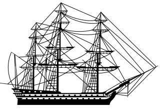

Vanguard®

Managed funds

Plain Talk® Library

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PASSPORT

Introduction to managed funds

Managed funds provide a cost-effective way for investors, large and small, to access a diversified mix of professionally managed investments. Typically, your money is pooled with other investors so you can invest in assets which might be too difficult or expensive to invest in directly.

This Plain Talk® Guide introduces the concept of managed funds, describes how they are managed, the types of funds available and their benefits and costs. It aims to improve your knowledge and understanding of managed funds and help you make more informed investment choices.

What is a managed fund and how does it work?

A managed fund is one type of investment vehicle where your money is pooled together with other investors. Instead of owning the investments yourself, like when you buy shares directly, the managed fund owns the underlying investments and an investment manager buys and sells the assets on your behalf.

Investing in a managed fund allows you to diversify your investment portfolio for a relatively small initial outlay. This may be as low as $1000, but is typically around $5000.

When you invest in a managed fund you are buying units in that fund. The value of your units is calculated on a daily basis and changes as the market value of the assets in the fund rises and falls.

You may receive regular payments from the fund, known as distributions, based on the income it receives from the underlying investments.

Buying and selling a managed fund

The number of units you are allocated depends on how much money you invest and represents your share of the fund. Managed funds generally have a product disclosure statement (PDS), which states the investment objective, costs and information needed to buy and sell.

You'll need to complete an application form which is usually found at the back of the fund's PDS or on the website.

The PDS also details the types of investments the fund will hold, how the investments will be managed and the types of risk investors can expect, which can help you align your risk and investment objectives with that of the fund.

Professional management

Professional investment (or fund) managers take care of managing money on your behalf. This means you don't have to worry about choosing which companies or securities to invest in.

Fund managers are experts in their field of investment, combining economic, market and corporate knowledge to analyse the sectors and companies they invest in. They'll make sure your money is invested in line with the fund's objectives, investment strategy and risk parameters.

The lowdown on fees

Like any other investment, there are fees involved when investing in a managed fund. Managed funds fees may vary and must be disclosed in the fund's PDS.

The types of fees you may pay when investing in managed funds include:

- Entry fee: An upfront fee that may be deducted from your initial investment. This can be up to 5% and will reduce the amount of your initial investment. If you deal directly through the fund you may not have to pay this fee. If you are using an adviser you may be able to negotiate this fee.

Smart investing tip 1: Invest consistently

Timing the markets for the best time to invest is easier said than done. Many investors use a dollar cost averaging strategy. This involves investing a set amount into a managed fund on a regular basis, regardless of the unit price, to average out market fluctuations over time. One of the easiest ways you can implement this strategy is to start a regular investment plan with a managed fund.

- Management expense ratio (MER) fees: An ongoing fee to cover the cost of managing your investment.
- Switching fee: A fee for switching between funds or investment options.
- Buy/sell spread: The difference between the entry unit price (buy price) and exit unit price (sell price). These can include brokerage, custody costs, government taxes and bank charges and are expressed as a percentage of the funds net asset value (fund size).

Not all funds charge all of these fees, and may charge others, so check the PDS for information on fees before you invest. Vanguard does not charge entry, contribution or switching fees (apart from the usual buy-sell spreads that apply to all transactions) and does not pay commissions to advisers.

Lower costs can translate into better long-term performance

The table below shows how cost differences between funds can affect your total return over time. This example assumes an average return for a $20,000 investment over a 5 to 30 year period.

Fund A has a higher management cost than Fund B

Number of years invested as at 30 September 2017	S&P/ASX 300 Accum. Index return % p.a. as at 30 September 2017	Fund A Investment value with expense ratio of 1.95% p.a.	Fund B Investment value with expense ratio of 0.75% p.a.	Difference
5	9.40%	$29,146.97	$30,947.23	$1,800.26
10	2.95%	$22,002.97	$24,804.93	$2,801.96
20	8.03%	$63,536.39	$80,748.80	$17,212.41
30	7.58%	$99,710.60	$142,860.34	$43,149.74

Assumptions: Initial investment of $20,000. MER paid at 30 September each year.
Past performance is not an indication of future performance.
Source: Vanguard using market data.

Tax—the hidden opportunity cost

The income distributions from a managed fund are assessed as part of your taxable income just like other income you receive, such as rent, wages and bank interest.

Some asset classes like shares provide tax concessions through dividend imputation or franking credits. Because companies listed on the Australian Stock Exchange have already paid tax on the profits they distribute, investors may receive a franking credit for the amount of tax the company has paid. This essentially eliminates the double taxation of cash payouts and allows investors to use franking credits as an offset against their income tax liability.

Like direct share investors, unitholders in managed funds may also have to pay capital gains tax. Capital gains are generally only taxable once realised, that is, when the asset is sold for a profit. For investments held for more than a year, discounts may apply to the taxable amount:

- for an individual investor only half of the capital gain will be taxable
- for a superannuation fund investor, only two thirds of the capital gain will be taxable.

Smart investing tip 2: Costs matter

Costs can take a large chunk out of your investment return. So it's important to compare fund fees before you invest. Look at things like contribution fees, adviser commissions and management fees as these can all add up over time. Not all managed funds charge these fees, so make sure you examine the fine print and know exactly what you are paying for and how much.

Types of managed funds

There are many different kinds of managed funds offering a range of investment objectives and strategies. Managed funds offer a wide choice of investment options so it's important to consider which fund is right for you.

Growth assets, such as shares and property, can be volatile but may provide a better chance of increasing the value of the investment over the long term.

Defensive assets, such as bonds and cash typically tend to provide more stable, albeit lower returns.

The right type of investment for you will depend on your investment objectives, timeframe and tolerance for risk*. The most common types of managed funds are:

Cash

- For short-term investors
- Usually includes higher paying interest than bank accounts or term deposits
- Lowest risk of all asset classes.

Australian and international fixed interest

- For short and long term investors
- Low to medium risk depending on the risk grade of the underlying bonds
- Can provide a steady and reliable income stream
- Usually offer a higher interest rate, or yield, than cash
- Provides access to Government, state governments, semi-government authorities and company debt from Australia or overseas
- Often used as a good source of a diversification relative to growth assets, such as shares, in a portfolio.

* Please see back cover

Australian and International property securities

- For long-term investors
- Potential for higher returns with higher risks
- Returns include income and capital growth
- Offers access to properties in retail, office, industrial and tourism
- You can invest in both Australian and international property security funds.

Australian shares

- For long-term investors
- Potential for higher returns with higher risk
- Returns include income and capital growth
- Potential for income through payment of dividends and tax benefits in the form of dividend imputation
- Provides access to a range of companies listed on the Australian Securities Exchange

International shares

- For long-term investors
- Potential for higher returns with higher risk
- Returns include income and capital growth
- Access industries and investment opportunities outside of Australia
- Offers diversification benefits when investing in a range of countries, industries and companies.

Diversified or multi-asset managed funds

- Available in a mix of investment profiles from conservative to balanced to growth and high growth
- Investment timeframe depends on type of fund chosen
- Invests in more than one asset sector, like shares, fixed interest and property
- Diversified approach can lower risk
- Professional fund manager decides the asset allocation (i.e. how much to invest in each asset sector) of the fund according to the fund's investment objectives.

What are the benefits of managed funds?

Choice and opportunity

As your money is pooled with other investors, you can access a much wider range of investments to meet your objectives. Managed fund investors can enjoy greater diversification than direct investors so they are less exposed to the performance fluctuations of individual shares or securities.

You don't need much money to get started

You can access a managed fund with a few thousand dollars or less. There are managed funds available for personal investors, higher net worth individuals, self-managed super funds, companies and major institutions.

Managed for you

You don't have to spend extra time managing your investments as the fund is serviced for you by the experts.

Global investment opportunities

As an individual investor it is difficult to build up a portfolio of international investments directly. Investing internationally via a managed fund can increase your diversification further and give access to industries and companies outside of Australia.

Regular income

Managed funds can provide a regular source of income. Some funds offer monthly, quarterly or six-monthly income distributions. Investors can choose to take distributions in cash payments or reinvest them back into the fund. Reinvesting your income distributions can compound your returns giving you potential for higher growth.

Flexibility

Most fund managers offer a switching service so you can change funds quickly and easily if your investment needs or circumstances change. You should check the PDS for information about switching, including any costs involved.

Choosing a managed fund

There are a number of factors to take into account, including:

- your attitude to risk and return
- your investment objectives and personal circumstances
- length of time to invest (your time horizon)
- costs and tax
- investment styles.

Risk and return

All investments have some level of risk and it'll vary from fund to fund. Risk and return are inextricably linked. Usually the higher the risk, the higher the expected return. As an investor, your appropriate level of risk will vary, based on a range of factors, including age, investment time frame, where other parts of your wealth may be invested, and your risk tolerance.

There are a number of different types of risk, which will be outlined in a funds PDS. Here's a few:

- Market risk: The possibility that market returns will decline. Financial markets will have periods with rising prices. It is important to note that the value of your investment can be directly or indirectly impacted and that you may not get back what you invested in the Fund.

- Fund risk: Managed funds, in simple terms, pool the money of many individual investors. Therefore, investing in a managed fund may give rise to different outcomes as compared to investing in the underlying securities directly. As an investor in the Fund, your investment returns may be impacted by the applications and withdrawals of other investors, the fees and costs imposed by the fund manager and different tax outcomes related to the tax laws applicable to the Fund.

- Regulatory risk: There is a risk that the Fund may be adversely impacted by a change in laws and regulations governing a security, sector or financial market, including in relation to tax. Regulatory risk may be higher when investing internationally due to the nature and actions of particular legal systems and/or regimes in effect.

How are returns generated?

The overall performance of a managed fund simply reflects how the underlying assets are performing. The market prices of these assets can go up and down daily.

Returns generally come in the form of income and growth. Income can include earnings from share dividends, rent from property and interest from fixed interest and cash type investments. It can also come from capital gains when profits are realised upon the sale of an underlying asset in the fund. Fund income distributions are generally made at regular intervals. Investors can choose to take their income payments in cash or reinvest them back into the fund.

Growth comes from any increase in the value of the portfolio's assets and is reflected in the fund's unit price. It is only realised when you sell your units in the fund.

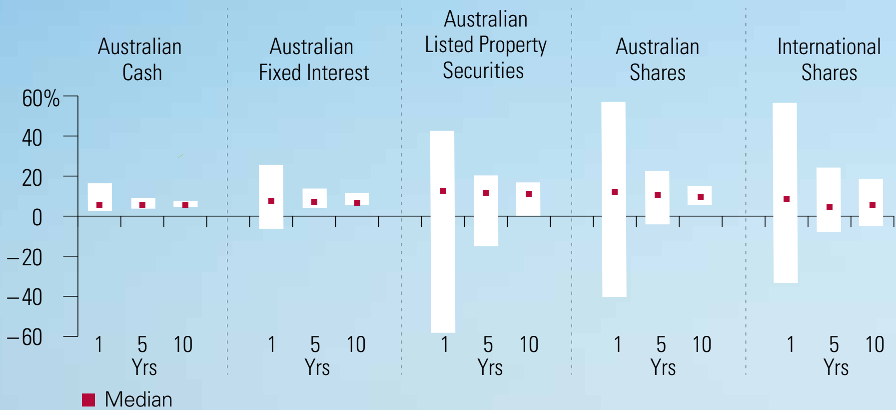
As performance can be volatile in the short term it's best to take a longer-term perspective (five years plus) when assessing managed fund performance. It is also important to remember that past performance is no guarantee of future performance.

Smart investing tip 3: Invest long term

People often get caught up with short-term stock selection, which can deliver inconsistent results. While one investment might deliver great returns one year, it is difficult to pick winners every year. When it comes to investing, it generally pays to diversify and invest for the long term.

Risk of major asset classes

Range of returns over 1, 5 and 10 year periods (1 January 1990 - 30 September 2017)



Note: Past performance is no indication of future performance. Assumes 100% reinvestment of distributions without any consideration of fees.

Source: Vanguard calculations using data from Morningstar Inc.

How much risk can you tolerate?

Your attitude to risk is one of the most important factors when considering a managed fund. While growth assets, like shares and property securities, tend to have more volatile returns over the shorter term, they do have the potential to produce higher long-term returns.

Generally, the longer you have to invest the more growth assets you can include in your portfolio. As the graph shows, over time the ups and downs of investment markets tend to even out. This is why it is important to consider your investment timeframe when choosing a managed fund.

Controlling risk

Using a diverse range of investments is one of the best ways to reduce your risk. This way you are not relying on the returns of a single investment. Investment markets are volatile meaning they move up and down at different times. With a diversified portfolio of investments, returns from better performing investments can help offset those that underperform. You can achieve diversification through a managed fund by investing in:

- a diversified fund that has exposure to different asset sectors, such as shares, fixed interest and property
- a number of funds administered by different fund managers—for example, blending share funds from one manager with fixed interest funds from another.
- a fund that holds an array of investments within an asset sector, such as different countries, industries and companies

Smart investing tip 4: Diversity

One of the most important investment decisions you can make is how you divide your money between each asset class, referred to as asset allocation. Diversifying across a range of asset sectors, industries and securities can reduce market risk and provide access to the performance potential of different asset exposures. In multi-sector managed funds the fund manager does this for you.

Investment styles

A management style is a framework that guides the way fund managers evaluate and select the investments they make. It is like a set of principles based on the fund manager's beliefs about investment markets. When choosing a fund manager, it is important that you feel comfortable with their investment style.

Active and index fund managers

Index managers aim to match the performance of a market index by investing in all or a representative sample of the securities in the index. A benchmark index measures the performance of a basket of securities. For example, the S&P/ASX 300 Index measures the performance of about 300 companies listed on the Australian Stock Exchange. Index funds invest in all or most of the securities in the index providing diversification, which can mean lower risk when compared to holding only a single or few securities.

Active fund managers usually try to outperform the market index by choosing a selection of stocks they believe will beat the benchmark. They tend to hold fewer stocks than index managers. They also charge higher fees as they have higher costs due to the need for research analysts as well as transaction costs from trading securities more often.

The benefits of indexing

Indexing has a proven long-term performance history in all the major asset classes.

Low costs

Indexing's 'buy and hold' approach can significantly reduce the cost of investing over time. This combined with low management costs means you can keep more of the returns you earn.

Tax effectiveness

Tax can potentially detract from your investment return so it pays to focus on your after-tax return. Because of its long-term nature, indexing benefits from capital gains discounts and the deferral of capital gains liabilities through lower level of security turnover, which can improve after-tax returns.

Diversification

Index funds invest in all or most of the securities in an index, so they provide diversification. Diversifying across a range of asset sectors, industries and securities reduces market risk and can improve your performance potential.

Simplicity

It is very difficult to continually pick winners and outperform the market over the long term. Index funds take the guesswork out of investing by providing a low-cost way to gain exposure to investment markets.

Smart investing tip 5: Less tax can mean higher returns

What's left in your pocket after tax is what really counts. Actively managed funds usually trade more often, which means they may generate more capital gains tax liabilities that can reduce returns. Index funds trade less, so they tend to realise capital gains less often.

The Vanguard difference

When you invest with Vanguard, you have more than 40 years of investing experience behind you. So no matter which investment products suit your needs, you can feel confident that Vanguard investments are built on a rigorous investment philosophy that stands the test of time.

Since launching the first index mutual fund for individual investors in 1976, Vanguard has strived to be the world's highest-value provider of investment products and services. We have an unwavering focus on our clients with a commitment to champion what's best for investors by offering outstanding service, while keeping costs low.

Low-cost investing

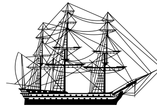
We know we can't control the markets, but we can control the costs of investing. To that end, providing low-cost investments isn't a pricing strategy for us. It's how we do business.

We can keep our costs low because of our unique ownership structure in the United States, which allows us to return profits to investors through lower costs so investors can earn more over time.

Our range of managed funds and ETFs

Vanguard offers a complete range of funds across all asset classes.

To see our complete product offerings, visit vanguard.com.au.



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