Mutual Fund Basics

What Does Mutual Fund Mean?

An investment vehicle that is made up of a pool of funds collected from many investors for the purpose of investing in securities such as stocks, bonds, money market instruments and similar assets. Mutual funds are operated by money mangers, who invest the fund's capital and attempt to produce capital gains and income for the fund's investors. A mutual fund's portfolio is structured and maintained to match the investment objectives stated in its prospectus.

You can make money from a mutual fund in three ways:
1) Income is earned from dividends on stocks and interest on bonds. A fund pays out nearly all of the income it receives over the year to fund owners in the form of a distribution.
2) If the fund sells securities that have increased in price, the fund has a capital gain. Most funds also pass on these gains to investors in a distribution.
3) If fund holdings increase in price but are not sold by the fund manager, the fund's shares increase in price. You can then sell your mutual fund shares for a profit.

Funds will also usually give you a choice either to receive a check for distributions or to reinvest the earnings and get more shares.

Advantages of Mutual Funds

• Professional Management - The primary advantage of funds is the professional management of your money. Investors purchase funds because they do not have the time or the expertise to manage their own portfolios. A mutual fund is a relatively inexpensive way for a small investor to get a full-time manager to make and monitor investments. (For more reading see Active Management: Is It Working For You?)

• Diversification - By owning shares in a mutual fund instead of owning individual stocks or bonds, your risk is spread out. The idea behind diversification is to invest in a large number of assets so that a loss in any particular investment is minimized by gains in others. In other words, the more stocks and bonds you own, the less any one of them can hurt you (think about Enron). Large mutual funds typically own hundreds of different stocks in many different industries. It wouldn't be possible for an investor to build this kind of a portfolio with a small amount of money.

• Economies of Scale - Because a mutual fund buys and sells large amounts of securities at a time, its transaction costs are lower than what an individual would pay for securities transactions.

• Liquidity - Just like an individual stock, a mutual fund allows you to request that your shares be converted into cash at any time.

• Simplicity - Buying a mutual fund is easy! Pretty well any bank has its own line of mutual funds, and the minimum investment is small. Most companies also have automatic purchase plans whereby as little as $100 can be invested on a monthly basis.

Disadvantages of Mutual Funds

• Professional Management - Many investors debate whether or not the professionals are any better than you or I at picking stocks. Management is by no means infallible, and, even if the fund loses money, the manager still gets paid.

• Costs - Creating, distributing, and running a mutual fund is an expensive proposition. Everything from the manager’s salary to the investors’ statements cost money. Those expenses are passed on to the investors. Since fees vary widely from fund to fund, failing to pay attention to the fees can have negative long-term consequences. Remember, every dollar spend on fees is a dollar that has no opportunity to grow over time. (Learn how to escape these costs in Stop Paying High Mutual Fund Fees.)

• Dilution - It's possible to have too much diversification. Because funds have small holdings in so many different companies, high returns from a few investments often don't make much difference on the overall return. Dilution is also the result of a successful fund getting too big. When money pours into funds that have had strong success, the manager often has trouble finding a good investment for all the new money.

• Taxes - When a fund manager sells a security, a capital-gains tax is triggered. Investors who are concerned about the impact of taxes need to keep those concerns in mind when investing in mutual funds.

Different Types of Funds:

Money Market Funds

The money market consists of short-term debt instruments, mostly Treasury bills. This is a safe place to park your money. You won't get great returns, but you won't have to worry about losing your principal. A typical return is twice the amount you would earn in a regular checking/savings account and a little less than the average certificate of deposit (CD).

Bond/Income Funds

Income funds are named appropriately: their purpose is to provide current income on a steady basis. When referring to mutual funds, the terms "fixed-income," "bond," and "income" are synonymous. These terms denote funds that invest primarily in government and corporate debt. While fund holdings may appreciate in value, the primary objective of these funds is to provide a steady cashflow to investors. As such, the audience for these funds consists of conservative investors and retirees. (Learn more inIncome Funds 101.)

Bond funds are likely to pay higher returns than certificates of deposit and money market investments, but bond funds aren't without risk. Because there are many different types of bonds, bond funds can vary dramatically depending on where they invest. For example, a fund specializing in high-yield junk bonds is much more risky than a fund that invests in government securities. Furthermore, nearly all bond funds are subject to interest rate risk, which means that if rates go up the value of the fund goes down.

Balanced Funds

The objective of these funds is to provide a balanced mixture of safety, income and capital appreciation. The strategy of balanced funds is to invest in a combination of fixed income and equities. A typical balanced fund might have a weighting of 60% equity and 40% fixed income. The weighting might also be restricted to a specified maximum or minimum for each asset class.

A similar type of fund is known as an asset allocation fund. Objectives are similar to those of a balanced fund, but these kinds of funds typically do not have to hold a specified percentage of any asset class. The portfolio manager is therefore given freedom to switch the ratio of asset classes as the economy moves through the business cycle.

Equity Funds

Funds that invest in stocks represent the largest category of mutual funds. Generally, the investment objective of this class of funds is long-term capital growth with some income. There are, however, many different types of equity funds because there are many different types of equities. A great way to understand the universe of equity funds is to use a style box, an example of which is below.

The idea is to classify funds based on both the size of the companies invested in and the investment style of the manager. The term value refers to a style of investing that looks for high quality companies that are out of favor with the market. These companies are characterized by low P/E and price-to-book ratios and high dividend yields. The opposite of value is growth, which refers to companies that have had (and are expected to continue to have) strong growth in earnings, sales and cash flow. A compromise between value and growth is blend, which simply refers to companies that are neither value nor growth stocks and are classified as being somewhere in the middle.

For example, a mutual fund that invests in large-cap companies that are in strong financial shape but have recently seen their share prices fall would be placed in the upper left quadrant of the style box (large and value). The opposite of this would be a fund that invests in startup technology companies with excellent growth prospects. Such a mutual fund would reside in the bottom right quadrant (small and growth). (For further reading, check out Understanding The Mutual Fund Style Box.)

Global/International Funds

An international fund (or foreign fund) invests only outside your home country. Global funds invest anywhere around the world, including your home country.

It's tough to classify these funds as either riskier or safer than domestic investments. They do tend to be more volatile and have unique country and/or political risks. But, on the flip side, they can, as part of a well-balanced portfolio, actually reduce risk by increasing diversification. Although the world's economies are becoming more inter-related, it is likely that another economy somewhere is outperforming the economy of your home country.

Specialty Funds

This classification of mutual funds is more of an all-encompassing category that consists of funds that have proved to be popular but don't necessarily belong to the categories we've described so far. This type of mutual fund forgoes broad diversification to concentrate on a certain segment of the economy.

Sector funds are targeted at specific sectors of the economy such as financial, technology, health, etc. Sector funds are extremely volatile. There is a greater possibility of big gains, but you have to accept that your sector may tank.

Regional funds make it easier to focus on a specific area of the world. This may mean focusing on a region (say Latin America) or an individual country (for example, only Brazil). An advantage of these funds is that they make it easier to buy stock in foreign countries, which is otherwise difficult and expensive. Just like for sector funds, you have to accept the high risk of loss, which occurs if the region goes into a bad recession.

Socially-responsible funds (or ethical funds) invest only in companies that meet the criteria of certain guidelines or beliefs. Most socially responsible funds don't invest in industries such as tobacco, alcoholic beverages, weapons or nuclear power. The idea is to get a competitive performance while still maintaining a healthy conscience.

Index Funds

The last but certainly not the least important are index funds. This type of mutual fund replicates the performance of a broad market index such as the S&P 500 or Dow Jones Industrial Average (DJIA). An investor in an index fund figures that most managers can't beat the market.

What to Know Before You Buy

Net asset value (NAV), which is a fund's assets minus liabilities, is the value of a mutual fund. NAV per share is the value of one share in the mutual fund, and it is the number that is quoted in newspapers. You can basically just think of NAV per share as the price of a mutual fund. It fluctuates everyday as fund holdings and shares outstanding change.

When you buy shares, you pay the current NAV per share plus any sales front-end load. When you sell your shares, the fund will pay you NAV less any back-end load.

Finding Funds

Nearly every fund company in the country also has its own website. Simply type the name of the fund or fund company that you wish to learn more about into a search engine and hit “search.” If you don’t have a specific fund company already in mind, you can run a search for terms like “no-load small cap fund” or large-cap value fund.”For a more organized search, there are a variety of other resources available online.

Identifying Goals and Risk Tolerance

Before acquiring shares in any fund, you need to think about why you are investing. What is your goal? Are long-term capital gains desired, or is a current income preferred? Will the money be used to pay for college expenses, or to supplement a retirement that is decades away? Identifying a goal is important because it will help you hone in on the right fund for the task.

For really short-term goals, money market funds may be the right choice, For goals that are few years in the future, bond funds may be appropriate. For long-term goals, stocks funds may be the way to go.

Of course, you must also consider the issue of risk tolerance. Can you afford and accept dramatic swings in portfolio value? If so, you may prefer stock funds over bond funds. Or is a more conservative investment warranted? In that case, bond funds may be the way to go.

Evaluate Performance of A Mutual Fund

All those mutual fund that quote their amazingly high one-year rates of return. Your first thought is "wow, that mutual fund did great!" Well, yes it did great last year, but then you look at the three-year performance, which is lower, and the five year, which is yet even lower. What's the underlying story here? Let's look at a real example from a large mutual fund's performance:

1 Year	3 Year	5 Year
53%	**20%**	**11%**

Last year, the fund had excellent performance at 53%. But, in the past three years, the average annual return was 20%. What did it do in years 1 and 2 to bring the average return down to 20%? Some simple math shows us that the fund made an average return of 3.5% over those first two years: 20% = (53% + 3.5% + 3.5%)/3. Because that is only an average, it is very possible that the fund lost money in one of those years.

It gets worse when we look at the five-year performance. We know that in the last year the fund returned 53% and in years 2 and 3 we are guessing it returned around 3.5%. So what happened in years 4 and 5 to bring the average return down to 11%? Again, by doing some simple calculations we find that the fund must have lost money, an average of -2.5% each year of those two years: 11% = (53% + 3.5% + 3.5% - 2.5% - 2.5%)/5. Now the fund's performance doesn't look so good!

It should be mentioned that, for the sake of simplicity, this example, besides making some big assumptions, doesn't include calculating compound interest. Still, the point wasn't to be technically accurate but to demonstrate the importance of taking a closer look at performance numbers. A fund that loses money for a few years can bump the average up significantly with one or two strong years.