Understanding the difference in stocks, bonds, mutual funds, and ETFs

by Charles B. Flowers, AIF®

Think of investing as if you were building a house, with each investment vehicle as a type of tool. The four most common types of investment vehicles include: individual stocks and bonds, mutual funds, and exchange traded funds (ETFs). Just as it is important to know how each tool works and what job each tool is best suited for in building a house, it is important to know how each kind of investment works best in building your portfolio.

Stocks and bonds are the two basic building blocks of investing. A stock is a direct ownership in a business, and a bond is a loan. The financial industry has taken stocks and bonds and created a variety of products ranging from mutual funds to credit default swaps. Having this many investment options is great, but along with these expanded options comes the responsibility to understand which of these options can be best used to help you meet your financial goals.

Purchasing stock means that you take ownership in an entity. One of the main benefits of direct ownership is that it is easy and clean. There are no management fees and no other organizations or people involved. The cost of purchasing an individual stock can be easily affordable—many times $10 or less per stock. The downside of direct ownership is that you must stay on top of your investments. At the very least, you should read company reports and filings and have a good understanding of basic accounting principles. Obviously this is a large amount of work and even if you do excellent diligence there is still a chance that your investment will fail.

Purchasing a bond means that you loan money to an entity, such as a business, individual, or government. Buying a bond is like buying a car: you have to be ready to negotiate with the dealer. Owning a bond also requires you to know what type of claim you have to company assets in the event of bankruptcy.

Mutual funds are a way for investors to pool their money together in order to increase purchasing power and to lower execution costs. One of the downsides to mutual funds is the various fees that can be associated with them. All mutual funds charge a management fee, and some charge sales fees in addition to the management fee. Should you decide to invest in a mutual fund, read the prospectus each year to understand the fees you are paying and the investment mandates of the fund. It is important to note that mutual funds can only be traded once a day at the close of the market.

The Exchange Traded Fund (ETF) is a more recent financial innovation. The ETF combines the principals of mutual funds into a vehicle that trades like a stock. The ETF works because of the law of one price. The law of one price states that if two investments track the same thing, then the return from holding either of the investments is exactly the same. For example, if one investment becomes over valued you would sell the overvalued investment and use the proceeds to buy more of the correctly priced investment. While in theory the law of one price always holds, in reality this is not always true. Should you choose to purchase an ETF, pay close attention to what the underlying group of investments being tracked is, and how many shares of the ETF are bought and sold each day. Check on who sponsors the ETF and that the sponsor ensures that the ETF functions properly.

Individual stocks and bonds, mutual funds, and ETFs are all good investment tools. Each has a place in a well-diversified investment plan. Research and find out what investment tool is best suited for your investment strategy, and monitor those investments carefully.

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