

## About the Firm

Lancaster Pollard Investment Advisory Group, an SEC-registered investment advisor, helps nonprofit organizations create the financial means to last the life of their missions by managing *total* financial risk rather than just investment-associated risk. Lancaster Pollard Investment Advisory Group shares common ownership with Lancaster Pollard, a leading provider of investment banking and mortgage banking services for the senior living, health care, affordable housing and private education sectors.

## Comparing Common Investment Choices for Nonprofits: Mutual Funds and Exchange-traded Funds

The limited financial resources of many nonprofit organizations drive them to minimize expenses as they search for the most cost-effective way to accomplish their missions. Mutual funds and exchange-traded funds (ETFs) can serve as lower-cost methods for nonprofit investors to experience professional investment management while gaining important portfolio diversification. They are available at virtually every financial institution, and require only an internet connection to monitor.

While index ETFs and index mutual funds carry lower fees, actively managed mutual funds offer more opportunity to beat performance benchmarks and enhance returns. Nonprofits must balance these considerations when diversifying their portfolios.

### Mutual Funds

Mutual funds are some of the most common investment vehicles found in nonprofit portfolios. Investors can purchase or sell mutual funds at a value determined at the close of business each day, offering a great deal of liquidity. Investors also have many options: According to the Investment Company Institute, the combined assets of the nation's more than 8,000 mutual funds now exceed \$12 trillion.

While 20 times more assets are managed via mutual funds versus ETFs, investors, risk managers, and regulators continue to question the expenses charged to the mutual fund investor.

### Loads, Fees, Expenses & Breakpoints

Mutual funds are distributed primarily by brokerage firms with salespeople who charge a commission, or sales load that can approach 4% or more. Some of these loads are charged at the time of purchase (front end), while others are collected at the time of sale (deferred). Loads may decrease as the amount invested increases if the mutual fund offers breakpoint pricing.

Many mutual funds have different share classes, created to compensate the salesperson based on the type or size of the investor. One mutual fund may have a front-end load share class as well as an institutional share class. The latter may not have a load at all. As institutional investors, it is important that nonprofit organizations know to purchase the institutional share class, or the lowest-cost share class available.

Mutual funds also charge management fees to compensate portfolio managers and analysts; administrative expenses to reimburse the mutual fund for costs such as fund transfer and accounting; and some charge a 12b-1 fee to compensate the brokerage firm for marketing and distributing the mutual fund. Charts showing historical mutual fund performance may not include all fees, so actual investor returns will be lower than the overall return depicted.

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It is not necessary to pay high fees to participate in the investment markets. Index mutual funds are also an option, though investors should keep in mind that index funds mean no active management, and no opportunities to beat investment benchmarks. The level of detail and disclosure of fees continues to increase, making it easier to choose low-cost investment alternatives.

### It's All in the Name, or Is It?

Investors should be aware that mutual fund names may not fully represent their risks or holdings. The hypothetical Domestic Fixed Income fund may offer managers the leeway to invest 20% of the fund internationally, or in riskier derivatives. This can be particularly troublesome for nonprofit investors, which need to understand the risk in their portfolios to best plan long-term strategies. Mutual fund prospectuses describe the latitude given to portfolio managers to invest in security types other than those indicated in the name.

### Beating the Benchmark and Peer Analysis

Many of the expenses associated with a mutual fund investment could be re-deployed into additional investments or other obligations of the organizations, but the question of expenses should not be the single driver in the asset allocation decision. Mutual funds have a better chance of beating benchmarks than ETFs, whose returns have historically mirrored indices. Choosing a fund that actually does so requires due diligence.

Most institutional investors benchmark their returns against "the market," commonly the S&P 500 Index. Collectively, most mutual funds have difficulty beating a single benchmark. In an effort to mirror the performance of relevant indices, funds tend to own many of the same stocks as the benchmark index itself. These "closet indexers" are fund managers who purport to offer actively managed funds (and charge to manage them), but who tend to stick to stocks held by the benchmark index.

Those funds that do manage to outperform indices tend to have a higher "active share," as defined in the 2007 Yale School of Management paper, "How Active Is Your Fund Manager? A New Measure That Predicts Performance." The fewer benchmark index securities held by a fund, the higher the active share.

Nonprofit investors should also look at peer analysis. A Morningstar Inc. review of the universe of equity managers determined that over a 10-year period ending in 2007, only two funds consistently ranked in the top half every year. Not only is it difficult to outperform "the market," it is difficult for one mutual fund to consistently outperform its mutual fund peers.

### Exchange-traded Funds

ETFs trade on exchanges, similar to stocks. An ETF holds assets such as stocks or bonds, similar to a mutual fund, trading throughout the day at approximately the net asset value of the underlying assets. The first exchange-traded fund was launched in 1993 as an index fund to track the performance of the S&P 500 index. ETFs have quickly become a logical part of a well-diversified portfolio: There are now 644 ETFs with over \$571 billion in assets. Until very recently, all ETFs were index funds. There are now actively managed ETFs.

ETFs do not have sales loads or 12b-1 fees, and generally have lower management and administrative fees than mutual funds. They offer intraday pricing:

investors can sell a position based on a mid-day price instead of waiting for the end of the day, as with mutual funds. Because ETF performance is aligned with the underlying index, investors should know to expect performance consistent with that index, rather than out-performance. They also pay lower fees. With so many indices from which to choose, an ETF

portfolio can include a great number of asset classes and risk profiles.

### Cost vs. Value

Every dollar not allocated to sales, management, and administrative fees can be invested. However, investors must not look only to reduce costs. By digging deeper and looking at peer analysis and benchmarks to extract value from investment managers, investors may find that fees should not be used as the first filter in identifying potential mutual funds. Cost reduction, however, should focus on unnecessary costs. Further review should include portfolio risk and a comparison of investment vehicles offering similar risk/return profiles.

