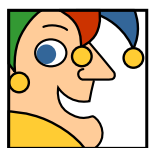


A MOTLEY FOOL UK SPECIAL REPORT

THE FOOL'S GUIDE TO INVESTING WITH FUNDS



The Motley Fool®
To Educate, Amuse & Enrich™

The Fool's Guide To Investing With Funds

Brought to you by  The Motley Fool

We're dedicated stock pickers at The Motley Fool, and we've built our company around the belief that with insight, patience, and a solid education, an individual investor can beat the market.

But to be successful, we believe you need to start early and consistently save a decent proportion of your money in order to achieve a prosperous retirement.

That's not to say it's easy, and we understand it can be overwhelming for anyone who's just starting out as an investor.

However, we definitely think there are steps new investors can take to become more comfortable putting their money in the market.

This report is designed to help you ease into the world of investing by introducing you to equity funds — an investment vehicle that can easily and relatively cheaply give you broad exposure to the stock market.

So read on to find out how get started on your road to a making a decent retirement a reality through equity investing.

Spread your risk with funds

There are few risk-free investments in this world, and those that are offer little return. However, to ensure your savings keep up with inflation, and are able support you in retirement, you will need to take on some risk. Historically, equity markets have outpaced inflation and provided strong enough returns to preserve your buying power into retirement.

There are no guarantees this will always be the case, and unexpected events can cause a company's share price to drop dramatically.

With that in mind, we think a good way to reduce the risks of stock picking is to invest in a wide array of shares. We generally suggest you have at least 15 shares in your portfolio, but we realize this may not be realistic for an investor just getting started. Instead, one option is to put some of your money into equity funds.

An equity fund is a portfolio of shares that you buy into by investing in the fund. In effect you own a piece of every company the fund owns. Most funds hold at least 30 individual companies, and it isn't unusual for the list to run into hundreds.

This means that by investing in a fund, you spread your money among a far larger array of companies than most individual investors could hope to follow (or hope to buy for that matter). Costs are an issue with funds, as we'll see in a moment, but the trading costs of buying into dozens of different shares can be prohibitive, too, even if you've got a very large pot of money to play with.

And funds bring more to the party than just a crowd of shares. Different funds tend to specialise in different areas of the market — small companies, say, or property outfits, or those that pay a higher than average dividend.

There are many funds available that invest exclusively in overseas markets, too. With funds you can easily put your money to work in the US, Europe, or countries like China and India, where the opportunities can be very different to back home. All this at the push of a mouse button or the posting of an envelope!

The fundamental problems with funds

Are you now keen to add some funds to your portfolio? Raring to hear about the new Warren Buffett we've discovered who's going to make you rich?

Not so fast, Fool!

As a matter of fact, we don't suggest you let any fund manager look after your money, unless you have a very specific purpose in mind (perhaps a specific market niche, or a hard to reach territory — gold miners in Antarctica, anyone?)

Because fund management is so competitive — and markets somewhat cyclical — few managers stay on top of the pile for long. And, almost across the boards, the fees funds charge here in the UK are pretty high, certainly when you compare them to similar funds in US.

One study of the UK market looked at the top 20% of funds over a five-year period to 2005. It found that only a fifth of these top funds still held their place in the top flight over the subsequent five years. Some two-fifths went on to either underperform, or were closed down (we'd guess for underperforming!)¹

Worse, if you think about it, the average return from all funds must equal the return of the overall market. That's because, taken in aggregate, they are the market (or least a substantial proportion of it).

But that's before costs! After costs, it's almost inevitable that

the average fund must lose to the market over the long term.

Given these two facts — that winning fund managers rarely stay winners, so it's nigh on impossible to pick 'em, and that, after costs, funds in aggregate tend to trail the market — it seems to us most sensible to simply try to get the same return as the market from your fund, for the lowest cost possible to preserve your returns.

Happily, we're not the first to have this idea.

The Foolish approach to funds

This is where index tracker funds come in. Instead of trying to beat the stock market, tracker funds simply attempt to match the return of a particular index, such as the FTSE 100 index (the 100 largest stock market listed companies in the UK).

Index trackers also aim to keep costs as low as possible so charges aren't eating up your gains.

Instead of a City fund manager trying to wheedle insights from company directors or the squiggles of a share price graph, index trackers use computers to tell them which shares to buy and sell to try to match their index. Much cheaper than paying a fund manager on bonus day!

At their simplest, you can think of index trackers as simply holding a bit of every single company in the market, in proportion to its size. As all these companies' share prices rise and fall — and so move the index — the fund's value rises and falls, too.

The actual details are a little more complicated than that; holding every share isn't usually very efficient, and some index trackers use slightly different strategies to try to follow the market more closely or to cut costs.

But that's the basic gist: Hold everything, instead of stock picking, and get stock market returns on the cheap, instead of paying over the odds and risking doing worse.

Index tracker funds versus ETFs

So what exactly are these index tracker funds, and where do you get hold of them?

There are two main types of tracker funds:

Index tracker funds are like other mutual funds (aka unit trusts or OEICs) that you might have bought in the past. They are available on fund platforms like Hargreaves Lansdown and BestInvest, or you can often invest direct with the fund provider (such as Legal & General or HSBC).

Exchange traded funds (ETFs) are in theory index tracker funds that are bought and sold on the stock market, like any company's shares. (See our 'Beware of synthetic ETFs' section for a complicating factor). You buy them via a stockbroker — usually an online broker these days — and hold them like other shares.

Both types of index tracker have no-upfront fees and low annual charges (best captured by a measure known as the

Ongoing Charges Figure, or OCF), with ETFs typically slightly cheaper to hold.

The main difference between the two types of tracker is how you invest.

With index funds, you can invest a lump sum or make regular investments (subject to the contribution rules of your fund platform). The big advantage of index funds is there are no dealing charges. The disadvantage is you can only buy and sell them once a day.

Because ETFs are bought and sold like other shares, you will pay your normal share dealing fees whenever you invest in them or sell them. One benefit over buying normal shares, however, is that because many of them aren't domiciled in the UK, buying ETFs does not attract the usual stamp duty charge of 0.5%.

So which vehicle should you choose to use for your low-cost index tracking?

There are dozens of index funds, and hundreds of ETFs (and millions of investors!) so it's difficult to generalise.

On balance, we'd say that most investors probably find index funds the lowest hassle way of adding some indexing goodness to their portfolios. There are no dealing fees to worry about, and provided you invest with the well-known UK providers and stick to plain vanilla index funds, you're unlikely to stray into an unsuitable product. The lack of dealing fees makes them particularly suitable for regular saving.

ETFs are more appropriate for slightly more sophisticated investors, who want more flexibility in where and when they invest their money, and who are investing lump sums rather than regular savings (so dealing costs are less of a factor). We'd suggest you stick to the iShares range of ETFs at first to avoid straying into murky waters.

A few other things to look out for

In a moment we'll round off this special report by giving you six index tracking ideas — three index funds, and three ETFs — to get you started.

Before then, here are a few other things worth knowing about.

Inc versus Acc units — Many funds are prefixed with either Income (Inc) or Accumulation (Acc) in their title. This tells you how they treat dividends, which all shareholders are usually entitled to from the companies in their portfolio. The Income funds pay a regular income, whereas Accumulation funds roll-up the income into the capital value of your holding.

Currency — Index funds and ETFs that invest overseas are usually denoted in currencies other than UK pound sterling (Euros or US Dollars, for instance). This is nothing to worry about, in that it's inevitable that by investing overseas you will be exposed to fluctuations in an alternative currency. It is worth remembering though that this currency risk is an additional cause of volatility in your portfolio if you choose

to track an overseas index.

ISAs and SIPPS — All the mainstream funds and ETFs are eligible to be held in these tax-exempt wrappers, enabling your money to grow beyond the reach of the taxman!

Fund platforms and supermarkets — Not every index fund is available on every fund platform. Your chosen platform may also charge extra fees for holding index (or other) funds, or an annual management fee or similar, so make sure you take all costs into account before deciding where to place your money.

Three Index Funds To Consider

HSBC FTSE ALL SHARE INDEX FUND

Competition to deliver the cheapest index funds in the UK has heated up recently. HSBC might not offer the very cheapest FTSE All-Share tracker the day you happen to read this report, but it will be a contender — and it's one of the most widely available funds across the different platforms.

The fund aims to match as closely as possible the return of the UK's main market for shares, for a cheap 0.17% OCF per year. We think it's an ideal way to diversify your UK shareholdings.

LEGAL & GENERAL EMERGING MARKETS INDEX FUND

There are a lot of fund managers willing to charge you a lot of money for investing in the emerging market growth story so beloved of the press.

Legal & General enables you to get in on the action for far less than the vast majority of active funds, with this index tracker boasting an OCF of 0.97%. It tracks the FTSE All-World Emerging Index, and gives you substantial exposure to Brazil, China, Taiwan, India, as well as a host of other young and fast-expanding economies.

VANGUARD LIFESTRATEGY FUNDS

We're often advised to hold a certain percentage of our money in shares and the rest in bonds, depending on a rule of thumb such as our age or our risk tolerance.

These neat funds enable you to do that with a single investment. Your investment in the fund is split between an equity component — which holds a collection of Vanguard's globally diversified share index trackers — and a bond component, which does the same job with bonds.

There are five LifeStrategy funds to choose between. You can elect to invest in say the 40/60 equity versus bond mix if you're young and very risk-tolerant, down to a 20/80 split in favour of bonds if you're approaching retirement or hate risk. The OCF varies slightly between the options, but they're all 0.24% or less.

These funds are still relatively new to the UK, and they are not yet available on every fund platform.

Three ETFs To Consider

ISHARES FTSE 100 (LSE: ISF)

Buy a stake in Britain's top 100 companies by purchasing a single ETF. While not a complete snapshot of the UK stock market, the FTSE 100 comprises roughly 80% of its total capitalisation, and it includes most of the big names, from BP and HSBC to Vodafone and Unilever. The OCF is 0.07%.

ISHARES MSCI WORLD (LSE: IWRD)

Why buy one country's companies when you can invest in the largest from across the globe? This ETF tracks the MSCI World index through investments in some 1,200 different shares. Many of the world's largest companies are American, so it's no surprise to find over 50% of the fund in US firms, but numerous other developed world countries' companies are in the mix, too. The OCF of 0.5% seems to us reasonable, given the diversity here.

ISHARES MSCI EMERGING MARKETS (LSE: IEEM)

Here's an easy way to bolt on the sexiness of investing in high-growth regions like China, India, and Latin America — without any of your money going towards paying a fund manager to fly on exotic fact finding missions on your behalf.

For a OCF of 0.75% a year, you'll be buying into over 800 companies, led by giants such as South Korea's Samsung, China Mobile, and Russia's Gazprom, giving you a ringside seat in planet Earth's most dynamic countries at a bargain price.

Beware of synthetic ETFs

In their 'traditional' guise, Exchange Traded Funds are essentially stock market-listed tracker funds. Like the latter, they hold (and buy and sell) shareholdings in a large range of companies to mirror the returns of their underlying index.

In contrast, synthetic ETFs are based around a legal contract — between an ETF provider and, say, an investment bank — to deliver the chosen market return. They can even be backed up by securities that aren't in their index.

Many people have warned that synthetic ETFs therefore bring additional risks to the table, including counterparty risk (the risk the bank that stands behind your synthetic ETF goes bust) and collateral risk (the securities held by your ETF could be illiquid or collapse in value in a market panic, hitting the ETF's pricing).

The three ETFs we've selected for this report are called 'physical' ETFs, because they own a basket of the same shares they seek to track. They are certainly not risk-free, but they don't have the particular risks of synthetic ETFs.

1. Research by Vanguard. See: <http://www.fool.co.uk/news/investing/investing-strategy/2010/11/12/a-chilling-lesson-from-dead-investment-funds.aspx>

<https://www.vanguard.co.uk/documents/inst/literature/case-for-index-fund-investing-in-uk.pdf> p.5

RISK WARNING

- The prices of all shares, and the income from them, can fall as well as rise.
- You run an extra risk of losing money when you buy shares in certain smaller companies including “penny shares”.
- There is a big difference between the buying price and the selling price of these shares. If you have to sell them immediately, you may get back much less than you paid for them. The price may change quickly, it may go down as well as up and you may not get back the full amount invested. It may be difficult to sell or realize the investment.
- You should not speculate using money you cannot afford to lose, or rely on dividend income for non-discretionary living expenses.
- Some securities may be traded in currencies other than sterling, and may also pay dividends in other currencies. Changes in rates of exchange may have an adverse effect on the value of these investments in sterling terms. You should also consult your stockbroker about any additional dealing or administrative charges.
- We have taken all reasonable care to ensure that all statements of fact and opinion contained in this publication are fair and accurate in all material aspects.
- Investors should seek appropriate professional advice from their stockbroker or other adviser if any points are unclear.
- This report gives general advice only, and the investments mentioned may not necessarily be suitable for any individual.

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(OCF amounts for each of the funds mentioned were correct as of 19th August 2016.)