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Financial know-how – this is how an equity fund works

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Shares (equities) and equity funds – the same or not?

Only a small minority of Austrians invest directly or indirectly (via equity funds) in shares. Is it the fear of losses or the lack of knowledge about this asset class that make investors shy away from it? In this blog entry, I would like to give you an overview of the features of shares and equity funds.

What is a share?

Let's assume a company is looking for capital for its business activities. The company can either take out a loan, i.e. debt, or it can offer an investment in the company (and in the company's success), i.e. equity. Investors should know that for the latter case, they invest in shares (also referred to as equity, or equities).

Their features:

- Investment in a company, no maturity, no redemption
- Possibly an annual dividend (distribution to shareholders, not fixed, depends on the dividend policy of the company)
- The investor has rights at the Annual General Meeting regulated by law

This means there are no regular payments, no fixed maturity, and no redemption of the capital invested. Are there, then, any arguments in favour of shares?

Participating in the rising value of the company through the investment

The investment in a company allows the investor to benefit directly from the know-how and ideas of the company. When a company produces good products, earnings and as a result the value of the company will be rising in the long run. This means that when it comes to shares, we are talking about investments in production facilities, human capital, buildings, brands etc. This is often referred to as "real assets".

Worry about losses

Why do Austrians not invest in companies? It is not the investment itself that people are worried about. Rather, it is the price fluctuations – mainly the ones on the downside, i.e. price losses. This means the problem emanates largely from the effects of the shares being traded on the stock exchange, not from the investment per se.

What does an equity fund do?

As investor, you can invest in individual shares on your own. But how do you achieve a sufficient degree of diversification with limited amounts of capital? Here, equity funds offer a good alternative. They tend to invest in 50 to 150 different shares.

The Austrian Investment Fund Act focuses on the protection of investors. The duty to diversify, i.e. to spread the assets across different investments, is laid down in law and therefore a statutory specification for investment funds set up under Austrian law.

Every equity fund comes with terms and conditions which stipulate the kind of shares or equity markets the specific fund may invest in.

Basic categories are for example:

- Countries
- Sectors

- Market capitalisation

Every equity fund is managed by one or more fund managers. (S)he selects the securities according to the terms and conditions and buys them on regulated markets.

An equity fund consists of many shares, i.e. the portfolio

An equity fund is supposed to cover a selected equity market on the basis of broad diversification. The capital paid in generally has to be invested entirely in shares (according to the terms and conditions of the fund). Cash plays a subordinated role in an equity fund.

The fund manager is solely responsible for the decision on what shares to buy. Investors have no say in this respect. The sum of all the assets in the fund is also referred to as fund portfolio.

The equity fund from the investors' point of view

Investors can invest in an existing fund any time. Usually that is possible for smaller amounts such as EUR 100 as well. In return for the capital invested, the investor receives (fund) shares. Crucially, these shares can be sold daily at the current value. The capital investment company sets the volume of the dividend. While it is independent of the earnings generated from equity dividends, it often follows their trend.

Are equity funds safer than individual shares?

Safety is a relative term that is subject to different kinds of interpretation. It is often talked about in the context of price fluctuations. Given that individual shares are subject to sometimes strong fluctuations (and the equity fund consists of many shares), the price of an equity fund may fluctuate substantially as well. A lack of safety can also be regarded as the possibility of a total loss of capital invested. The price of every single individual share can fall to zero, if the underlying company goes bankrupt. Here, risk diversification in the portfolio serves as protection, because the scenario of all companies in the portfolio going bankrupt at the same time is very unlikely. Due to diversification, the weight of the individual shares in relation to the entire portfolio is rather small.

The different share categories of equity funds

Like other funds, equity funds, too, come with two different categories for investors:

- **A-shares**: A-shares offer regular (at least annual) dividends. As part of the dividend payout, taxes are withheld as well. The dividend is paid from assets under management and is credited to the investor's clearing account. As a result, the calculatory value of the fund share is reduced on the day of the dividend payout. This is a price movement that comes on top of the usual fluctuations.
- **T-shares**: This share category focuses on value growth. The earnings remain with the fund, and only the taxes are paid out and at the same time forwarded to the tax authorities.

How is the share price of an equity fund established?

An equity fund consists of shares, the prices of which are established on the stock exchange. This means that for every security in the fund portfolio there is a daily market price. The calculatory value (i.e. price) of the fund is established by dividing the aggregate price of all assets under management (i.e. shares and cash) by the number of fund shares issued.

How to handle price fluctuations?

Equity funds may be subject to significant fluctuations. As example, please have a look at ESPA STOCK GLOBAL, a fund that invests globally in equities.

Chart: ESPA STOCK GLOBAL, performance 10Y, initial value standardised at 100 %
Source: Datastream, data as of 6 June 2017
Calculated according to the OeKB method. The performance data take into account the management fee, but do not take into account the one-off load of up to 5.00% due at the time of issue nor other costs that diminish performance such as account and depositary fees. Past performance is not indicative of the future development of the fund.

The chart illustrates the significant fluctuations very well. The right timing is important for the success in case of one-off investments.

Investment plans

In order to insulate one's investment against the relevance of the price on a specific day, equity funds offer investment plans where investors can invest for example EUR 100 per month over a longer period of time. While this alternative will not allow investors to invest at the optimal (i.e. lowest) price, it will also protect them from investing at the peak. The ongoing investment plan results in an average price. Erste Bank and Sparkassen call this way of investing "s Fonds Plan".

Note: Depending on the performance of the investment fund, the performance of an s Fonds Plan will differ from that of a single investment (higher or lower). A loss of capital is possible in both cases.

How do I buy the equity fund that I am interested in?

Equity funds are not usually traded on the stock exchange. Having chosen a fund, investors just have to go to their bank where the fund will be ordered. The fund shares are credited to the securities account within a matter of days. The purchase of fund shares tends to involve costs. Most often, the investor has to pay a one-off load (NB some banks charge transaction costs or advisory fees), which for equity funds usually ranges from about 3% to 5%.

Conclusion:

Equity funds offer investors the chance to participate in companies (and their development) with small amounts while upholding the principle of broad diversification.

There are many different shares and stock exchanges. Likewise, there are numerous equity funds that cover these markets. The big advantage of an equity fund in comparison with individual shares is its diversification of the capital invested across many companies that operate in different countries and/or sectors. Diversification refers to a strategy that does not put all the eggs into one basket.

Diversification is part of the active managements of all Erste Asset Management funds.

For more information on the product range of Erste Asset Management, please visit our homepage at www.erste-am.at

Johann Griener

Johann Griener has worked at Erste Asset Management in Sales Retail since 1 January 2001. In this function he supported for example the Sparkasse banks in Austria, with a current focus on Upper Austria. His scope of duties includes the servicing, training, training and education of Sparkasse employees who work in the securities field. This means creating and holding presentations in the local branches and in Erste Asset Management for the purpose of promoting sales of Erste Asset Management GmbH and Erste Immobilien KAG funds. He also supports the Sparkasse banks (Austria-wide) in their own investments (nostro business). In addition, Griener is developing numerous publications for internal and external use. The "1x1 of Investment Funds" that he wrote is found in all of the branch offices of Erste Bank and the Sparkasse banks as basic reading and an introduction for customers on how investment funds work.

Griener began his career in 1988 as an employee at the bank counter in a local Sparkasse bank. There he learned the banking business, from a savings book to loans to investment operations. After a few years at the Sparkasse, he decided to continue his studies at the Vienna University of Economics and Business, with a focus on "banks" and "securities". After completing his master's degree, he remained loyal to the Sparkasse sector and has been working at Erste Asset Management since.

His motto: "Only a day with laughter is a good day"