THE H. KENT BAKER INVESTMENTS SERIES

THE SAVVY INVESTOR'S GUIDE TO POOLED INVESTMENTS

Mutual Funds, ETFs, and More

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If there's a book that you want to read, but it hasn't been written yet, then you must write it.

Toni Morrison

We took Toni Morrison's advice to heart and wrote *The Savvy Investor's Guide to Pooled Investments – Mutual Funds, ETFs, and More*. Many people played an important role in this process. We thank our partners at Emerald Publishing for their many contributions, especially Charlotte Maiorana (Senior Editor) and Nick Wolterman (Assistant Editor). We also appreciate the research support provided by our respective institutions – the Kogod School of Business at American University, Black School of Business at Penn State Behrend, and Crummer Graduate School of Business at Rollins College. Finally, we dedicate this book to our families: Linda and Rory Baker; Janis, Aaron, Andrea, Kyle, and Grant Filbeck; and Nilgun and Tunc Kiymaz.

INTRODUCTION

Investing can be a murky business, like driving on a foggy day on an unfamiliar road. It's easy to get confused and you may want to turn around and return home. However, don't stop driving just because weather conditions are not always ideal. Learning how to become a savvy investor is not as hard as it may seem. Once you get through the murky parts, your trip won't be as daunting and you'll also enjoy a smoother and safer ride to reaching your financial goals. As Warren Buffet notes, "Investing is simple, but not easy."

Are you someone who has a relatively small amount of money to invest? If so, you may think that you have only a few investment choices, but you'd be wrong. One of the most common ways to invest is through a *pooled investment vehicle* (PIV). A PIV is an investment fund that commingles the monies of many different investors to buy a portfolio that reflects a particular investment objective. Thus, PIVs are formed by aggregating relatively small investments from many individuals who want to participate in investments that would otherwise be available only to large investors. A wide range of PIVs are available that invest in different assets with distinctive investment strategies. Investing in PIVs can be more accessible and less risky than directly buying shares in individual companies or real assets such as real estate.

PIVs offer many inherent benefits of being part of a group of investors. Perhaps, the most important advantages are professional management and diversification. Additionally, most PIVs are subject to government oversight and many offer high *liquidity*, which describes the degree to which you can quickly buy or sell an asset or security market without affecting its price.

Of course, investing in PIVs isn't without some disadvantages. Two major drawbacks involve costs and a lack of choice and control. In investments, there's an old saying that "There's no such thing as a free lunch," meaning that you don't get something for nothing. You can't invest in PIVs for free. Hence, PIVs charge fees and expenses that eat up part of your returns. Although you can select the PIV in which to invest, you don't have any control over the types of individual holdings that make up the fund. Thus, you can't customize your portfolio. You also have less control over the recognition of income as well as gains and losses for tax purposes.

You should keep in mind that all PIVs, just like all other types of investment, carry risks. Different PIVs have different levels of risk. Thus, before selecting any PIV, you should be sure it offers the right level of risk for you. That is, the PIV could be consistent with your *risk tolerance*, which is the degree of variability in investment returns that you are willing to endure. If you don't have a realistic understanding of your ability and willingness to tolerate large swings in the value of your investments, you are likely to take on too much risk and possibly panic and sell at the wrong time.

Given that you are ultimately responsible for your investment decisions, you need to avoid the common pitfall of investing in something that you don't understand. This is where *The Savvy Investor's Guide to Pooled Investments* comes into play. Although many different PIVs are available, this book focuses on PIVs that are readily available to the general public. For example, you don't need much money to gain entry into open-end funds (OEFs) also called mutual funds, exchange-traded funds (ETFs), closed-end funds (CEFs), unit investment trusts UITs), and real estate investment trusts (REITs). OEFs, CEFs, and UITs have been around for many decades compared to ETFs and REITs, which are relatively recent innovations in the fund business. Although OEFs are by far the largest, this fact doesn't mean that they are always your best choice or that you should ignore other PIVs.

Each PIV shares some fundamental similarities. For example, each investor is a stakeholder in every investment the fund makes in proportion to the size of that investor's holdings in the fund. Yet, distinct differences exist among each PIV in the pooled fund menagerie. Before choosing among PIVs, you should understand the distinctive characteristics of each investment. Remember: Don't ever put money in something you don't understand. As multi-billionaire Warren Buffett notes, "When a person with money meets a person with experience, the one with experience ends up with the money and the one with money leaves with experience."

The Savvy Investor's Guide to Pooled Investments offers a practical guide to anyone interested in gaining a basic understanding of PIVs. It uses a question and answer format to delve into issues that investors want and need to know before choosing a particular PIV. This handy and concise guide helps to uncover the nuances associated with PIVs. Each chapter clearly defines a particular PIV, discusses how it works, explains its advantages and disadvantages, specifies what type of investor is best suited for investing in a specific PIV, and sets forth criteria for selecting a PIV and evaluating its performance. If you are interested in becoming a savvy investor in pooled investments, this book is intended for you.