

Funds and Returns

BUSI 721: Data-Driven Finance I

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Some U.S. stock indexes

- Dow Jones = 30 stocks
- S&P 100 ~ 50% of U.S. stock market capitalization
- S&P 500 ~ 80% of U.S. stock market capitalization
- Russell 1000
- Russell 3000
- Russell 2000 = Russell 3000 excluding Russell 1000, small-cap index
- Wilshire 5000



How do stock indexes work?

- % change in index is % increase/decrease in total value of companies in the index (except for Dow)
- % change in index does not include dividend return



Funds



Mutual Funds

- Owned by the investors (mutual), managed by the sponsor
- Easy way to get diversification
- Can also perhaps benefit from professional active management
- Can usually invest directly with no need for a brokerage account
- Over 7,000 U.S. mutual funds \sim number of U.S. stocks
- Mutual funds for stocks, bonds, international stocks, real estate, ...



Net Asset Value

- NAV (net asset value per share) is calculated daily after close of trading.
- Equals value of portfolio less any expenses not yet paid divided by number of shares outstanding
- Invest money → get shares in fund at next end-of-day NAV
- Withdraw money → sell shares at next end-of-day NAV



Example

- Invest
 $10,000 \text{ Thursday end-of-day NAV}$
 $=$
250, get 40 shares
- # of shares can be fractional
- Fund \uparrow , withdraw 6,000, $\text{next end-of-day NAV} = 300$
 - $6,000 / 300 = 20$ shares that are redeemed
 - Still have 20 shares, worth $20 \times 300 = 6,000$



Active and passive funds

- Passive funds track an index. They do not try to "beat the market." They have low expenses.

Vanguard was the original and largest provider of index mutual funds: Vanguard 500, Vanguard Total Market, ...

- Active funds try to beat the market or their market sector by choosing the best stocks. They have higher expenses.
- There is some evidence that active fund managers can beat the market before payment of fees.
- But there is little evidence of extra returns to investors, after payment of managers' fees.
- There is also little evidence of repeat performance, except that the worst funds after fees tend to remain the worst.



Other types of funds

- Hedge funds, private equity funds, venture capital funds, funds of funds
- Less regulated
- Open only to qualified investors (minimum net worth or income)
- Higher fees, minimum investments, sometimes lock-ups



Exchange Traded Funds (ETFs)

- ETFs were invented in 1990. Now ~ 3,000 U.S. ETFs.
- ETFs are listed on stock exchanges and trade like stocks. You buy/sell them through your broker.
- Another easy way to get diversification. And lower fees than mutual funds.
- There are ETFs for stocks, bonds, international stocks, real estate, currencies, commodities
- ETFs calculate NAVs daily, but you do not buy/sell at the NAV. You buy/sell at the price determined by the market.



How do ETFs work?

- ETFs are not open to new cash investments.
- Neither can anyone withdraw cash from them.
- They *are* open to exchanges with *authorized participants (APs)*.
 - APs deliver baskets of assets and receive ETF shares when ETF market price is higher than NAV.
 - APs deliver shares and receive baskets of assets when ETF market price is lower than NAV.
 - This activity moves the ETF market price towards NAV.



Futures based ETFs

- Commodity ETFs generally hold futures contracts on the commodity instead of the physical commodity.
- An example is USO (U.S. Oil). A counter-example is GLD.
- There are also ETFs that take positions in stock index futures to deliver
 - multiples (2-to-1 or 3-to-1) of the stock index return (levered ETFs)
 - the negative of the stock index return (inverse ETFs) or multiples of the negative (levered inverse ETFs)



Some example of ETFs

- SPY = S&P 500
- IWM = Russell 2000
- IEF = Treasury bonds
- LQD = corporate bonds
- UUP = short foreign currencies (bet on dollar)
- QUAL = "quality stocks"
- MTUM = high momentum stocks
- etfdf.com/screener/



Returns



Basic definition

- Return usually means rate of return = percent gain = (price + dividends) / purchase price
- Often work with close-to-close returns = (closing price + dividend if any) / prior day closing price
- Letting r_i = return on day i , return over longer period is

$$(1 + r_1)(1 + r_2) + \cdots (1 + r_n) - 1$$

- For an account with multiples deposits and withdrawals, best definition of return is IRR



Dividend example

- [Chevron's 2021 Q2 dividend](#)
- Nasdaq's statement: Chevron Corporation (CVX) will begin trading ex-dividend on August 18, 2021. A cash dividend payment of \$1.34 per share is scheduled to be paid on September 10, 2021. Shareholders who purchased CVX prior to the ex-dividend date are eligible for the cash dividend payment.
- Three dates:
 - August 18: (begins trading ex-dividend)
 - August 19: (shareholders of record will receive the dividend)
 - September 10: (dividend is paid)
- Aug 18 = ex-dividend date means must purchase on Aug 17 or before to be shareholder of record on Aug 19 (T+2 settlement)



Close-to-close returns

- Put dividend on the ex-dividend date Aug 18
- Return from close Aug 17 to close Aug 18 is $(P_{\text{Aug18}} + 1.34)/P_{\text{Aug17}}$



Stock splits

- If a company does an n -for-1 stock split, then each shareholder gets n new shares for each of her existing shares. Shares are worth $1/n$ as much.
- Companies traditionally split their stocks to get the price in a more affordable trading range.
 - It was customary to trade in round lots (100 shares)
 - Odd lots are now common. Can even trade fractional shares.
- Data providers routinely adjust past prices for splits (e.g., cut all past prices in half when a company does a 2-for-1 split).



Dividend and split adjusted prices

- Yahoo and some other providers adjust past prices whenever a dividend is paid (in addition to split adjustments).
- Yahoo's Aug 17 adjusted price for CVX was $P_{\text{Aug17, adj}} = P_{\text{Aug17}} - 1.34$.
- Percent change in adjusted prices (no adjustment for Aug 18) is

$$\frac{P_{\text{Aug18}} - P_{\text{Aug17, adj}}}{P_{\text{Aug17, adj}}} = \frac{P_{\text{Aug18}} + 1.34 - P_{\text{Aug17}}}{P_{\text{Aug17}} - 1.34} \approx \frac{P_{\text{Aug18}} + 1.34 - P_{\text{Aug17}}}{P_{\text{Aug17}}}$$



- Let's compute close-to-close daily stock returns. Let P_t denote the price at close on day t .
- If no dividends, the gain on day t is $P_t - P_{t-1}$. ∴

∴

...

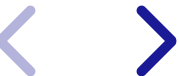
The return per 1 invested in a share at close on $t-1$ is

...

$$(P_t - P_{t-1})/P_{t-1}$$

What about dividends? CVX in Fall 2021

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Nasdaq's statement

Prior prices are adjusted by the same ratio, preserving % changes as they were:

$$P_{\text{Aug17, adj}} = \frac{P_{\text{Aug17}} - 1.34}{P_{\text{Aug17}}} \times P_{\text{Aug17}}$$

$$P_{\text{Aug16, adj}} = \frac{P_{\text{Aug17}} - 1.34}{P_{\text{Aug17}}} \times P_{\text{Aug16}}$$

$$P_{\text{Aug15, adj}} = \frac{P_{\text{Aug17}} - 1.34}{P_{\text{Aug17}}} \times P_{\text{Aug15}}$$

etc.



Data



Daily Returns



In [18]: `import yfinance as yf`

```
ticker = 'CVX'
price = yf.download(ticker, start="1970-01-01")["Adj Close"]
ret = price.pct_change().dropna()
ret.name = "ret"
ret.describe()
```

[*****100%*****] 1 of 1 completed

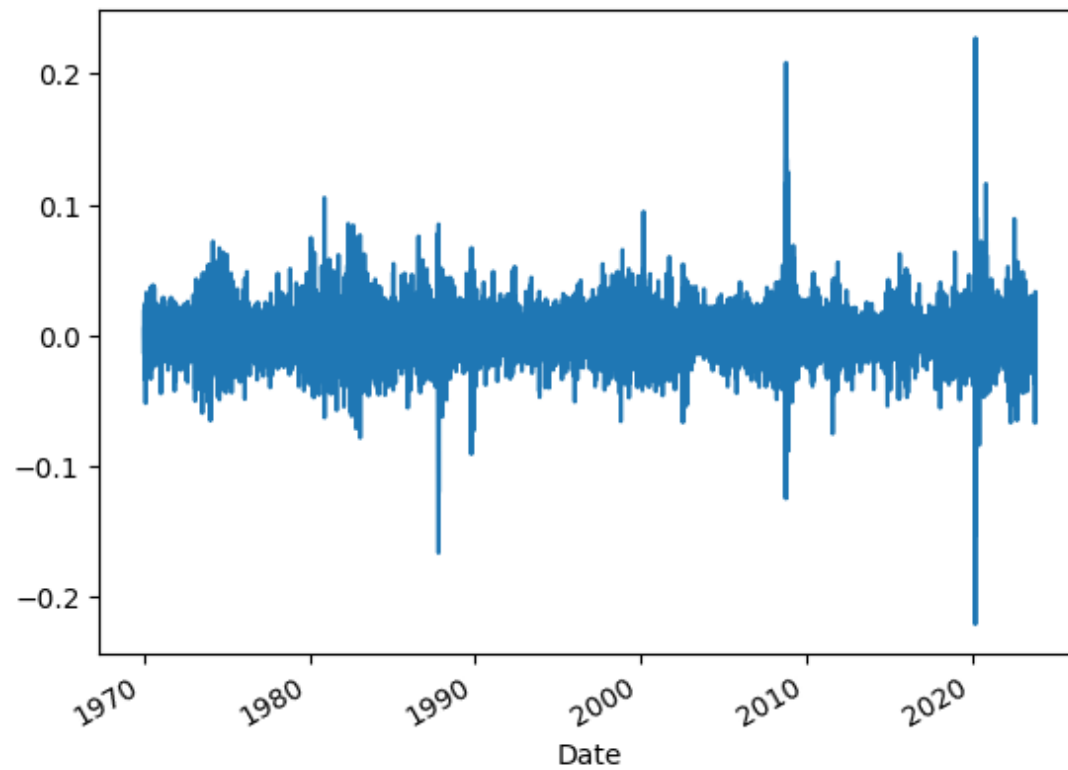
Out[18]:

count	13580.000000
mean	0.000568
std	0.016795
min	-0.221248
25%	-0.008283
50%	0.000000
75%	0.009217
max	0.227407
Name: ret, dtype: float64	



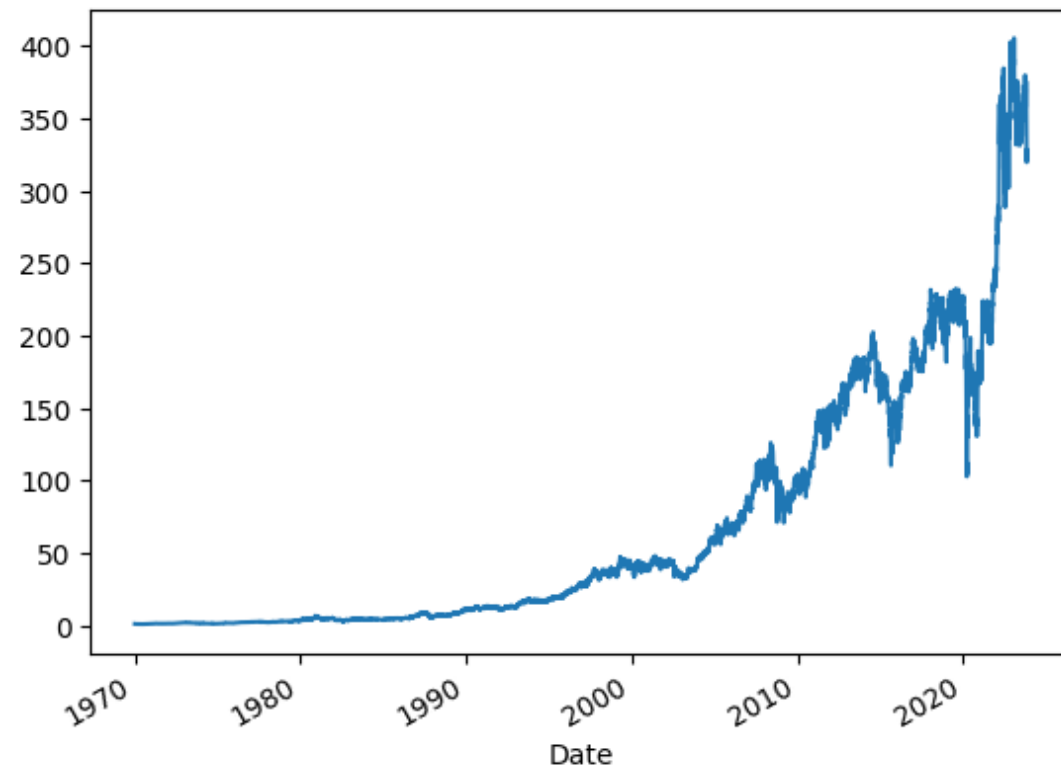

```
In [19]: ret.plot()
```

```
Out[19]: <AxesSubplot: xlabel='Date'>
```



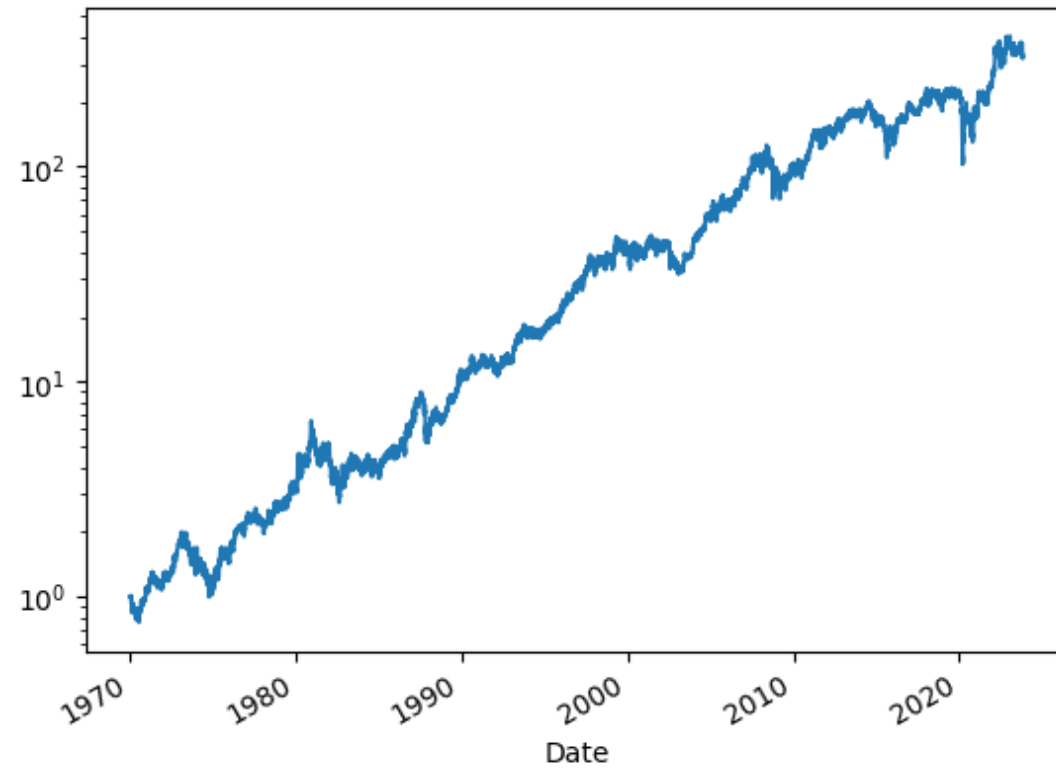
```
In [20]: (1+ret).cumprod().plot()
```

```
Out[20]: <AxesSubplot: xlabel='Date'>
```



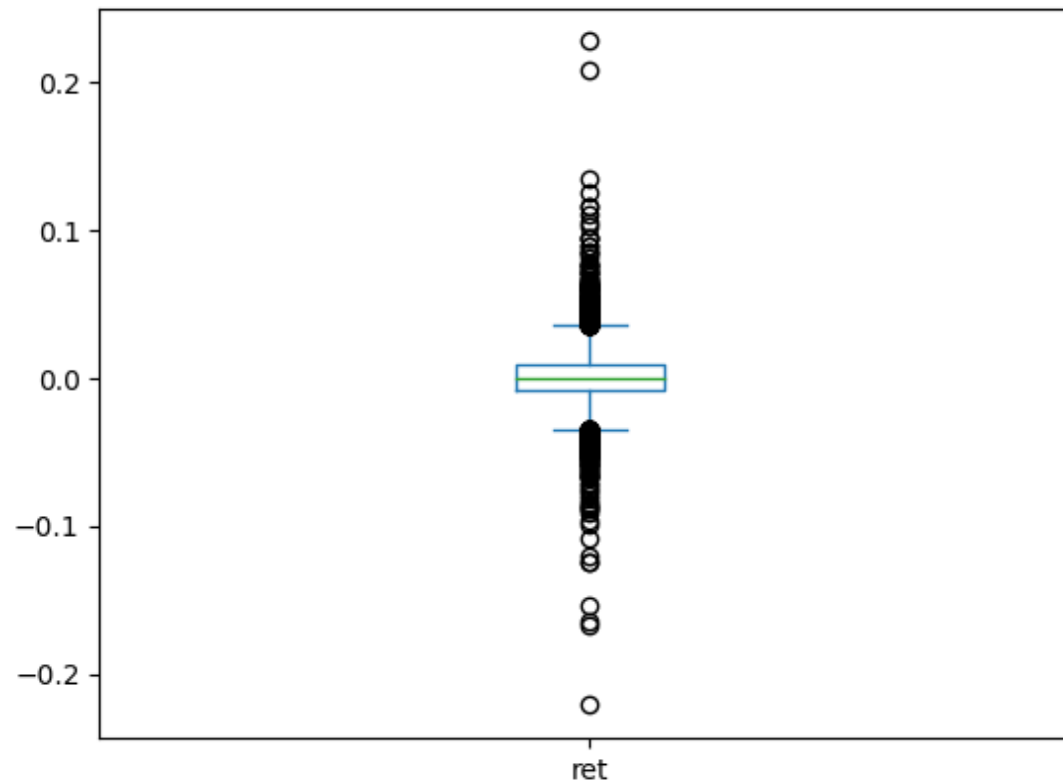
```
In [21]: (1+ret).cumprod().plot(logy=True)
```

```
Out[21]: <AxesSubplot: xlabel='Date'>
```



```
In [22]: ret.plot(kind="box")
```

```
Out[22]: <AxesSubplot: >
```



Annual Returns



```
In [23]: price_annual = price.resample("Y").last()
ret_annual = price_annual.pct_change().dropna()
ret_annual.name = "annual return"
ret_annual.describe()
```

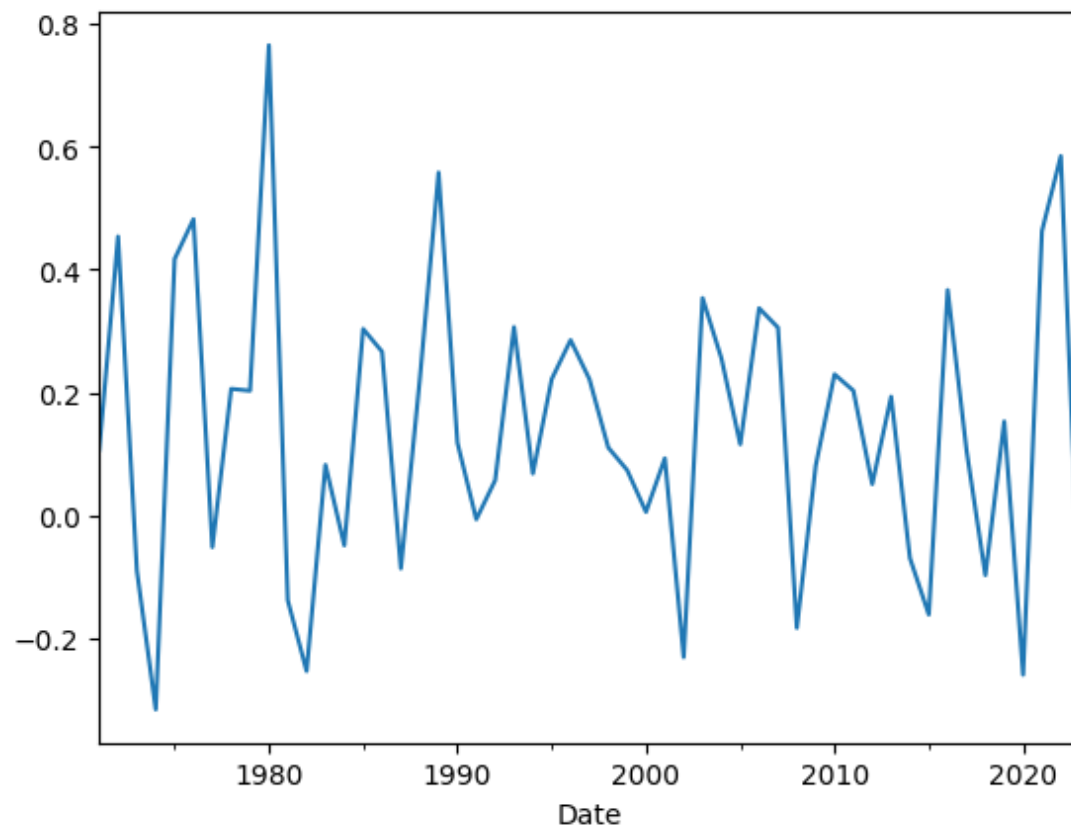
```
Out[23]:
```

count	53.000000
mean	0.137142
std	0.233844
min	-0.316028
25%	-0.048961
50%	0.115425
75%	0.285149
max	0.764966

Name: annual return, dtype: float64

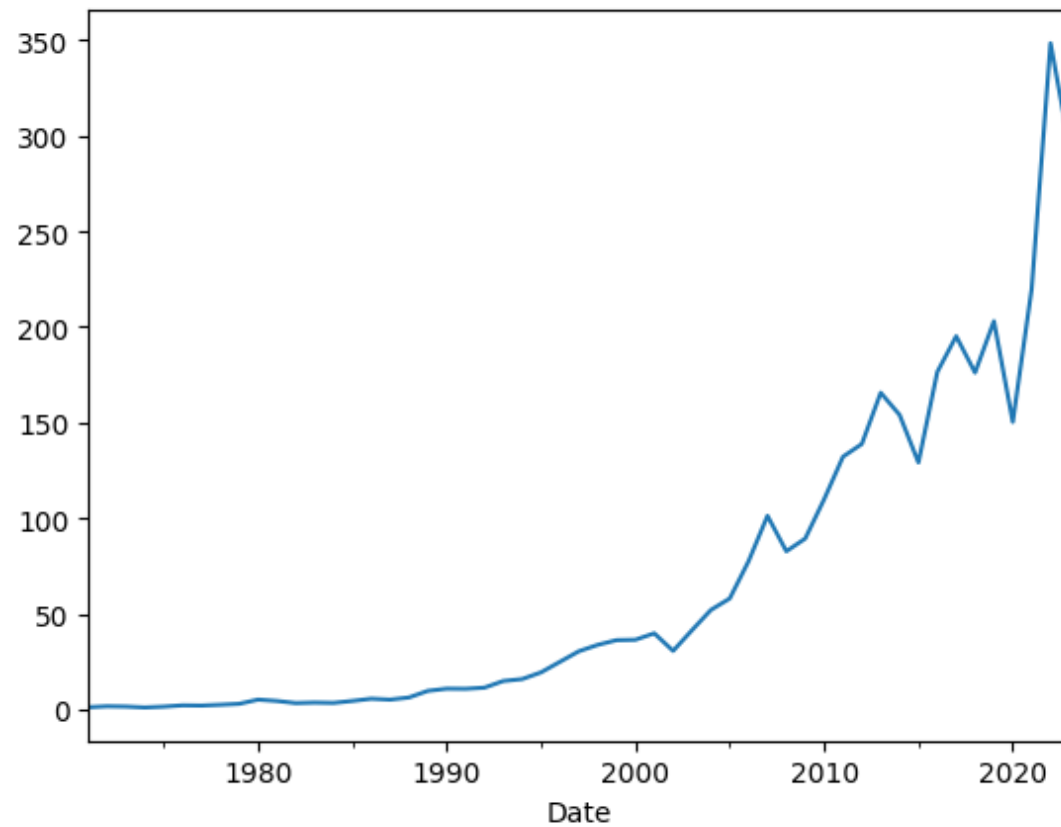
```
In [24]: ret_annual.plot()
```

```
Out[24]: <AxesSubplot: xlabel='Date'>
```



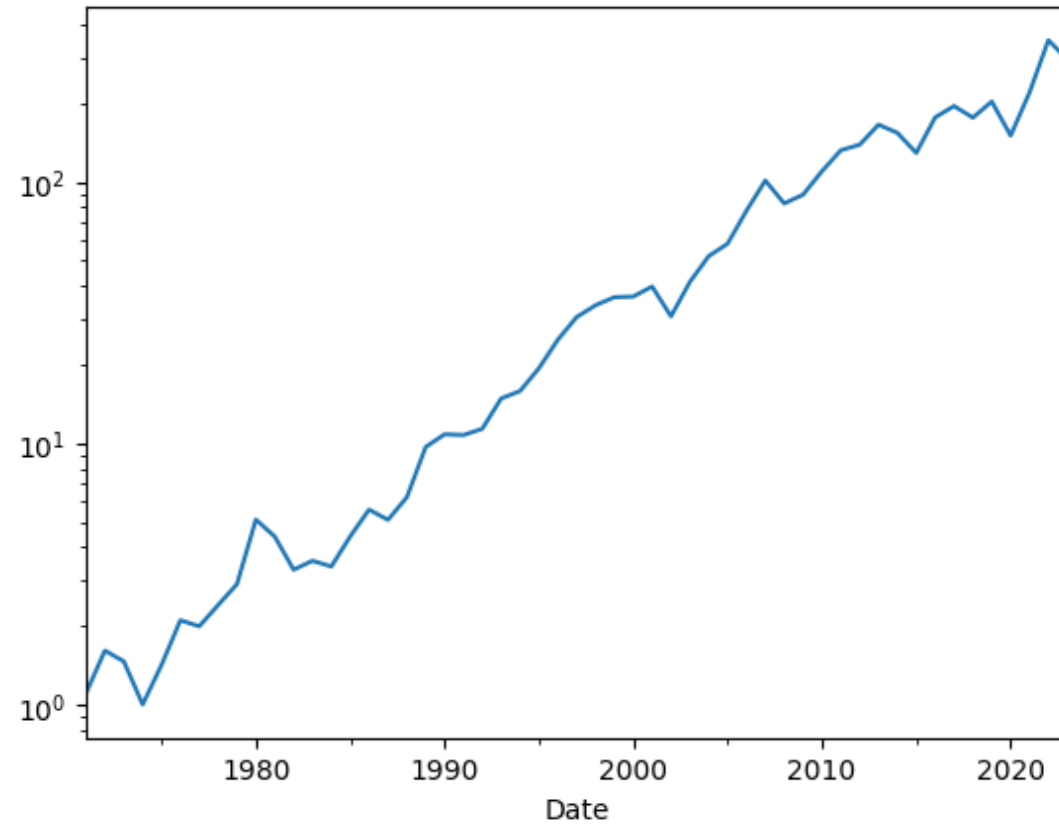
```
In [25]: (1+ret_annual).cumprod().plot()
```

```
Out[25]: <AxesSubplot: xlabel='Date'>
```




```
In [26]: (1+ret_annual).cumprod().plot(logy=True)
```

```
Out[26]: <AxesSubplot: xlabel='Date'>
```



```
In [27]: ret_annual.plot(kind="box")
```

```
Out[27]: <AxesSubplot: >
```

