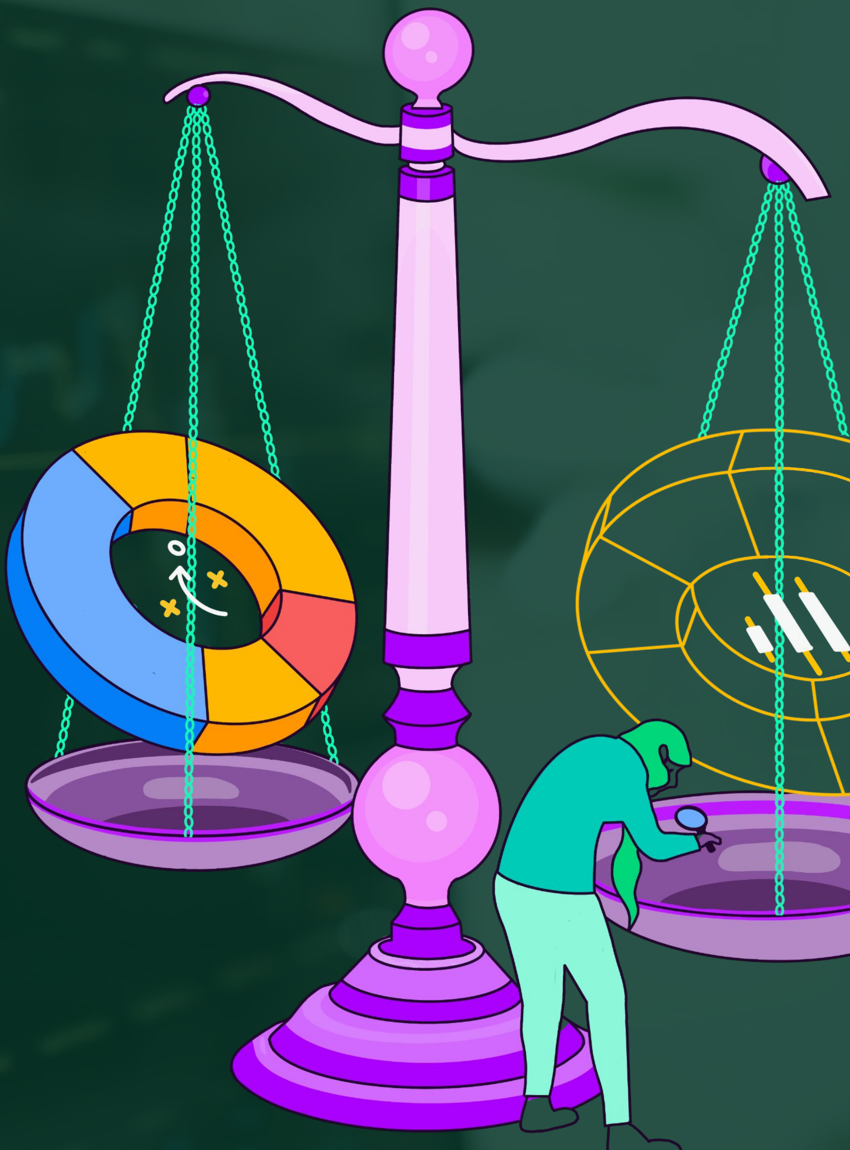
MODULE 10

Diving Into ETFs & Mutual Funds

POWERED BY

Rapunzl



Key Takeaways From This Module

Guiding Questions

- What are ETFs and Mutual Funds?
- How can ETFs and Mutual Funds help build a more diversified portfolio with exposure to hundreds of companies?
- Are there any special tax treatments for ETFs or Mutual Fund which we should appreciate before investing?
- What are Capital Markets and Why are they important?
- How do investment banks help launch an ETF or Mutual Fund?
- What Is An IPO?

Enduring Understandings

- ETFs & Mutual Funds provide a way for investors to invest in a basket of stocks or other assets at a much lower cost than purchasing all of the assets independently.
- ETFs provide investors with the opportunity to own shares in an asset whose performance is designed to mirror a stock index or industry.
- Mutual funds are more actively managed than ETFs, so they may cause investors to incur a greater tax liability.
- Mutual funds make distributions to investors which may provide an additional source of income for some investors.

What Are ETFs?

An ETF (exchange-traded-fund) is a basket of securities that you can buy or sell through a brokerage firm on a stock exchange.

They exist for virtually every conceivable asset class from traditional investments to so-called alternative assets like commodities or currencies.

ETFs are a way to invest in nearly every possible asset through publicly traded "stocks" which track the performance of the security.

An ETF is bought and sold like a company stock during the day when the stock exchanges are open. Similar to a stock, an ETF has a ticker symbol and ETFs trade whenever the stock market is open.

NOTE: Unlike a company stock, the number of shares outstanding of an ETF can change daily. This is because ETF companies continuously create new shares and redeem existing shares to ensure that the market price matches the value of assets owned in an ETF basket.

Why Would Someone Invest In An ETF?

Easy To Trade

An ETF provides investors with an opportunity to buy & sell a basket of assets at any point with only a brokerage account, which is simpler than a mutual fund and easier than many other asset classes. Investors can also place different types of trades which are not available with other assets.

Transparency

ETFs are subject to the same requirements as many major companies with publicly traded stocks, since they are listed on stock exchanges. This means that they must publish their holdings daily, providing investors with insight into what the ETF currently owns at any point in time.

Tax Efficiency

Most ETFs help investors lower the total taxes an investor must pay to invest in a specific asset class. This is due to the benefits of long-term capital gains taxes which allow investors to pay less taxes on their gains, making them a more favorable investment to achieve a diversified portfolio.

Finding ETFs On The Rapunzl App

Alright so you want to get started by purchasing an ETF on the Rapunzl App?

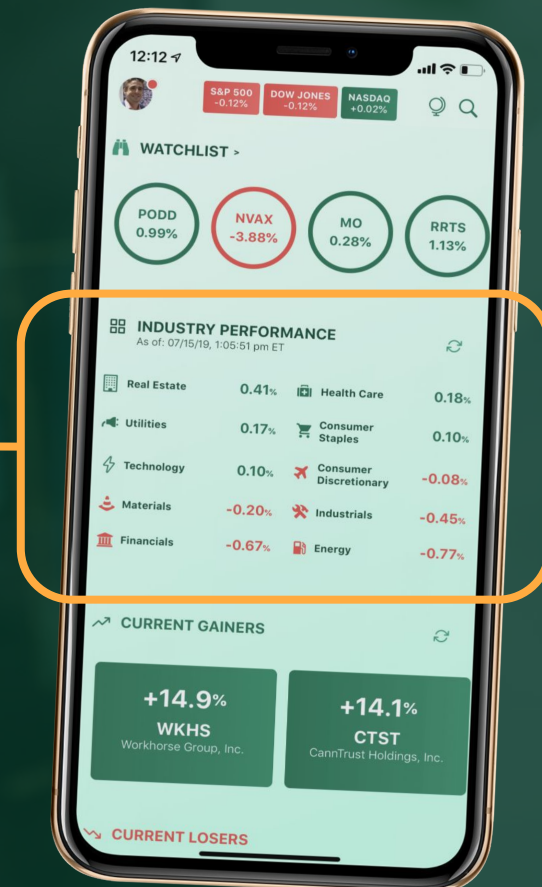
That's a great decision because with one trade, you can gain exposure to hundreds of companies and build a well-diversified portfolio.

We've taken away a little bit of the struggle researching ETFs by organizing some of the largest and most popular ETFs on the Rapunzl Home Screen.

Just scroll down to the Industry Performance Section and tap the header, which will take you to a list with the 10 major industries.

If you select an industry, you can learn more about how the industry performs during different market cycles, understand why some industries have higher risk-reward profiles, and discover ETFs which track companies specific to that industry!

This is a great opportunity to get started. Once you have a portfolio which is exposed to a lot of companies and diversified across industries, you can start using parts of your capital towards specific stocks.



Now, What Are Mutual Funds?

A mutual fund operates as both an investment and an actual company, unlike an ETF which is listed by a company as a security for investors to trade.

A mutual fund starts by raising large amounts of capital from public investors to purchase hundreds of different securities, usually stocks and bonds, which means mutual fund shareholders (similar to investors in ETFs) **gain diversification at a low price**. Similar to an ETF, the value of a mutual fund depends upon the performance of the underlying securities the mutual fund purchases.

The value of the mutual fund company depends on the performance of the securities it decides to buy, however, an investor's performance in a mutual fund is not the same as owning the underlying stock.

Mutual fund shares do not give its holders any voting rights.

Additionally, mutual funds do not aim to mirror the performance of underlying securities in the long-run. That's because mutual funds make distributions!

Mutual Fund Distributions

A collection of the funds' profits derived from dividends and the result of selling investments at a higher price for a gain. Typically mutual funds will distribute this excess capital each quarter, providing a source of income to mutual fund shareholders.

The Difference Between ETF's & Mutual Funds

Mutual Funds and ETFs are both created through the concept of pooled fund investing, where investors attempt to replicate the returns of a different asset or stock market index.

With that said, there are some important differences:

1. Mutual funds have more complex structures than ETFs, with varying fees which are typically higher than ETFs.
2. ETFs are actively traded on stock exchanges, while mutual funds only trade at the end of each trading day.
3. Mutual funds are actively managed by a professional fund manager, while ETFs are (mostly) passively managed through a set of rules and algorithms.
4. Mutual funds pay investors a distribution, which is similar to a dividend but it is taxed as a capital gains distribution. ETFs typically do not pay distributions.

A Venn Diagram of ETFs & Mutual Funds

Exchange Traded Funds

- A vehicle for investors to earn from the performance of multiple securities in an underlying ETF while only owning shares in a single fund.
- Typically passively managed.
- Have lower fees, more tax efficient, and offer more liquidity

Both

Help investors build a diversified portfolio which would be challenging & expensive for investors to create on their own.

Mutual Funds

- A pool of like-minded investors who collectively decide to have their money invested and managed by a professional.
- Typically actively managed, with managers regularly buying and selling securities to beat the market
- Have higher fees and expense ratios

What To Look For In ETFs & Mutual Funds

Substantial Assets
If an ETF or Mutual Fund has less than $10 million in assets, there will be limited interest from investors, resulting in wide spreads & lower liquidity.

High Liquidity
Higher trading volume for an ETF or mutual fund indicates higher liquidity, which means you can sell shares more easily than in an illiquid security, which may force you to sell at a discount.

Low Expense Ratio
ETFs have lower expense ratios because they are are passively managed, however, even for an actively managed mutual fund, investors should aim for expense ratios that are less than 1%.

Tight Spread
Investors should seek out ETFs and Mutual Funds which have narrow Bid/Ask prices because this indicates that there is a high level of investor interest & trading activity.

Value Tracking
ETFs & Mutual Funds track the value of the assets the fund owns, however, if the fund does not track the underlying assets closely, tracking errors may impact your performance.

Tax Implications for ETFs & Mutual Funds

Unfortunately, investing is so accessible these days that no one explains the tax implications of investing until it's too late.

ETFs are structured so that they don't pass capital gains onto the investors in the ETF and incur fewer tax liabilities. An ETF can be thought of a basket of assets, and while there may occasionally be rebalancing for an ETF, most ETFs are very passive.

However, in a mutual fund, the manager must constantly buy and sell securities to keep the fund balanced due to people withdrawing money from the fund or the change in pricing of the securities they have in their portfolio. Typically, the sales of these securities accumulates a capital gain for the shareholders of the fund, even if the shareholder has an unrealized loss over the time they have been invested in the mutual fund since tax implications are applied each year.

To mitigate this, many mutual funds tend to be passive and do not rebalance their portfolio frequently. This means the fund is creating less transactions so are realizing less of their gains in the current year.

The end goal for many mutual fund managers (in addition to making money) is to reduce the amount of taxes the shareholder has to pay.

Understanding Major Indices

Stock market indexes around the world are powerful indicators for global and country-specific economies, because they are a collection of some of the largest companies in a specific economy or industry.

The the United States, there are 3 indices which are followed the most by investors:

- **S&P 500:** Tracks the market capitalization of ~500 companies and creates a weighted-average of the value of the stock in each of those companies.
- **Dow Jones Industrial Average:** Measures the daily price movements of 30 large American companies that are publicly traded on the New York Stock Exchange and the Nasdaq, but excludes transportation and utility companies.
- **Nasdaq Composite:** Follows the stock performance of companies which are listed on the Nasdaq stock exchange. This index is also market-cap weighted, which means that a larger companies price movements impact the index more than a smaller company.

NOTE: Most major indices have multiple ETFs which try to replicate the returns of the index. This provides ordinary investors with a great opportunity to diversify their investments through one ETF.

The World's Largest ETF: SPY

The world's largest ETF has the ticker symbol SPY and is designed to track the S&P 500.

Many investors who dollar-average the S&P 500 use the SPY because they do not need to purchase stake in 500 different companies. Plus, the ETF automatically rebalances their portfolio every day so that one stock does not have too large of an impact on the overall price of SPY.

SPY follows the S&P 500 which includes 500 of the largest companies that fit certain criteria:

- The company must be worth at least a $14.6 billion.
- Most shares of the company are traded by the public.
- At least a quarter of a million shares of the company have traded in the previous 6 months.
- The company held an IPO over one-year before being added to the S&P 500.
- The company had a positive sum of earnings in the previous 4 quarters.

How Many ETF's Are There?

ETFs have become extremely popular with ordinary investors in the past 20 years because they offer an easy way to diversify a portfolio without much work.

In 2003, there were 276 ETFs traded across the world. Now, there are over 8,500!

ETFs have grown in popularity because they can be as specific or broad as investors desire.

Some ETFs specifically track the healthcare industry or renewable energy, while other ETFs try to replicate the returns an investor would experience if they owned stock in every publicly traded from around the world.

Many Wall Street Firms such as State Street, Vanguard, Fidelity, and Guggenheim make billions of dollars every year creating ETFs and selling shares in these ETFs to the market. They make a majority of these profits from expense fees charged to investors for operating the ETF.

The Major Benefit of ETFs & Mutual Funds

ETFs and Mutual Funds have have become extremely popular with public investors over the past 20 years because they solve the challenge of ensuring that an investor does not need to invest in hundreds of companies to diversify their portfolio.

Simplicity

Rather than tracking hundreds, if not thousands of investments, ETFs and Mutual Funds create opportunities for investors to own one investment, even if that investment tracks the performance of many companies.

Diversification

As pooled investment vehicles, both ETFs and Mutual Funds allow investors to invest a small amount of money but track the performance of many different companies.

The Path To Launching An ETF: IPOs

An ETF becomes publicly traded on the stock market just like any other company's stock: by listing shares on a stock exchange through an initial public offering (IPO).

An IPO allows private companies to raise capital from public investors by making their shares available to the broader market.

IPOs typically work like an auction, where the public bids on the company's shares and these bids create the price which a company's stock (or a share of an ETF) will trade.

IPOs provide the opportunity to raise a lot of money in order to pursue new investments.

Investment banks play a vital role in IPOs because they act as intermediaries who determine the price per share of the company or ETF which is publicly listing their shares.

When a company successfully IPOs, privately held shares are made public, which allows early investors to sell their stock at the public trading price.

Why are Capital Markets Useful?

Capital Market: A market where investors can trade securities. A security holds financial value, such as equity or debt, a type of loan to companies.

- **Primary Market:** A capital market where securities are first sold to the public. This is where companies come to raise capital with an IPO. The better the access the investment bank has to the primary market, the better chance the company can get more investors.
- **Secondary Market:** A capital market where securities can be traded, such as the stock market.

What's in it for the economy?

By allowing buyers and sellers to interact with each other efficiently, companies are able to get funding for research and spend more on their products and employees.

In addition, capital markets allow for the government to sell bonds, so that they can have money to build infrastructure and fund different types of economic policies.

Key Takeaways From This Module

CORE & FUNDAMENTALS

- ETFs & Mutual Funds provide a way for investors to invest in a basket of stocks or other assets at a much lower cost than purchasing all of the assets independently.
- Mutual funds are more actively managed than ETFs, so they may cause investors to incur a greater tax liability.
- Check expense ratios for ETFs and Mutual Funds so that you capture the most growth.

APPLIED KNOWLEDGE

- ETFs & Mutual Funds are the fastest and easiest way to diversify your portfolio or buy the market.
- An IPO allows a private company goes public, allowing retail investors to own shares in exchange for raising capital to grow the business.
- Investment banks help launch IPOs for ETFs, Private Companies & all other sorts of investment vehicles.

RELEVANCE FOR YOU

- ETFs provide investors with the opportunity to own shares in an asset whose performance is designed to mirror a stock index or industry.
- Mutual funds make distributions to investors which may provide an additional source of income for some investors.