Mutual Funds Come in Many Formats

What is the difference between a mutual fund and an index fund?

With the abundance of theme funds available, and the ever-expanding number of growth funds, value funds, balanced funds, bond funds, tax-free funds, socially conscious funds, and more, how can an individual investor efficiently establish a broadly diversified account? Index funds.

Index mutual funds try to mirror, not outperform, the results of the securities listed on a particular index – such as the S&P 500. The S&P 500 comprises 500 widely held large-cap American stocks (Coca Cola, General Electric, IBM, McDonalds, Merck, etc.), and covers about 75% of the capitalization of the entire market. You can easily find indices of the NASDAQ 100, the Russell 2000, the Wilshire 5000, and various other small-cap, precious metals, international, and emerging markets listings as well. Whether the underlying index represents blue-chip corporations or more speculative companies, a mutual fund based on a particular index enables shareholders to own a portion of every included holding.

Is it a bad idea to buy into an index fund knowing that you will only reap an average return? Not at all. In many cases, index funds have outperformed diversified, general equities, and sector funds. In fact, professionals frequently debate the merits of active versus passive management. In support of passive investing, lower fees help the performance of index funds. Since their composition rarely changes, they have limited turnover (amount of trading each year) inside the fund. Less trading means fewer commissions. Moreover, having less activity means fewer opportunities for taxable capital gains like you find in actively managed funds. Managed mutual funds average a turnover rate of about 85%, meaning that most of the holdings change on an annual basis. Compare that with index funds, which normally see well under 10% variation year over year.

Since many indices use the "capitalization weighted" model to determine which positions have more sway on the return of the index, often a few stocks (like Exxon Mobil and Apple) represent a disproportionate amount of the fund. In other words, an index such as the S&P 500 will give more weight to larger companies, and thus its value will reflect the price movements of a fairly small number of stocks. So even though the "500" in the name of the index correctly refers to 500 individual companies in the portfolio, the top 10 holdings represent about 20% of the index's return – which is not much diversification. In fact, the single top holding, Apple, represents a greater percentage of the index than the bottom 100 stocks combined. You may want to own a fund with top-heavy weighting, so purchasing a capitalization weighted index fund makes sense. However, don't buy into such a fund believing it will diversify your money equally among all the elements of the index.

Open-end mutual funds

Most fund companies come under the heading of "open-end mutual funds." This means that they issue new shares to meet buyer demand (at a cost calculated daily, based on the net assets of the company divided by the number of outstanding shares) and buy back the shares when investors wish to sell (based on the same calculations). The fund's capitalization and number of outstanding shares changes daily.

Closed-end mutual funds

Most of the time, when people talk about mutual funds, they're referring to open-end funds. But closed-end funds (CEFs) have been on the scene for a long time and share many similarities with their more popular counterparts. Both types of funds employ professional managers, and both provide a diverse selection of holdings (often with a particular theme). However, their shares trade differently. With open-end funds, the company issues and redeems shares. If you want to buy shares, the fund receives your money (either directly or through your brokerage firm) and then creates new shares for you. When you sell, the fund liquidates shares and sends the proceeds to you or to your brokerage account.

In the case of closed-end funds, however, the managers raise a large amount of capital in the form of an initial public offering (IPO). They collect the money and issue a finite number of shares at the outset. Investors thereafter wishing to purchase shares or get rid of their current holdings have to go to the stock exchange and buy or sell at prices set by supply and demand.

For example, if ABC Investment Strategists, Inc. wishes to create a closed-end stock fund, they may hire XYZ Brokerage Firm to help them raise $100 million. Once the money has been collected, ABC will begin trading with that cash. The people who put money in originally will each own a piece of the ABC portfolio. If you missed the original offering and want to own some of those shares, you would then have to buy them from a current owner at the market price. You would not have any direct interaction with ABC itself, because they no longer create new shares; they simply manage the closed portfolio.

Discount or premium

In many cases, the price per share of a closed-end fund will closely correspond with the actual value of the securities within the portfolio. In fact, it makes sense. You should expect the price per share to trade in line proportionally with the sum-total value of all the holdings (known as the "net asset value," or NAV). Sometimes, however, the price per share and the NAV fall out of line. If you could buy shares of the fund at a price below the actual NAV, you would say that the fund is "trading at a discount to NAV." In the opposite case, where the price per share is greater than the NAV, it's trading at a "premium."

Factors that create a discount or premium

If a fund had a net asset value of $10 per share, would you pay $11 per share – thus buying at a premium? Likewise, if you held a fund with a $12.50 NAV, would you sell it below that price at a discount? Many different factors influence the trading price of a closed-end share versus its actual, underlying net asset value. For example:

- **Out of sight**. Unlike open-end funds that advertise in order to increase their asset base, closed-end funds operate in relative obscurity. These funds have no reason to advertise, since they don't collect more money if more people own shares. In fact, if they spend money on advertising, they'll diminish their asset base and negatively affect their performance. Moreover, less money in the pot means slimmer management fees. Lacking the exposure of their more conspicuous cousins, closed-end funds generally command less attention, which leads to weaker demand, and thus they may trade at a discount to NAV.

- **Lagging performance**. If a fund's results trail a comparable index, large numbers of investors may sell, and new ones may not line up to buy. This lack of demand for shares will erode the price. In addition, as shareholders lose faith in the fund's managers, the share price will drop (as investors look to sell their shares) even if the underlying assets that define the NAV retain their value. There have been cases where the shareholders of funds trading at deep discounts have voted to disband the fund, sell off all the assets, and then actually profit by walking away with their share of the true value of the underlying companies and not the prevailing price per share. Even though many CEFs may trade at a discount, this type of scenario is very rare.
- Sometimes investors cannot readily buy certain stocks on foreign exchanges. When a country limits foreign investment or imposes certain restrictions, for example, a fund might offer the only route for individuals to get in on the action. That exclusivity may cause a greater demand for the CEF, thereby creating a market premium.
- **Priceless portfolios**. "Priceless" here doesn't mean expensive. Rather, traders cannot always establish a price for some investments – such as unusual bond issues, private placements, bankrupt companies, parcels of real estate, penny stocks, and more. CEFs that specialize in these more illiquid securities tend to trade at a discount because the funds' managers cannot quickly convert the assets into cash.

Tax exposure with closed-end funds

Like open-end fund buyers, CEF investors must also bear the brunt of the capital gains that the funds return. Often, a long-established CEF may hold large positions in highly appreciated stocks. If the fund sells those shares and pays out a capital gains distribution, its current shareholders must pay the tax on the gains. Immediately following these distributions, the share prices usually drop. Knowing about the potential tax liability could cause investors to shy away from a CEF, which would inevitably lead to its trading at a discount to NAV.

Pros and cons of open- and closed-end mutual funds

In addition to structural distinctions between open- and closed-end funds, there are differences in the managers' actual trading styles. Those in charge of open-end funds have to deal with fluctuating amounts of available money, as ups and downs in the markets often convince investors to buy in large amounts – thus loading up the fund with an influx of cash – or sell on bad news, making it necessary for management to dig into cash reserves, or even sell positions in order to redeem investors' shares. Closed-end fund managers, on the other hand, can invest following a pre-determined plan since they know in advance how much capital they have available. Along these same lines, closed-end fund managers can more easily invest in speculative or less liquid investments that they feel have great promise because they know the shareholders can't force them to sell at an inopportune time by redeeming shares. Note that open-end funds trade only once per day. In comparison, you can buy and sell CEFs throughout the trading day since they trade on a stock exchange.