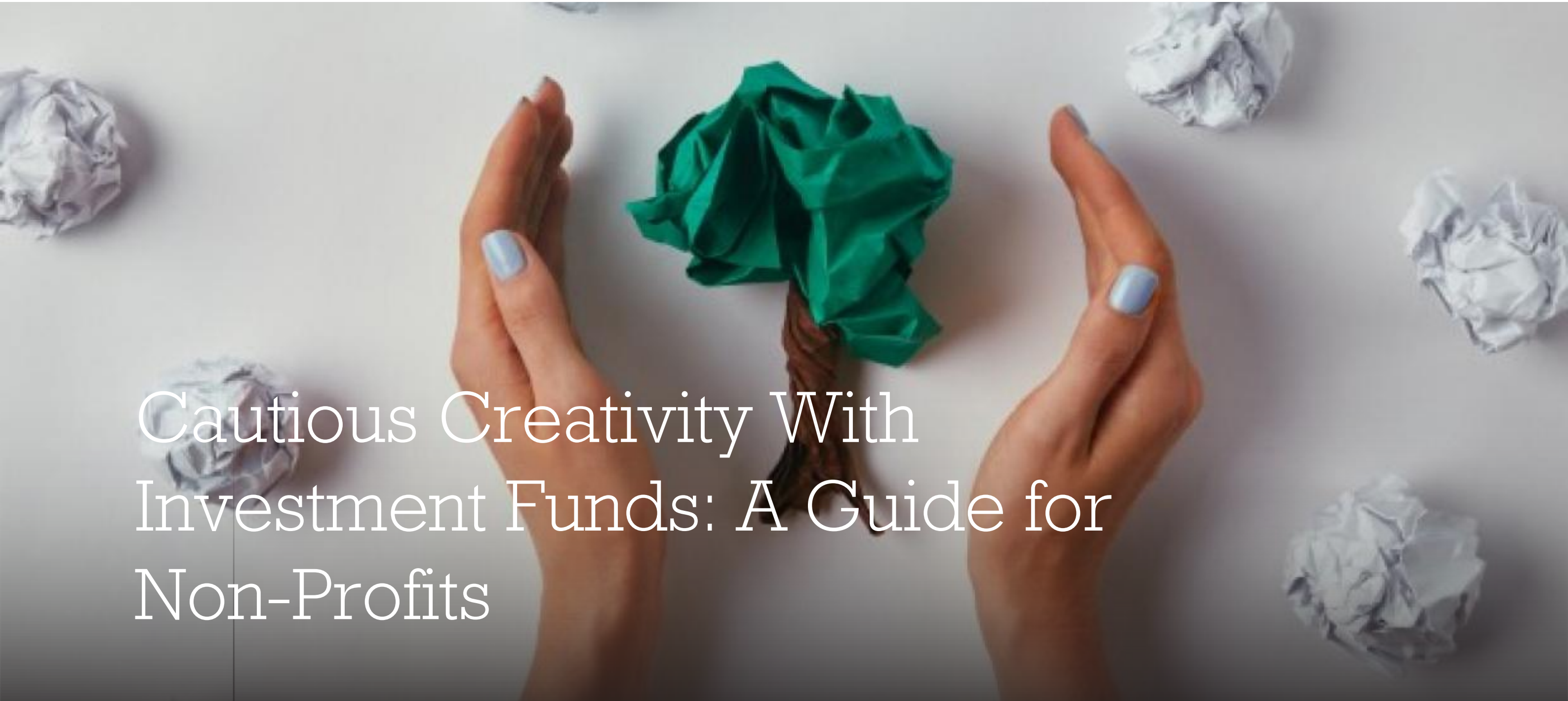
INSEAD The Business School for the World®

KNOWLEDGE



Cautious Creativity With Investment Funds: A Guide for Non-Profits

Why charities should be interested in exchange-traded funds.

In our previous articles, we looked at how charities should use investment instruments such as stocks, bonds and cash.

This article, which discusses the use of exchange-traded funds (ETFs), is the ninth in a **series** based on our forthcoming book *Good Practices for Managing Funds for Non-Profit Organisations*.

Fund management companies offer a variety of funds that cater to the investment requirements of their customers. Not just instruments of investment, these funds can also be considered as a package or wrapper around individual investment instruments such as shares or bonds.

With the growth of the investment funds industry, significant developments have made fund products a key part of the financial industry. That is why fund products should be viewed as financial instruments in their own right.

Thousands of funds to choose from

What are these significant developments? First, the industry's explosive expansion has made Luxembourg, the hub of Europe's fund industry, home to about 15,000 registered investment funds with more than 4,000 billion euros of assets to choose from.

Fund products became increasingly specific in their investment guidelines thanks to the ease and speed with which they can now be registered.

In some cases, funds automatically track individual securities indices such as the DAX in Germany or the Hang Seng in Hong Kong. For these funds, an automated process has replaced the fund manager in realigning the fund portfolio's weighting of instruments as and when the index it tracks is adjusted.

As fund products became more specific and narrow in what they can invest in, investors increasingly included them within their overall portfolio so as to gain exposure to specific assets. Thus the investors' need for fund managers' expertise was reduced.

The rise in the number of equity funds allows multi-asset fund managers to focus on how much of their funds to allocate to certain asset classes. Fund managers could choose the appropriate equity or bond funds to invest in that would give them their desired exposure to an asset class.

ETFs offer a cheap and fast way to invest

The second significant development in the funds industry is the creation of ETFs as an alternative to open-end mutual funds.

Copyright © INSEAD 2019. All rights reserved. This article first appeared on INSEAD Knowledge (http://knowledge.insead.edu).

Units of ETFs are traded on stock exchanges just like shares. But unlike mutual funds for which fund managers analyse stocks to find the best ones, ETFs use algorithms to track market indices. So an ETF's portfolio mirrors the index that it tracks.

And unlike purchasing parts of mutual funds in which investors have to wait until the end of the trading day to know how much they would have to pay for each unit, they can buy and sell units of ETFs at the unit's known market price without any lag.

Simply put, ETFs are handy for investors who lack the capacity or ability to pick individual stocks among the hundreds listed on a stock market. By investing in ETFs, investors can gain exposure to market indices that reflect individual markets and provide decent diversification.

For instance, an investor could invest in the Hong Kong Tracker (SEHK: 2800) ETF, which tracks the Hang Seng Index. This frees the investor, who wishes to invest in Hong Kong shares, from having to analyse and pick listed companies or having to monitor market movements.

ETFs behave like shares and ETF investors can see price updates instantly. They can easily buy and sell ETF units, receive dividends and avoid additional charges for buying ETF units, unlike direct purchases of stocks.

To be sure, the creation of ETFs has changed market indices from being general market information tools to investment products. Consequently, the number of indices has grown. There are now indices for medium-sized and small companies.

Nearly every country has created its own national indices of stocks and bonds. Today, indices are no longer limited to individual markets or sectors. They have become regional or global. The MSCI EAFE Index, for example, tracks large and mid-cap securities in Europe, Australasia and the Far East.

So if an investor in New York wants to invest quickly in a well-diversified portfolio of stocks in Southeast Asian countries, they could just call their broker and choose from a wide variety of ETF products. They could, for instance, buy US-dollar-denominated units in an ETF that tracks the MSCI AC Far East Index.

One area that distinguishes ETFs from actively managed funds is the very low cost of management fees that stem from the passive management of ETFs. Algorithms, not human analysis of securities, decide which shares to buy or sell. That is why ETFs are ideal investment instruments for individual investors to gain access to global markets.

Why charities should use ETFs

Indeed, ETFs are ideal investment instruments for charities of all sizes. Large charities can use ETFs to control their asset allocation, while small and medium charities can achieve easy diversification.

Charities should, however, be mindful of ETFs with complex features such as derivatives, leverage or buy and sell options. Because passively managed ETFs carry low management fees, fund management companies try to make more money by offering ETFs with complex features. Such ETFs are hard for individual investors to value. They do not present investors with high fees, yet they are highly profitable for fund management firms.

So charities should invest in simple, easily understandable ETFs if they are unable to measure the real risks and costs of complex ETFs.

To conclude, charities should use ETFs as a smart way of accessing low management fees and affordable diversification of investment assets. They should look closely at ETFs to ascertain whether they really only track indices or whether they carry complex features. Charities should ask questions of fund management companies to understand the costs and risks of the ETFs on offer. Investing in ETFs should result from a thorough investment process, not from sophisticated presentations by investment bankers over lavish meals.

__Boris N. Liedtke__ is a Distinguished Executive Fellow in the __INSEAD Emerging Markets Institute__.

__Peter Lai__ is the Chairman of HML Consulting Group and Executive Director of Riverside Asia Partners.

Found this article useful? __Subscribe__ to our weekly newsletter.

Follow INSEAD Knowledge on __Twitter__ and __Facebook__.

Find article at
https://knowledge.insead.edu/blog/insead-blog/cautious-creativity-with-investment-funds-a-guide-for-non-profits-12216

Download the Knowledge app for free

Copyright © INSEAD 2019. All rights reserved. This article first appeared on INSEAD Knowledge (http://knowledge.insead.edu).