

And...we're back! A few months ago, we started a series of letters called "Questions You Were Afraid to Ask." Each month, we look at a common question that investors may have but feel uncomfortable asking. Because when it comes to investing, the only bad question is the one left unasked!

In our last letter, we looked at two categories of investment funds – passively managed funds and actively managed. Both come with their own pros and cons. But regardless which categories you choose to invest in, there are many types of funds *within* those categories. This month let's look at three of those types. This is important information to know, because many IRAs and 401(k)s will give you the option of choosing from at least two of them.

Questions You Were Afraid to Ask #5: What Differentiates Mutual Funds, Exchange-Traded Funds, and Hedge Funds?

Let's start with **mutual funds**, one of the oldest and most common ways that people invest. Here's how the Securities and Exchange Commission (SEC) defines mutual funds:

*A mutual fund is a company that pools money from many investors and invests the money in securities such as stocks, bonds, and short-term debt. The combined holdings of the mutual fund are known as its portfolio. Investors buy shares in mutual funds. Each share represents an investor's part ownership in the fund and the income it generates.*¹

As we've already covered, mutual funds can be either actively managed or passively managed. Regardless of which umbrella the fund falls under, though, many investors flock to mutual funds because they offer several potential benefits:

- **Simplification.** Mutual funds can simplify the process of investing because instead of devoting time to researching dozens – or even hundreds – of individual companies to invest in, the fund does it for you. (Note, of course, that you or your financial advisor should still research which *fund* is right for you.)

- **Diversification.** Mutual funds often invest in a wide range of companies and industries to meet the funds stated objective. This could lower your overall risk. This means that if one company/industry does poorly, you may not experience the same kind of loss you would if you invested *all* your money in that company or industry.

There *are* potential issues with mutual funds, though. For example, sometimes, it can be difficult to understand what or how the fund actually invests (Mutual funds can differ *drastically* depending on their objectives, investing style, time horizon, and other factors.) Mutual funds are required by law to provide a **prospectus** to investors that explains how the fund works, but if you don't know what you're looking at, this information may confuse more than enlighten. This is why it's important to do your homework. (And by the way, everything in this paragraph is true for Exchange-Traded Funds (ETFs) and hedge funds, too.)

Mutual funds can also sometimes come with more expenses than other funds, too. They might include management fees, purchase fees, redemption fees and tax costs. These expenses can eat into your returns, thereby lowering your overall profit.

Finally, mutual funds may not be a great choice if immediate liquidity is a high priority. All mutual fund trades run at the end of day. So, for example, if you wanted to sell a mutual fund at the beginning of the day, hoping to avoid what you think the market will do, you will still get the end of day price. For this reason, some investors turn instead to...

Exchange-Traded Funds

ETFs can be actively managed. More often, however, they track the companies in a specific index, just like an index fund. (See our last letter for more information on index funds.) Otherwise, ETFs differ from mutual funds in a few ways. For one thing, the shares each investor has in an ETF can be traded on the open market. That means you can buy or sell your shares in an ETF just like you would an individual stock. You can't do that with regular mutual- or index funds. That's a big advantage for investors who value flexibility and liquidity.

Most ETFs also come with lower expenses than mutual funds.² ETFs fully disclose all holdings held. This makes it easier to see exactly what you are investing in. It also makes it easier to see where you have overlap.

But of course, nothing's perfect. Since ETFs can be traded like common stock, that might lead to trading too often. You may find yourself paying more than you anticipated in trading fees. Then, too, some ETFs are thinly traded, meaning there's just not a lot of activity between buyers and sellers. This could make it difficult to sell your shares.

Hedge Funds

Most people will never invest in a hedge fund. They're generally not an option when investing through a 401(k) or IRA. But we include them here because we often get asked about them – and for good reason! You often hear about hedge funds in the media, and they're the subject of multiple films. While mutual funds and ETFs can be either passive or actively managed, hedge funds are *always* active. The idea behind hedge funds is that the manager can use all sorts of strategies and tactics to help investors beat the market while “hedging” – hence the name – against risk. Hedge funds often invest in non-traditional assets beyond stocks and bonds, too.

The reason hedge funds are not an option for most investors is because of the huge cost associated with them. Legally, to invest directly in a hedge fund you must be an accredited investor. Meaning, you must have a net worth of at least \$1 million or an annual income over \$200,000 to invest in one. Plus, you must be willing to stomach paying all sorts of fees that are *much* higher than your average mutual fund. For these reasons, while hedge funds may be right for some people, they're simply not necessary for the average investor to save for retirement or reach their financial goals.

Whew! We've thrown a *lot* of information your way over the past few months, haven't we? That's why, for our letter of the series next month, we're going to look at the most important question of all: How to know which investment options are right for *you*.

Have a great month!

Sincerely,

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¹ "What are Mutual Funds?" *Securities and Exchange Commission*, <https://www.investor.gov/investing-basics/investment-products/mutual-funds>

² "ETFs vs Mutual Funds," *Kiplinger*, <https://www.kiplinger.com/investing/etfs/602576/etfs-vs-mutual-funds-why-investors-who-hate-fees-should-love-etfs>

Disclosure: Alternative investments, such as hedge funds, funds of hedge funds, managed futures, private capital, real assets and real estate funds, are not appropriate for all investors. They are speculative, highly illiquid, and are designed for long-term investment, and not as trading vehicle. These funds carry specific investor qualifications which can include high income and net-worth requirements as well as relatively high investment minimums. The high expenses associated with alternative investments must be offset by trading profits and other income which may not be realized. Unlike mutual funds, alternative investments are not subject to some of the regulations designed to protect investors and are not required to provide the same level of disclosure as would be received from a mutual fund. They trade in diverse complex strategies that are affected in different ways and at different times by changing market conditions. Strategies may, at times, be out of market favor for considerable periods with adverse consequences for the fund and the investor. An investment in these funds involve the risks inherent in an investment in securities and can include losses associated with speculative investment practices, including hedging and leveraging through derivatives, such as futures, options, swaps, short selling, investments in non-U.S. securities, "junk" bonds and illiquid investments. The use of leverage in a portfolio varies by strategy. Leverage can significantly increase return potential but create greater risk of loss. At times, a fund may be unable to sell certain of its illiquid investments without a substantial drop in price, if at all. Other risks can include those associated with potential lack of diversification, restrictions on transferring interests, no available secondary market, complex tax structures, delays in tax reporting, valuation of securities and pricing. An investment in a fund of funds carries additional risks including asset-based fees and expenses at the fund level and indirect fees, expenses and asset-based compensation of investment funds in which these funds invest. An investor should review the private placement memorandum, subscription agreement and other related offering materials for complete information regarding terms, including all applicable fees, as well as the specific risks associated with a fund before investing.