Your Guide to Asset Allocation: Mutual funds, ETFs, and SMAs

Whether you are saving for retirement, large purchases, or to build wealth that you hope to pass down to children or grandchildren, you will need to invest your money to see growth. Money sitting in a standard savings account, or worse yet, in cash, is a lost opportunity that will depreciate over time.

But when you are getting started with investing, even later in life, how can you know which investment type is right for you? Let's break down three of the most common investment types, Mutual Funds, Exchanged Traded Funds, and Separately Managed Accounts, so you can understand where to begin on your financial path.

Three investment types: What they are, what they offer, and the risks involved

Mutual Funds

A mutual fund is a pool of money comprised of many individual investors and managed by a fund manager. This manager uses the full pool to invest in a diverse portfolio of securities, including stocks or bonds. Each investor owns a share of this total portfolio, proportional to the amount invested, and is therefore entitled to that portion of the income generated by the fund.

Mutual funds can come in various forms. The main types are:

- **Stock funds** that invest in the stock market can employ various investment strategies or priorities. For example, they may focus on large or small-cap, growth-oriented, or sector-specific companies, to name a few. Stock funds also may invest in index funds that distribute investments equally across all companies in a full stock market index, like the S&P 500.
- **Bond funds** invest in bonds that pay fixed income—or set rates of return. This can include corporate or government bonds, junk bonds, and everything in between. The diversity of bond types means that returns can vary drastically.
- **Money market funds** only invest in risk-free short-term debt, like treasury bills, which makes them one of the safest fund types. As a result, returns may be lower than other assets, but they also are more predictable, especially in tumultuous market environments.
- **Target date funds** can be seen as the best of both worlds, mixing their investments across stocks, bonds, and more. These funds are aimed at individuals saving for retirement who have a specific date in mind. The fund manager will adjust the investment balance and strategy over time to achieve the best possible returns by that date.

The pros of investing in mutual funds

Stability through diversification

When you invest in single company stocks, for example, you make yourself dependent on the performance of that one business, thus incurring significant risk. The benefit of a mutual fund is the diversification across the full portfolio, which makes your money less susceptible to massive volatility.

Management
If you are not a market expert, mutual funds come with the benefit of being "Actively Managed," which means they are managed by professionals who will spend their working hours conducting market research and making strategic adjustments to the portfolio for your benefit.

Accessibility
The cost of investing in a mutual fund is affordable to many investors, and trading in and out of various funds is relatively simple, allowing widespread participation.

Highly liquid
Fund investors can typically cash out their shares at any time with little trouble, so you can regain control over your own money if needed.

The cons of investing in mutual funds

Investing brings inherent risk
While not unique to mutual funds, it has to be stated that there is inherent risk attached to any investment, as it is susceptible to market fluctuations and, therefore, no returns can be guaranteed.

"Cash drag"
We explained earlier that liquidity is one of the benefits of mutual funds, but because of this feature, mutual funds have to keep a significant portion of their assets in cash to enable this cash-out potential for their investors. As a result, the fund's returns may be decreased because some of the money is sitting as un-invested cash.

High fees
In order to cover the management of the fund, mutual funds take a percentage of your monetary investment, regardless of whether the fund performs well or not. It is essential to look into the fine print of the fees associated when you are looking at various funds because although a 1.5% fee sounds minor, it can be tens of thousands of dollars over just a few years, depending on your investment amount and the fund's performance.

Exchange Traded Funds (ETFs)

Similar to mutual funds, ETFs are also pooled investments. However, they function differently. These funds typically track indexes, sectors, or assets; unlike mutual funds, they are sold and traded on the stock exchange like any individual stock. Because they are traded on the market, their price and value increase and decrease throughout the day, whereas a mutual fund is only valued as its total losses or gains of the day with no intra-day fluctuations.

Additionally, most ETFs have no limit to the number of investors that can buy the product. This is unlike an individual stock where there are a designated number of shares available, and a share has to be sold for one to be bought.

When you invest in an ETF, you gain returns based on the performance of the bundle of assets that the fund is investing in. The ETF is essentially a market-traded portfolio that matches up to either a strategy or asset class (for example, small-cap stocks, European indexes, etc.).

There are two main types of ETFs:

- **Passive**: These ETFs are typically Index funds that simply represent a bundle with an equal share of every stock in a particular index, like the S&P 500. This means there is no manager actively adjusting the portfolio.
- **Active**: These ETFs operate like a mutual fund and can contain a mixture of stocks, bonds, currencies, commodities, and other investments where a portfolio manager is in charge of actively buying and selling parts of the portfolio according to market conditions and performance.

The pros of investing in ETFs

Diversification

Because ETFs represent groups of various assets, you will benefit from diversification and reduced exposure to a single company's performance. Similarly, if you are investing in a fund that contains multiple asset types, you will benefit from that added level of diversification.

Passive funds have few fees

Because passive funds do not pay a fund manager, you will see fewer overhead fees than a mutual fund or actively managed ETF.

The cons of investing in ETFs

Market risk

As with any investment type, you are exposing yourself to a level of risk without any guarantee of returns. This risk is even more enhanced when you invest in single-sector funds, which may rise and fall more dramatically according to market and political climates.

Separately Managed Accounts

Also called SMA's, individually managed accounts, or separate accounts, these investment types are geared toward wealthy individual investors who want more personalization in their investment strategy than a mutual fund can offer. In this structure, your portfolio of assets is managed by a professional firm that will customize the investment strategy to meet your particular needs, goals, and priorities. They offer different features like tax savings, but it comes at a high cost, with financial advisors charging a percentage of the portfolio's assets in exchange for overseeing investment decisions on a daily basis.

Within a mutual fund, you sign up for a strategy that is applied to the entire group of investors, and an SMA transcends this limitation. In order to open an SMA, you typically need to put in at least $100,000 - $5 million to fit within the guidelines of the account requirements.

The pros of investing in SMAs

Tax savings

Because of the potential burden of capital gains tax, these accounts employ a strategy called tax gain and loss harvesting which can minimize these taxes to help you save additional income.

Customization

For higher net worth individuals (but not ultra-high net worth), these accounts allow you to work with a professional to create a truly personalized strategy oriented around your goals and needs.

The cons of investing in SMAs

High fees

Professional money managers typically charge 1% - 3% of your assets as a fee for managing the account, which can represent hundreds of thousands of dollars over time, so it's essential to decide whether the cost is worth it for your situation.

High monetary requirement

This investment type is aimed toward wealthy individuals, so it may not be suitable for those who have a small pool of funds or are just getting started.

Which one is right for you?

When choosing which direction to pursue with your investments, it is important to clearly understand your goals, the capital you have available to invest, and the timeline you are aiming for. Someone in their 20s who won't retire for over 40 years has much more room to take on risk than someone looking to retire in the next 10-15 years, for example.

Each investment type brings about a set of opportunities and risks. It is all about finding the right solution that will provide you with returns while also helping you sleep at night, knowing your money is being invested in a way that resonates with your values and goals.

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