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Funds and ETFs without the jargon

What they are, how to read the documents, how much costs weigh and which questions to ask before any decision.

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IN THIS GUIDE

Investment funds and ETFs are the instruments through which most people come into contact with financial markets. This guide explains how they work and how to read their documents. It does not say which to choose: that requires knowing a person's circumstances, and it is the job of an authorised adviser.

01 What a fund is

02 Active management, passive management, ETFs

03 Costs, and why they matter so much

04 Reading the key information document

05 The questions to ask

Educational and informational content only. It is not personalised financial, tax or investment advice, and it is not an invitation to buy or sell financial instruments. Numerical examples are hypothetical. All investments involve risks, including the possible loss of invested capital.

01

CHAPTER 1

What a fund is

Many savers, one portfolio, stated rules.

An investment fund pools the money of many people and invests it in a set of financial instruments according to a policy written in its documents. Participants own units and share the result, positive or negative, in proportion to how many they hold.

The fund's assets are separate from those of the company that manages it and are held in custody by a different entity, the depositary. This is an important safeguard, but it concerns custody: it does not protect against market movements. If the securities the fund invests in fall, the value of a unit falls.

Type of fund	What it mainly invests in	Expected swings
Money market	Very short-term instruments	Low
Bond	Government and corporate bonds	Low to medium, depending on maturity and issuers
Mixed	Shares and bonds together	Medium
Equity	Shares	High

THE MAIN ADVANTAGE

A modest sum gives access to a broad set of securities. Building the same diversification alone would take far more money, time and dealing costs.

02

CHAPTER 2

Active management, passive management, ETFs

Two different ways of doing the same job, at different costs.

With active management, a manager decides which securities to buy and sell, aiming for a better result than a benchmark index. This work has a cost, taken every year from the fund's assets, and the aim is not guaranteed.

With passive management, the fund simply tracks an index: it buys the securities that make it up, in the same proportions. It does not try to beat the market: it follows it, up and down. Costs are generally lower because there is no selection activity.

ETFs are funds, usually passively managed, whose units are bought and sold on an exchange during the day, like a share. This makes them easy to buy, but no less risky: an ETF tracking an equity market falls when that market falls.

NOT ALL ETFS ARE SIMPLE

There are leveraged ETFs, which multiply the index's daily movements, and "short" ETFs, which move the opposite way. They are designed for experienced traders and very short periods: held for long, they behave very differently from what the name suggests.

03

CHAPTER 3

Costs, and why they matter so much

Small percentages, charged every year, on a growing base.

A fund's costs are of three kinds: those paid once, on entry or exit; ongoing ones, such as the management fee; and incidental ones, such as performance fees. On top come the cost of the service of whoever sells or advises on the product, and taxes.

Ongoing costs are the most insidious, because they never appear as a charge: they are already deducted from the unit value. And they build up over time, like compound interest in reverse.

Hypothetical example: 10,000 euros for 25 years, constant gross return of 4%



Constant return only to show the effect of costs: in reality returns vary and can be negative. Taxes not considered.

In the example, the difference between the first and third case is about 7,572 euros and does not depend on anyone's skill: it depends only on costs. This does not mean the cheapest instrument is always the most suitable: a higher cost may pay for a service that some people value. It means cost must be known and weighed.

04

CHAPTER 4

Reading the key information document

Three pages, the same for every product, made to be compared.

Before buying a fund or ETF you are entitled to receive a short, standardised document, the KID in the European Union (the United Kingdom has its own equivalent). It is not advertising: it is a disclosure required by regulation.

Section	What it says	What to watch for
What is this product	Objectives, what it invests in, who it is for	That it matches what you thought you were buying
Risk indicator	A scale from 1 to 7	Valid only if you stay for the recommended period; 1 does not mean zero risk
Performance scenarios	Four scenarios: stress, unfavourable, moderate, favourable	They are estimates, not forecasts; look above all at the unfavourable one
Costs	Total costs and their effect on annual return	The most useful number for comparing different products
Holding period	How long it should be held	That it fits with when you will need the money

> *If, after reading the document, it is not clear what the product invests in, the reasonable answer is not to buy it until it is.*

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CHAPTER 5

The questions to ask

A list to keep in front of you before signing anything.

- [ ] Do I have an emergency reserve and no expensive debt?
- [ ] When will I need this money? Does that fit the recommended holding period?
- [ ] Have I understood what the fund invests in, in my own words?
- [ ] Do I know what it costs in total, every year, including the service of whoever is offering it?
- [ ] Have I looked at the unfavourable scenario, and could I bear it without selling?
- [ ] Is the person offering it authorised? Have I checked the official register?
- [ ] Do I know how to exit, how long it takes and at what cost?

If any of these questions has no answer, the right thing to do is to ask. A serious firm answers willingly and in writing. Haste, in this field, is never in the interest of the person who has to decide.

TO CONTINUE

All courses, the glossary and the calculators are freely available at getinfofree.co, with no registration.

Institutional sources for further reading

- ESMA — Investor Corner — https://www.esma.europa.eu/investor-corner
- Financial Conduct Authority (UK) — Consumers — https://www.fca.org.uk/consumers
- European Central Bank — Explainers — https://www.ecb.europa.eu/ecb-and-you/explainers/html/index.en.html

Sources consulted for this guide

- ESMA — Investor Corner — https://www.esma.europa.eu/investor-corner
- Banca centrale europea — «What is a deposit guarantee scheme?» — https://www.ecb.europa.eu/ecb-and-you/explainers/tell-me-more/html/deposit_guarantee.en.html

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