eventually repay the principal. Bonds, and therefore bond mutual funds, are far less risky than stock funds. We will see later on that bonds often move in the opposite direction of stocks. When stocks are experiencing a market downturn, bonds often move up, or at least keep their value. Hence, many investors use bond mutual funds for stability and preservation of capital. In the following discussion, as we did with the stock mutual funds, we will start with the riskiest bond mutual funds and then move to the least riskiest.

The riskiest bond mutual funds are high-yield bond funds. This is the polite name. Usually these funds are referred to as "junk" bond funds. High-yield bonds are also known as junk bonds, speculative bonds, distressed bonds, and non-investment grade bonds. They pay much higher rates of interest. By now, you obviously understand why. These bonds are issued by entities that have low credit standing and, in many cases, are in danger of default. Default is another polite name we use in the industry for an individual or entity who can make good on the financial promises they made. High-yield bond funds typically invest in the bonds of corporations that are in distress but there are also high-yield municipal bond funds that invest in state and local governments and entities that are also in distress.

High-yield "junk" bond mutual funds also have a characteristic unlike other bond funds; they tend to follow the stock market up and down. This is counter to most other bond funds. However, when investigated further, it makes sense. Often, the stock market falls in response to falling economic conditions. When economic conditions are falling, companies that are in distress are in far more danger of defaulting. Therefore, the high-yield "junk" bonds that populate the high-yield "junk" bond mutual funds become more likely to default and the high-yield "junk" bond mutual funds suffer along with the stock market and stock mutual funds. When economic conditions improve, the stocks and the stock market typically rebound and so do the high-yield "junk" bonds. We say that high-yield "junk" bond mutual funds are positively correlated with the stock market and the stock mutual funds. We will discuss correlation in more detail later on in our journey together.

The next bond fund category consists of corporate bond mutual funds. Corporations borrow money for many of the same reasons that you and I borrow money; the difference is just that the numbers are orders of magnitude greater. Most individuals repay their debts and that is true of most corporations. With the exception of the high-yield "junk" bond funds described above, most corporate bond mutual funds have a long track record of earning interest income and returning principal repayments to bond fund investors.

There is a caveat that needs to be addressed here. Since the Global Financial Crisis of 2008, interest rates for many bonds have fallen to levels not seen since the Great Depression. Bond mutual fund investors were accustomed to 5% or 6% or higher annual returns over decades. They became unhappy with the 2% or 3% or lower returns that their corporate bond funds were now returning. In response, many corporate bond mutual fund money managers began to incorporate corporate bonds of lower credit quality, including some that would be categorized as high-yield, distressed "junk" bonds. In the industry, this is referred to as stretching for yield. This led Morningstar, the mutual fund research and reporting company, to create separate bond funds into two new categories, core and core-plus. The term core-plus is misleading as it might tempt potential bond mutual fund investors to believe that core-plus funds are somehow higher quality or better quality than core funds. In reality, the exact opposite is the case. The core-plus funds are the funds incorporating higher yield but lower quality bonds into their portfolios.

Sliding down the risk versus reward spectrum to our next category, we find municipal bond mutual funds. These funds invest in the bonds issued by state and local municipalities, such as states, cities, counties, school districts, bridge and water authorities, and other local governmental entities. In general, these governments and institutions will suffer default far fewer times than corporations. Some municipal bond mutual funds will even invest in municipal bonds that are insured to further reduce the risk of default.

One of the major benefits of investing in municipal bond mutual funds is that interest from municipal bonds is tax-exempt at the Federal level. This makes municipal bonds and municipal bond mutual funds very popular with high net worth investors in higher tax brackets. In addition, if an investor chooses a municipal bond fund that invests in municipal bonds domiciled in their state of residence, the interest from the municipal bond will also be tax-exempt at the state and local level. Hence, state-specific municipal bond funds are often called double tax-exempt. Because of this tax advantage, it is difficult to compare the returns from municipal bond funds to other bond funds. Later on, we will learn how to compute the taxable-equivalent yield of municipal bonds and municipal bond funds.

The next two categories consist of bonds that are either issued by the United States Treasury or an organization that is somehow backed by or associated with the United States government. Over the decades, the United States government chartered various private institutions such as Fannie Mae and Freddie Mac and other such entities. Their purposes were to issue bonds to raise funds for such worthy goals as increased home ownership and offering student loans. The representatives in the United States Legislative branch of government, the Congress, and the Executive branch of government, the White House, always maintained that these institutions were separate from the United States government. No way would the United States taxpayer ever be asked to bail them out of default. Over the years, the investment community never believed these assertions. The bonds issued by the organizations were normally considered to be as safe as those from the United States Treasury.

In the Global Financial Crisis of 2008, the investment community's belief was borne out. When Fannie Mae and Freddie Mac and others were in danger of default, none other than the United States Treasury came to the rescue. As of this writing, these companies are still under the protection of the United States Treasury. Thankfully, they have come back from the brink of disaster and now add billions of dollars of earnings to the Treasury each year. Although there is often much talk about how important it is for the government to extricate itself from these institutions, there is very little agreement about how it should be done. Consult your Political Science professor for more discussion of this particular controversial topic.

The last category consists of United States Treasury bond mutual funds. They are also often referred to as government bond funds. These carry the least amount of risk of default. The United States Treasury has never defaulted and it is safe to say that it will never default in our lifetimes. Over the past few decades, the issue of raising the debt ceiling has come into the news. There have been times when rabble-rousing politicians have threatened default by not allowing the debt ceiling to be raised. This is pure political theater. The United States government will pay its debts. In fact, there are constitutional experts who argue that the debt ceiling is a ruse and can be ignored by the Treasury. The 14th Amendment of the Constitution states, "the validity of the public debt of the United States, authorized by law...shall not be questioned." This is yet another delicate matter for your long-suffering Political Science professor.

One often overlooked aspect of Treasury bond mutual funds is that the interest from Treasury bonds is exempt from state and local taxes. Hence, the interest from Treasury bond funds is also exempt from state and local taxes. This is an important benefit for those investors in higher tax states such as California and New York.

As we did with stock mutual funds, we will overlay two additional types of categories, the domesticity and the maturity of the bond funds. The categories of domesticity are identical to the stock mutual fund categories, namely domestic, global, and international, as is the risk versus reward profile. The second type of category refers to the bond maturity within the bond mutual fund. When will the bonds repay their principal? There are three broad categories, long term, intermediate term, and short term. Long term bond funds typically have bonds that will mature in 7, 10, 20, and up to 30 years. Intermediate term bond funds favor bonds that mature in approximately 3 to 5 years. And short term bond funds will populate their funds with bonds maturity in 1 to 2 to 3 years.

With regard to the risk versus reward profiles, one might be tempted to liken these categories to the large-cap, mid-cap, and small-cap categories of stock mutual funds. Large and long both start with the letter L, small and short both start with the letter S, and the terms mid and intermediate are very similar, right? The reality is that they are exactly the opposite from one another. Long term bond funds are the riskiest and offer the greatest returns, short term bond funds are the least riskiest and offer the least returns, and intermediate term bond funds fall somewhere in between the two. Upon further investigation, this scenario fits with the facts. With regard to lending your money to others, the longer the time frame, the more opportunities there are for adverse events. Hence, investors would require a higher rate of return. The opposite is true for shorter time frames. In fact, short term bond funds start to resemble short term securities such as money market mutual funds as the maturities get closer and closer to short term time horizons such as three, six, or nine months.

As they did in the stock mutual fund world, the mutual fund industry is guilty of the same fragmentation in the bond mutual fund world. According to the industry, more options is obviously better and so we experienced the same explosion of permutations and combinations of bond mutual funds as we saw with stock mutual funds. Referring again to the mutual fund scramble sheet, we randomly chose one category from column A, one from column B, and one from column C and, lo and behold, we brought forth a mythical domestic, long term, high-yield bond fund, just one of dozens and dozens of variations. So did the mutual fund industry but their creations are factual funds that contribute to the further bewilderment that is choosing a mutual fund.

## Balanced Funds

The next category of mutual funds is balanced funds. Balanced funds traditionally offer a balance of stocks and bonds and are one of the original categories of mutual funds. Indeed, the nation's oldest balanced fund has been around since 1929 so the idea of blending stocks and bonds together is not new. Since we said that we would be moving from the most riskiest to the least riskiest, one might be tempted to exclaim, "Wait a minute! If you blend stocks and bonds together, wouldn't the resulting investment be less risky than stocks but more risky than bonds?" The answer is no. Balanced funds often exhibit less risk than either stock mutual funds or bond mutual funds. The reason has to do with the history of stock and bond price movements. Although every market downturn is different, in the past, often when the stock market fell, the bond market rose or at least stayed relatively stable. We will discuss this phenomenon in more detail much later on. It has to do with the aforementioned negative correlation of stock and bond prices.

Typically, balanced funds will have an approximate allocation of 60% stocks and 40% bonds. The investment advisor can adjust the allocation as conditions in the economy and the stock and bond markets warrant, but in general, responsible money managers strive to stay balanced. One of the nation's oldest and largest balanced funds states in its prospectus that the fund is "managed as the complete U. S. investment program of a prudent investor." They can never be more than 75% stocks, 25% bonds or less than 50% stocks, 50% bonds.

Balanced funds are not immune to the confusion and puzzlement endemic in the mutual fund industry. A category of mutual fund that is closely associated with balanced funds is asset allocation funds. Asset allocation funds spread their investors' money across stocks, bonds, and money market securities. They are similar to balanced funds, however, the investment advisor often more diligently tries to "fine-tune" the allocation as market conditions change. Whereas a balanced fund usually stays around 60% stocks and 40% bonds, an asset allocation fund might try to move money into cash when they thought the stock and bond markets might fall. Or they might move all the assets into stocks if they believed the stock market was ready to surge ahead. Critics at times accuse some asset allocation fund managers of being stealth market timers. For all their hype, the returns of many asset allocation funds are very close to balanced funds. Some asset allocation funds trail balanced funds considerably because they "timed the market" badly.

Adding to the befuddlement with regard to balanced funds comes from the tendency of some in the industry to also describe balanced funds as blend funds. Recall that the term blend funds was also used to describe growth and income stock mutual funds. However, even with all the accompanying unsettling distractions, well-managed balanced funds are a prudent choice for investors, especially for those who are nervous about investing in the stock market alone. They also become excellent options for those in retirement who are in good health with statistically many years of life ahead of them. Balanced funds allow us to eat reasonably well and sleep reasonably well.

## Money Market Mutual Funds

The mutual fund category with the least amount of risk is money market mutual funds. We covered money market mutual funds, usually just referred to as money markets, in detail in chapter 1 in the section on short term securities. To review, although money market mutual funds are not guaranteed by an entity of the Federal government, they are very secure. And we now understand that low risk investments are accompanied by low returns. Currently, at the time of this writing, money market mutual funds are paying close to zero percent interest. Money market mutual funds are a place to park your money in the short term.

We have run through the major categories of mutual funds, from the riskiest to the least risky. It is now time to turn our attention to a few other categories of interest.

## Mutual Funds of Mutual Funds

It was inevitable that it had to happen. There are now mutual funds that invest in other mutual funds. Some might throw up their hands in frustration and exclaim that the industry has simply gone mad. However, upon further investigation, we find that there are legitimate reasons for these so-called funds of funds. Many employers offer employer-sponsored retirement plans such as 401k or 403b plans to their employees. In an effort to promote their employees to save for their retirement, employers would often automatically place 3% or 4% or 5% of the employees' salaries into the plan. The employee always has the option to "opt-out" of the plan but empirical evidence has shown that employees tend to allow inertia to take its course and the retirement savings continue with interruption. There was, however, a serious problem with this system that concerned the choice of investments.

Whenever an investment choice is recommended, whether explicitly or implicitly, if the investor is not happy with the choice, there is always the possibility that the investor may sue the individual or organization that made the recommendation. The investor may claim that the investment was not suitable to their circumstances, especially if the investor experienced unsatisfactory results. To guard themselves from these legal actions, employers would typically automatically place the savings into short term investments such as money market mutual funds. These are very safe but also very low-yielding. For someone just starting out in their careers, short term investments are certainly not the most desirable long term choices. Something needed to be done.

The Pension Protection Act of 2006 gave employers legal protection from lawsuits if the employer used an appropriate fund of funds for their employees. These funds are often called target-date mutual funds. They also go by the names target-retirement or lifecycle. The mutual fund manager then appends a year to the name. This year corresponds roughly to the approximate year that an employee plans to retire. For example, the Federal employees' Thrift Savings Plan offers their so-called Lifecycle funds from Lifecycle 2025, Lifecycle 2030, on up to Lifecycle 2065. The Thrift Savings Plan uses the employee's year of birth and chooses the appropriate Lifecycle fund. For the underlying investments in the funds, the manager chooses a mixture of other mutual funds that are appropriate for the year that the employee plans to retire. When the year of retirement is in the distant future, the investments are more growth oriented. As the year of retirement approaches, the underlying investments become more and more risk averse. Of course, the employee has full control over their contributions and the investments in their account but as mentioned, often employees simply allow the system to make the choices for them.

Funds of funds are also popular for investors saving for a child's education with names like College 2030 and College 2035. They are often paired with tax-qualified educational savings accounts such as 529 plans. The tax advantages of these plans are often skewed toward high net worth and high income families. For many others, a Roth IRA or other account might be a better alternative.

## Specialty "Boutique" Funds

The mutual funds categories and types above constitute the majority of mutual funds available and hold the vast majority of investors' assets. However, there are numerous speciality funds available. They are sometimes referred to as "boutique" mutual funds. The competition in the mutual fund industry is ferocious and new companies must do their best to differentiate themselves from other funds to attract investors. It is not hard to argue that many of these attempts have resulted in outlandish and laughable results. There was the StockCar Stocks fund that invested in companies that sponsored Nascar races. There was the Pauze Tombstone mutual fund that invested in cemeteries, mortuaries, and casket makers. The investment manager of The Timothy Funds "avoids investing in companies that are involved in practices contrary to Judeo-Christian principles" and that it tries to "recapture traditional American values." Not to be outdone, The Amana Funds invest with Islamic principals foremost in mind which include avoiding interest, gambling, pornography, liquor, and pork. But the silliest of all attempts must be The Chicken Little Growth Fund for investors who were afraid that the sky is falling.

Obviously, such gimmicks and grandstanding should be met with more than a skeptical eye by prudent, long term oriented investors. However, there have been some specialty funds that may deserve your attention. Some investors want to invest in more than just stocks and bonds and there are mutual funds that will allow them to do so. Some sector mutual funds invest in real estate, typically through Real Estate Investment Trusts (REITs). Also worthy of attention of a select group of investors are commodities funds.

### Social ESG – Index Funds and Exchange Traded Funds (ETFs)

### Derivative assets

### The Great Debate – Active Management versus Passive Management

Here it is, D

### The History of Passive Management

Investment risk, on the

### Index Funds

perilous. .

### Exchange-Traded Funds (ETFs)

Some

### The Financial Media Orthodoxy versus Not So Common Sense Heresy

After certainty.

## Mutual Fund Families and Fund Services

To review, s

### Mutual Fund Families

As we.

### Mutual Fund Services, Transactions, and Sources of Information

es, sh

## A Sample Mutual Fund

To review, s

## "Okay, So How Do I Pick a Mutual Fund?!"

ac

## ICA: Investment Company of America, A Sample Mutual Fund

does n

## Dollar-Cost Averaging

Systematic Investment Plan (SIP?)

Hypothetical Illustrations

gov is the subject of one of your chapter 1 assignments.

## Mutual Fund Returns versus Investors' Returns

T

## The Bottom Line on Mutual Funds

not have the

# Congratulations – You Have Finished Chapter 2 – Mutual Funds: Investments for the Masses

We

## There is a Future for You in the Investment Services Industry

Have you enjoyed listening to and watching the presentations and reading the text? Instead of being dry and dull, did the material seem exciting and promising to you? Can you envision yourself relating this material to potential clients who are terrified of investing but know they need to do something soon because they are not getting any younger? Would you like to help them understand that investing is not as difficult as it seems and that can you show them investments that are prudent, long-term oriented, and have performed well over decades?

If so, please consider pursuing a career in the industry. The financial and investment industry is enormous. The industry is always looking for new, energetic individuals. There are numerous career path opportunities. From banking to real estate finance to insurance to brokerage firms, there is a place for you. In fact, the industry is actively seeking bilingual speakers and women.

Going forward, they understand that diversity is essential to the success of their businesses. They simply love ex-military folks. (The financial industry is highly regulated and who better than those who have already lived and worked in a structured, regulated environment?)

Here at Southwestern, we offer an Associate in Business Administration with an Emphasis in Finance. We also offer a Certificate of Achievement in Financial and Investment Services. Either of these will help you land a position at a bank or credit union, an insurance company, a real estate finance firm, a brokerage or other investment management company, or any of the many other finance-related and investment-related companies.

You don't believe me? You think you need a four-year degree from a prestigious university? Aha! You are wrong! The dirty little secret in our industry is that a degree from a prestigious university is not a guarantee that someone will perform well as a financial adviser with the general public. The recruiters will tell you that they have no reliable method for predicting how someone will do in the industry. Someone with a certificate from a community college might surpass a whole room full of graduates from the Ivy League universities.

I have my own predictors. Are you a positive, optimistic person with a sunny disposition? Do you like to socialize? Do you enjoy meeting new people? Do you want to help them succeed? Are you not afraid to ask someone if they need your help? If they say, "No," are you still willing to go to the next person and ask the same question ... and then go on to ask twenty-seven more people? In short, are you a go-getter who refuses to give up? Will you never give up?

If you can answer, "Yes," to all or most of these questions (especially the part about never giving up), I guarantee you will do well in the industry. You might bounce around from one position to another for a bit but you will find your place. Talk to a counselor about our programs. Or better yet, please contact me at home or via email. I gotta' warn ya'! I can talk about finance and investments far longer than most any reasonable person would ever want to listen.

I wish you all tremendous success in the future and I look forward to talking to you about a potential career in the finance and investment industry.

P.S. Did I mention that salaries in the financial and investment industries are well above the national norms? Hmmm? Think about it seriously, Dear Students. The investment industry needs you!

Your Feedback, Please

Are you lways contact me directly if you have any questions, comments, criticisms, suggestions, complaints, etc.

We are now ready for stock. Exciting stocks! Sexy stocks! Risky stocks! You, Dear Students, are going to be the Investment Guru for your family, friends, and fellow co-workers. You Can't Let Them Down! See you in our next chapter.