

Making Money with

Funds

Samuel Blankson

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Introduction

Today the world fund market is a multi trillion-dollar industry. There are many types of funds and as many reasons for choosing them. In this book, you will learn how Funds work, and how you can profitably trade them.

Samuel Blankson

Chapter 1

- *What are Funds*

What is a fund?

When a group of investors pool their funds together, hire a manager to oversee, allocate, and trade this fund in equities (stocks and shares), debt (bonds, fixed income), and other securities (other funds, REITS etc), as well as redistributing interest, dividends, and other profits back to investors, a fund is born. Sometimes investors do not initiate this fund, a financial institution will decide to start a fund and thus seek to attract money from investors into the fund.

Whichever way it begins, all funds have the same objective. This objective is primarily to make money for the fund manager and hopefully to make the investor money too.

There are many types of funds available to suit all types of investors. Many ways have been devised to charge investors commission, management fees, and transaction fees for the privilege of being a fund member.

Whole industries have sprung up to feed on these funds. From government taxes, to broker loading fees (mainly referral-based commissions).

To invest successfully in funds, seek to avoid these charges, and select funds that offer you low risks with high gains.

What Are The Different Fund Types And Their Characteristics?

There are two main types of funds:

1. *Open-Ended Funds*. They sell as many shares as investors wish to buy. They also buy back as many shares as investors wish to sell. (The majority of mutual funds in the US and unit trusts in the UK are open-ended).
2. *Closed-Ended Funds or Investment Trusts (also called Investments Funds)*. Investment trusts have a fixed number of stocks. They are traded like shares, and are regulated by the Investment Company Act of 1940 (see <http://www.law.uc.edu/CCL/InvCoAct>).

Open-Ended Funds

An open-ended fund has an unlimited amount of units to sell. Each unit it sells reduces the NAV. The NAV is the Net Asset Value of the fund, divided by the total amount of units held by investors. An investor wishing to buy shares in the fund would pay the NAV per unit.

The underlying asset value changes because the shares, bonds, and other securities prices change. The amount of units sold also changes, and so the NAV changes. Therefore, at any moment in a high volume fund, the unit price will be moving. When you come to sell your units, you will receive the current NAV per unit.

This can be confusing so let us look at a simple example:

Open-Ended Fund X (at time of purchase)

Current units = 100,000

Underlying assets value = \$1,000,000

Current NAV = \$10

If you had \$1000 to invest in Fund X, you would get 100 units, each worth \$10 at time of purchase.

Because the underlying assets all pay interest (bonds) or dividends (equity), most open-ended funds are setup to reinvest these payments by buying more units, automatically.

Let us then say that a year later you want to sell your units. During the interim, the underlying assets have paid dividends and interest that amounted to 10 more units (remember these are reinvested). Therefore, you now have 110 units.

Let us also suppose that the underlying assets have increased in value by 10% in the interim. Therefore, the new picture is as follows:

Open-Ended Fund X (one year later)

Current units = 110,000. (Let us assume no new units were sold, and all unit dividends and interests were reinvested into more units. Let us also assume that there were no redemption charges levied in the interim).

Underlying assets value = \$1,100,000

Current NAV = \$10

You have 110 units so you would receive \$1100 for your units. This would be a 10% increase in this simple example.

That is how open-ended funds work.

There is an overwhelming amount of open-ended funds to choose from; therefore, they are liquid and flexible. Their popularity has grown greatly in the last 20 years, almost to the same levels as their underlying equity. In the US, there is an open-ended fund investor to account for each household

We will revisit this fund type again shortly. In the mean time, let us look at the closed-ended fund.

Closed-Ended Funds

Closed-ended funds raise money from the public by offering a limited number of units for sale. When these units are all sold, the fund is closed. From then onwards, to buy these units, investors have to go to the stock exchange and hope someone is willing to sell. If some of the original investors want to sell their units, they also have to do so via the stock exchanges.

Because the values of these units are due to supply and demand, the price will not be a reflection of the NAV. Instead, the traded price is often 30% below NAV. With closed-ended funds, there is less to choose from, therefore, they are inflexible and illiquid. These simple facts have driven closed-ended funds almost into obscurity in comparison to open-ended funds. Today they are used mainly by institutional investors and other sophisticated investors.

How to Trade Funds Successfully

We shall now look at how to make money with funds. We will concentrate on open-ended funds for obvious reasons.

There are four main ways to make money with funds, these are:

1. Dividends on stocks and interest on bonds. This type of payment is called a distribution. Funds distribute almost all earned income from the underlying assets.
2. When a fund liquidates some of its assets, there could be a possibility for investors to receive further distributions if the assets value has appreciated, and if the fund has a policy of passing on these gains to investors.

3. Funds are traded on stock market exchanges. If an underlying asset increases in value and the fund does not liquidate it, the market price of the fund will also appreciate in value allowing you to be able to profit by selling your shares in the fund on the exchange.
4. Most funds give their investors the option of reinvesting distributions back into the fund.

Today the most popular fund types are mutual funds. (These are known as unit trusts in the UK, although a unit trust is not technically a mutual fund, but it behaves the same way).

We will concentrate specifically on open-ended mutual funds. Open-ended mutual funds have several advantages and it is important to understand these advantages so that you can better determine when to use them.

Advantages of mutual funds:

1. **Professional Management** - Funds employ qualified professional traders who manage the fund. This advantage is oversold because looking at some funds performance; you would not think professional fund managers managed them. After reading this book and applying its investment strategies, you will be able to beat the performance of most funds.
2. **Diversification** – Funds pool millions, often billions, of dollar buying power into their underlying assets. This allows the fund to diversify in many equities and debt instruments. This is something that you would not be able to do as effectively, given your available funds.
3. **Buying power** – The huge buying power of funds allows them to reduce their transaction costs. The resultant negligible transaction costs further increase the fund's efficiency and profitability.

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4. ***Liquidity*** - As we saw in the explanation for open-ended funds, the unlimited amount of units makes mutual funds exceptionally liquid. You can buy and sell them at any moment during the exchange trading hours. (Some unethical individuals even do so after the exchange closes, making it look as if they traded during trading hours).
5. ***Ease of Acquisition*** – Mutual funds are easy to purchase and have low minimum purchase size requirements. There are now many regular payment plans offered by banks and financial institutions that will allow you to invest from \$50 per month into mutual funds.

Disadvantages of mutual funds:

1. ***Professional Management*** – Because most managers are paid regardless of the funds performance, they are not greatly motivated to perform well. Another thing that happens is certain managers are better in a particular economic cycle than others. Often you will see a fund performing well during a bull market, whilst it will lose value during a Bear market. It is easy for most traders to make money when the going is good; the true test of a great trader is how they perform during the bad times.
2. ***Costs*** – The real ingenuity in mutual funds lies in their costing systems. Never has a financial instrument been devised that so efficiently ebbs at your profits through fees and charges. More will be covered on this later on page 19.
3. ***Dilution*** – When you over diversify, you lose the effect of movement in either direction. This is because each asset is such a minority of the whole, that its appreciation or depreciation in value, no matter how great, will not make a major impact on the portfolio as a whole. This can happen to funds

that invest in too many assets or in a fund of funds (a fund that invest in other funds).

4. **Taxes** – When investing in assets yourself, you can defer taxes to a future date to better suit your situation. However, when you invest into a fund, you no longer control this. If the fund liquidates an asset whose value has appreciated, you will be liable to pay capital gains tax on that distribution.

Today, the amount of mutual funds available exceeds stocks; this is great news for the mutual fund investor. With so many funds available, there is bound to be one to suit every investor's style and preference. That means different risk levels and returns are available to the investor. However, selecting the right one can be a daunting task if you had to review them all individually. Luckily, for us, there are fund screeners that automate most of this task. This will be covered in more detail later.

Mutual funds are similar in many ways but also different in some fundamental ways. The type of assets a fund invests in, and the strategies it uses, are two of these defining fundamentals. Let us look at these differences in detail.

There are three main types of mutual fund, they are:

1. **Money market funds** – These are the safest mutual funds available.
 - a. *Treasury Bills*: These are short-term government debt.
 - b. *Certificates of Deposit (CD)*: These offer a higher yield than treasury bills, and pay dividends monthly, semi-annually or annually. A CD is a deposit at a bank for a specific term. During that term, you will be paid interest. The period of interest payments will determine the effectiveness of the CD, with the shortest periods generating

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the most yields. These are offered in any denomination and range from three months to five-year maturity terms.

- c. *Commercial Paper*: This is a loan to a corporation for one to nine months. The denominations are normally from \$100,000 upwards. The corporations that issue these normally have very high credit ratings. They are normally issued at a discount.
- d. *Bankers Acceptance*: This is a short-term credit issued by a company and guaranteed by a bank. They do not need to be held onto until maturity, as they are traded in the secondary markets. They are normally issued at a discount.
- e. *Eurodollars*: This is a US dollar denominated deposit in banks outside the US. They are sold at narrow margins due to regulation-free trade outside the US. They are normally for millions of dollars.
- f. *Repos*: These are repurchase agreements normally held from overnight to 30 days or more. This is the selling of treasury bills and repurchasing them for an agreed price, at an agreed date. There are two variations on the standard repo, which are as follows:
 - Standard repo.
 - Term repo – this is a repo where the term is over 30 days.
 - Reverse repo – this is a repo where the dealer buys a treasury bill from an investor and sells it back for a higher price later.

2. *Fixed-income funds*

- a. *Government bond funds*: These invest in government debt securities. In the US, these invest in treasury bills, treasury notes, treasury bonds, and mortgage-backed securities issued by

government lending agencies such as Fannie Mae. Some bond funds are exempt from federal tax. They are some of the safest funds you can invest in; however, their returns are quite low. Their main risk is related to fluctuating interest rates and inflation.

- b. *Municipal bond funds*: These invest in state and local government issued debt securities. These bond funds are exempt from federal taxes, and in some cases, from state taxes too.
- c. *Corporate bond funds*: These invest in corporate debt. The underlying bond could default if companies that issue them go bankrupt.
- d. *Zero-coupon bond funds*: These invest in zero coupon bonds.
- e. *International bond funds*: These invest in bonds issued by foreign governments and corporations.
- f. *Convertible securities funds*: These invest in bonds that may be converted into stock.
- g. *Multi-sector bond funds*: These invest in all types of bonds: corporate bonds, municipal bonds, international bonds etc.

3. ***Equity Funds***

- a. *Growth funds*: These invest in stocks with the potential for long-term capital appreciation, keeping their focus on companies experiencing earnings and revenue growth. These funds are great in bull markets but often fall further than other funds in bear markets.
- b. *Value funds*: These invest in companies that appear to have good fundamentals, and are trading at low P/E (price to earnings) ratios. They tend to pay high dividends, as their value is higher than their price.
- c. *Aggressive growth funds*: These invest in companies that are experiencing rapid growth.

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These funds are highly risky as they take more risks and trade more frequently. They may invest in IPOs, options, and futures. These are all very high-risk investments.

- d. *Blended funds*: These invest in both value and growth stocks to capitalise on current income and long-term capital appreciation within the same fund.
- e. *Sector funds*: These invest in a single sector of the market. These funds are good to use as a growth fund to cover a sector that is experiencing rapid growth or is poised to do so.
- f. *Large Cap, Mid Cap, Small Cap, and Micro Cap funds*: They invest primarily in stocks that match the capitalisation criteria. Normally, the smaller the cap, the more volatile and risky the fund.
- g. *Focused funds*: These invest primarily in a small number of stocks. Their emphasis is on quality not quantity, and they can hold as few as 10 stocks.
- h. *Index funds*: These invest in stocks to mirror an index. They do not require active management, as their stock selection is automatic. They are passively managed, with their main advantages being lower management fees, lower transaction costs, and therefore, lower capital gains tax. (Every time an asset is liquidated at profit, you have to pay capital gains tax on the profits. Most indexes do not change their stocks frequently; therefore, their investors have less need to pay taxes).
- i. *Exchange-Traded Funds (ETFs)*: This is a financial instrument that creates a portfolio of securities using a trust (a legal entity much like a company), and trades the portfolio on a stock exchange. You can then buy shares in the portfolio. ETFs only buy securities that offer real

time holdings disclosure; therefore, actively managed mutual funds are not included in the portfolio. Because of its status as a company, the ETF stocks can be treated in every way as you would a normal company stock. This includes short selling. There is an ETF for most major indexes like the SPDR for the S&P 500, QQQQ for the NASDAQ 100 and DIA for the Dow Jones Industrial Average.