Investors' Chronicle

Investing explained

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Investing in funds

Whether you want to try to outsmart the market or simply follow its rise, a plethora of funds are available for different investors. Understanding the most important differences can be key to picking the best options for you.

Funds are a great route to investing, regardless of your level of knowledge or interest. A basket of different investments, they spread your money more widely than if you were to buy shares directly. This should reduce the risks.

Having said that, investors can understandably feel overwhelmed by the sheer amount of choice on offer, with thousands of funds available. Add to this the confusing jargon commonly thrown around and even experienced investors can quickly feel out of their depth. A few basic ideas should help you navigate the funds universe and find the best option.

There are many important distinctions between funds. A good starting point is asking whether they are active or passive.

Passive

Passive funds (sometimes called trackers) provide exposure to an entire market, such as the FTSE 100 in the UK, the S&P 500 in the US, or the global MSCI World index. These funds will give almost the same returns as the market, good or bad, minus a fee. Those fees (sometimes referred to as ongoing charges or total expense ratio) tend to be extremely low. In the case of a FTSE 100 tracker, these should charge less than 0.1 per cent of your investment. That would be 10p on a £100 investment pot, for example.

Active

Active fund managers mainly look to outperform a given market by picking its best investments. A US manager may look to grow your money by more than an S&P 500 tracker, for example. Some managers do have slightly different goals, such as protecting your money in a market crash, focusing on a certain theme or picking investments that pay a regular income.

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Author: Dave Baxter

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Key characteristics

Active	Passive
An investment team manages the fund, and tries to pick the best selection of investments for a purpose	A fund with broad market exposure by tracking an index, such as the FTSE 100
Often they will be trying to grow their portfolio by more than the relevant market over a period of a few years	You simply get the same performance of the market (minus a small fee)
They tend to charge a good amount more than passive funds	Extremely cheap, especially in the established markets
While some active managers generate much more money than passives, most active funds have failed to consistently beat the market	Passives have done extremely well in recent history
Some teams have other goals than 'beating' the market, such as protecting your money in a market crash	Some worry good performance may not continue
Active might appeal if you wish to target a certain theme, or want an investment aligned with your personal ethics.	

Types of passive

Back to passive, they can come in two different structures:

- Exchange traded funds (ETFs): [View IC top 50 ETFs]
- Open-ended funds (often referred to as index funds)

There are subtle differences between the two. ETFs and open-ended passives don't vary hugely in how much they charge, but you will also be charged by the investment platform you use to hold and trade them. Platforms tend to have different charging structures when it comes to shares (which includes ETFs) and funds. Sometimes it can make sense to choose one over the other because of the charging structure.

ETFs can also be traded more quickly, and their shares are regularly repriced when the market is open, meaning you can almost instantly buy or sell at different prices. Open-ended passive funds take longer to trade and are only repriced once a day, often at midday. That means you could tell a platform to sell the fund at 3pm one day but have to wait for the price to be set the following day.

Types of active

There are two main active fund structures, and these come with big differences:

- Open-ended active funds (terms like 'Oeic' and 'Unit trust' tend to describe these)
- Investment trusts (also called closed-ended funds)

Open-ended active funds are relatively simple. An investor pays for a 'unit' in the fund, and the value of that unit will grow or shrink depending on the performance of the investments. When you sell back your unit, the manager should give you the money within a few days.

This is important, because it means the manager often has to raise the money by selling investments relatively quickly. Investment trusts are different: you buy or sell their shares on a secondary market, meaning the manager has no need to provide existing investors with cash. That means they can hold investments that are less 'liquid', or less easy to buy and sell quickly.

This means that while open-ended funds are fine for holding shares in major companies, investment trusts can be better for unusual but hard to sell investments such as:

- Physical property, such as an office block.
- Infrastructure projects, from solar farms to bridges and schools.
- Investments in private companies – those that do not have shares listed on a stock market.
- Smaller companies – those whose shares have a small total value, and which can be less liquid.
- Private loans.
- Music royalties.

Other differences

Investment trusts come with other differences to open-ended funds:

- The price of their shares can differ from the value of the trust's investments. This means the shares can trade at a premium to that value (referred to as the net asset value, or NAV), or at a discount. Investors sometimes try to bag bargains by buying in at discounts, although this can be risky.
- Investment trusts can be more volatile due to share price movements.
- Investment trusts can borrow money to invest more – something called gearing. The use of gearing will amplify the performance of the trust, meaning bigger gains when things go right and bigger losses when things go wrong.
- Those trusts that receive dividend payments from their holdings can hold a proportion of these back and keep a "revenue reserve" they can use to top up their own dividend payments in difficult times. There is no obligation on trusts to actually use these reserves
- Generally, these characteristics make investment trusts more complex, but tools such as gearing can help them perform better than open-ended funds when markets rise

Active versus passive

Passive funds are a great choice for beginner investors because they are often very broad – meaning your money is well-diversified across different companies, reducing risk. Active funds have less predictable results.

Over the past decade, active managers have struggled to beat the US equity market, which has been dominated by a few giant tech companies. Because most of the MSCI World index is in US shares, global managers have also struggled. Active funds in out-of-favour markets such as the UK have done slightly better.

One area where active funds do fare well is in smaller companies. These shares tend to be less well-researched, giving active managers a chance to find hidden gems. Active funds are also a good route to many of the illiquid asset classes available in investment trusts. Many of these investments are not available via a passive fund.

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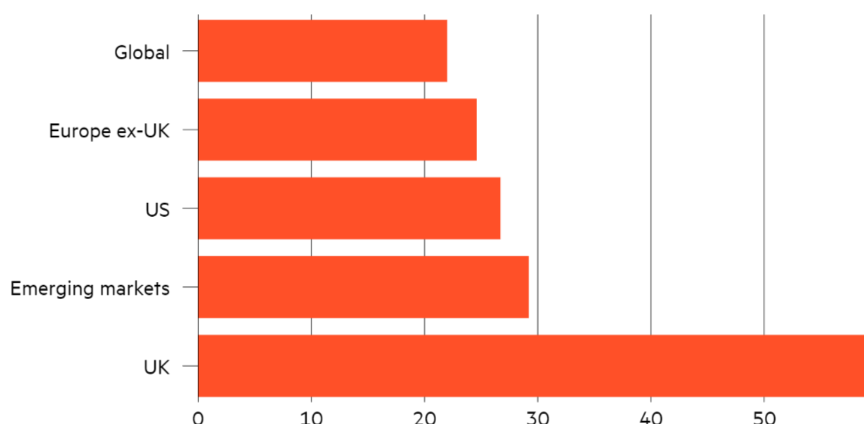
MANY ACTIVE FUNDS STRUGGLE AGAINST THE MARKET

Proportion that beat the relevant index over five years to 30/06/21



Sterling-denominated funds
Source: Spiva Europe Scorecard

Finding a good fund

There are thousands of funds available, but plenty of online resources can give you a starting point. Many investment websites offer lists of their favourite funds, and there are several investor forums where possible ideas are discussed. Remember that this should just be a starting point for your own research, which can include reading commentaries and analysis from the manager of the fund and third-parties.

When it comes to identifying a good fund, that's fairly easy with passives. You want it to target the most relevant market, such as the S&P 500 if you want broad exposure to the US. It should also not charge much – as noted, this should usually be less than 0.1 per cent in the big markets.

With active funds it gets trickier. Asking the following questions might help:

- What's the theme behind the fund, and does that appeal to me?
- How has the fund performed in the past, and does the future look bright for what it does?
- How risky is the fund, and am I happy to ride out difficult periods? Funds investing in more exciting areas, such as private companies or emerging markets, might be taking more risk.
- What does this fund do better than its rivals, including passives? What makes it stand out?

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Building your portfolio

If you are starting out with limited knowledge and limited money to invest, buying a broad fund often makes sense. That could be a global passive fund, a 'multi-asset' passive that holds shares and some other investments such as bonds, or an active global fund that invests fairly widely, for example.

If your interest in investing grows over time, you may want to start taking a more targeted approach. But remember the risk of what's called "diworsification", where people buy too many holdings. Because funds are already pretty diversified, holding too many can often mean you end up spreading your money too thinly, offsetting the effects of good investments. You also end up paying multiple fund fees.

With passives, a very small number of funds – even just one – can give you broad exposure to the world's stock markets. If you want to get more targeted, it can make sense to use a 'core/satellite' approach. This involves having most of your money in a broad fund, and then having much smaller investments in more niche funds.

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