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Mutual Funds[1]

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Mutual funds are open-end investment companies that use a pool of many investors' money to buy shares of different investments. The companies are called "open ended" because they not only sell shares in the fund to investors, but they will also buy those shares back from investors. Closed-end investments can only be disposed of when there is another investor who will purchase them. The price of a share in a mutual fund is set daily and is called the net asset value (NAV). NAV is the net value of the investments in the fund per share.

Why Mutual Funds?

Mutual funds can be a cost-effective way for a small investor to build a diversified portfolio of investments. This is because a mutual fund purchases investments in many types of securities. A stock mutual fund will purchase shares of many different companies. A bond mutual fund invests in a bundle of bonds. A balanced fund will invest in both stocks and bonds.

A mutual fund may hold shares in hundreds or even thousands of securities. When investors purchase shares in a mutual fund, they have purchased a proportional amount of all the investments held by the fund. This means for a relatively small investment—in some cases less than a $1,000—the investor can start building a portfolio of many securities. By spreading the money over different securities or companies, the fund ensures that the risk any one investment causes is offset by the others; this is a key method to diversify your investment portfolio. This diversification will mean that an investor's fortune is not tied to one particular company or asset type. Reaching the same level of diversification by buying individual securities would require many more dollars, both for the purchase price of the securities and for the transaction/trading fees required for each security purchased. Diversification is often not cost effective for smaller investors without mutual funds.

Many mutual funds allow investors to invest with reasonable initial amounts. This can range from $250 to $10,000 or more. Some require regular additional investments; others do not.

Mutual funds are investment products, so they do come with risks. However, not investing also comes with the very real risk of having inflation erode purchasing power. For future financial goals that are years away (10 years or so), it is especially important to try to earn a return that will beat inflation. This is why people invest and take the accompanying risks. Investors understand that inflation is always a risk that needs to be mitigated.

Understand Your Goals before You Invest

People invest for different reasons, and often these reasons change over the life cycle. For example, individuals who are just starting out are likely to invest to increase their financial assets so that they will be able to fund future goals. In this case, a person may purchase funds that are likely to increase in value. A person who is retired may want to try to preserve capital. In this case, the investor's priority may

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be to invest in funds that provide returns through income or cash dividends.

Mutual funds are classified as to the type of investments they hold (such as stocks or bonds) and also their investment objectives. Common types of fund objectives are growth, income, or a blend (growth and income). A fund with growth as an objective will purchase stocks in companies that are expected to grow. As a company grows, the value of the company stock will rise. A fund with income as an objective will be likely to invest in bonds and stocks in companies that pay cash dividends. A mutual fund with a blended objective means that the company is likely to invest in both stocks and bonds.

How Might You Profit from Owning a Mutual Fund?

Investors can profit from owning mutual funds through income distributions and capital gain distributions. Mutual funds earn income when bonds held as part of the fund pay interest or stocks held in the fund pay cash dividends. In these cases, the investor will receive an income distribution. A fund earns a capital gain when stocks held in the fund are sold for a profit. In this case, the investor will receive a capital gain distribution. An investor can choose to receive the income distributions and capital gains directly or reinvest that money by using it to purchase additional shares in the fund. For some investors, particularly retirees, income distributions can be a way to supplement other retirement income. Investors who reinvest are usually seeking to build an investment portfolio and achieve longer-term financial goals.

An investor can also earn a profit if the Net Asset Value (NAV) of the funds held has increased from the time it was purchased. The investor can realize the profit (also called a capital gain) by selling their shares back to the mutual fund company. This is called redeeming shares and some funds charge redemption fees, especially if the fund has not been held by the investor for very long. Fees, commissions, and transaction costs can reduce the profit and will be discussed later in this article.

Mutual Fund Management

Mutual fund companies have mutual funds that are either actively managed or passively managed. An actively managed fund means that investments are chosen by a fund manager to match the investment goals of the fund. The goal of actively managed funds is to outperform the market. Passively managed funds purchase securities from a particular index. The goal of a passively managed fund is to achieve the same level of performance as the index the fund tracks.

There are many different types of index funds. Index funds can track stocks or bonds. A few examples of stock indexes are the S&P 500, the Nasdaq Composite Index, the Willshire 5000 Total Market Index, and the Russell 200 index. Bond index funds are generally classified by the types of debts they hold. There are government bond funds, corporate bond funds, mortgage-backed security funds, and many more. Within a type of bond fund they may hold short- or long-term debt.

Many academic studies indicate that actively managed funds do not consistently outperform the market. In addition, these funds often come with higher costs than passively managed funds.

Purchasing Mutual Funds

Mutual funds can be purchased from brokers, investment companies, insurance companies, and also directly from mutual fund companies. It is important to carefully compare your options because these different kinds of outlets have varying fees and commissions.

In many cases, mutual funds will be your primary choices in retirement accounts. Many employer-provided plans may have a specific set of funds to choose from. In addition, state education savings plans may also use mutual funds or similar assets for your investment options. Investors can also purchase mutual funds through their Individual Retirement Account (IRA) providers.

Mutual funds also allow investors to regularly invest a set amount of money. This is called **dollar cost averaging**. For instance, an investor can dedicate a relatively small amount of money from each paycheck to purchase mutual funds shares. This means the investor will be purchasing more shares when prices are low and fewer shares when prices are high. A dollar-cost averaging approach allows an investor to remove some of the emotion from investment decisions so as to avoid making emotional mistakes or trying to “time the market.”

Costs of Owning Mutual Funds

Mutual funds come with many types of fees that can have a serious impact on investor return. For instance, if a fund earns a return of 7% but 2% is going for fees, the investor only earned 5%. Over many years, fees can add up to

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thousands of dollars or more. One way to compare the expenses of different funds is to compare expense ratios.

In addition to fees, some funds charge loads. This is particularly true if you purchase a fund from an investment professional such as a broker or insurance agent. Loads are commissions that can be charged when the fund is purchased, when the fund is sold, or every year that the fund is held. A front-end load is an up-front commission charged when the investment is made. So if one invests $100 and faces a 5% front-end load, then only $95 is actually invested. By contrast, a back-end load is charged when an investor withdraws funds. The amount of this charge typically diminishes the longer the money is left invested. For this reason, this load is also known as a contingent-deferred sales load. Note that some funds are no-load funds and do not charge a commission at all, but these may charge a "12-b1 fee," an annual marketing fee of up to 1%.

Mutual funds often have different classes of shares. "A shares" are front-end load. "B shares" are back-end load. "C shares" can vary. Some will have a level load, which is collected every year, and some have a back-end load. C shares may charge a higher 12-b1 or marketing fee. C shares cannot be converted to other share types. Investors usually must choose between these classes of shares for each specific fund they are interested in acquiring, with cost being a significant factor in that choice.

Expense ratios are the percent of each dollar that goes towards the fund's recurring expenses—such as management expenses. Expense ratios do not include the cost of commissions. One way to avoid paying commissions is to purchase funds directly from a no-load mutual fund company. Some types of no-load mutual fund companies may also sell funds with relatively low expense ratios.

The Financial Industry Regulatory Authority has an online fund analyzer that can help you examine different funds and their fees at http://apps.finra.org/fundanalyzer/1/fa.aspx. Screeners such as this one can help you identify a fund or several funds that meet your needs and fit your preferences, such as the amount you'd like to invest, how much you're willing to pay in loads, and your fund objectives.

Types of Mutual Funds

An investor has many options when choosing mutual funds. As discussed, the first consideration is to examine your financial goals and compare those to the fund's objective. Another consideration is whether you would like to have a fund that is actively or passively managed. In addition, there are many different types of funds. Some funds hold just stocks, others bonds, and some a mix of both stocks and bonds. Below are some examples of different types of mutual funds.

Income funds invest in stocks that pay regular dividends and bonds that pay interest income. These funds tend to be less speculative than growth funds.

Growth funds seek to achieve growth through capital appreciation. They invest in companies whose stock they hope will increase in value. These funds tend to be more speculative, but have the potential for higher returns than income funds.

Stock Index funds invest in funds that seek to match the performance of an index by creating a portfolio of securities that replicate the index. They are not actively managed funds, so they come with lower management fees and expenses. Several studies have shown that actively managed funds do not consistently outperform the market. So index funds are often considered a cost-effective alternative.

Sector funds invest in a particular segment of the economy, such as healthcare, technology, or energy. These funds acquire stocks from different companies in that specific sector. They are considered more risky than index funds because they are not diversified among different industries.

International funds invest in stock and bonds of non-US companies. Some of these funds may invest in companies with a global presence, and others may concentrate on a particular region of the world.

Target Date funds are designed to match an investor's predicted need for money at a specific time in the future, such as retirement or funding a child's college education. The name of the fund is the target date. The funds typically invest in a mix of stocks and bonds. When the target date is far off, the portfolio may contain more speculative investments focused on growth. As the target date approaches, the focus shifts toward capital preservation. The portfolio is rebalanced to reduce the proportion of speculative investments and increase the proportion of income-producing investments.

Examples of Bond Funds

Money Market funds invest in short-term debt such as Treasury bills and short-term corporate debt. These are

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the least risky of funds and are often referred to as cash equivalents.

Short or Intermediate Bond funds invest in government and corporate bonds with short or medium maturity rates. Bonds with shorter maturity dates are considered less risky than those with longer maturity dates and tend to pay less interest

High-Yield Bond funds invest in bonds with companies that are rated as less stable and thus more risky. Since they are more risky, they pay higher interest rates. High-yield bonds are also referred to as junk bonds.

Taxes

For funds held as part of a retirement account, such as a traditional IRA or 401(k), money can accumulate tax free until funds are withdrawn. For funds held outside of a retirement account, taxes must be paid on capital gains distributions even if those gains are reinvested. If an investor sells shares in a fund and realizes a capital gain, then taxes must be paid on that gain. The rate at which capital gain taxes are assessed will be determined by whether it is a short- or long-term capital gain. Shares that are held for less than a year and then sold are taxed at the higher short-term capital gain rate. In addition, the difference between the cost basis and the sales price will determine the amount of a capital gain and thus the amount of taxes owed. Cost-basis can be calculated using different methods, so it may be helpful to consult a tax advisor.

Summary

Mutual funds can be an effective way for the average investor to build a diverse portfolio. Although these funds come with fees, taxes, and, in the case of load funds, commissions, an investor still has the potential to achieve positive returns and beat inflation.

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