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Types of Stock Mutual Funds

Introduction

Stock mutual funds, also known as equity mutual funds, are a type of investment fund that pools money from many investors to purchase a diversified portfolio of stocks. These funds are managed by professional portfolio managers who make investment decisions on behalf of the investors. Stock mutual funds invest in a variety of stocks, which can include large, well-established companies as well as smaller, up-and-coming firms. A stock mutual fund is generally used to seek capital growth, dividend income, or some combination of the two. The strategy used to pursue the investment objective will vary from one stock fund to another and depends largely on the kind(s) of stocks that a given fund's portfolio holds.

For example, the investment strategy of an aggressive growth fund will differ sharply from that of a large-cap fund. The strategy and makeup of a given stock fund, in turn, determine the level of risk as well as the potential return associated with the fund. Funds that strive mainly for capital growth will typically carry a higher degree of risk in exchange for potentially higher returns. Conversely, conservative funds that primarily seek to generate current dividend income will typically offer more modest returns and are considered less risky. Mutual funds are managed based on their investment objective and strategy.

In terms of risk, however, it is important to remember that, as a general rule, a stock fund is considered a less risky investment than an individual stock. With a stock fund, you get diversification because it invests in several to many individual stocks; that spreads the risk of loss.

***Caution:** Diversification alone cannot guarantee a profit or ensure against the possibility of loss. All investing involves risk, including the potential loss of principal, and there can be no guarantee that any strategy will be successful. Before investing in a mutual fund, carefully consider its investment objectives, risks, fees, and expenses, which can be found in the prospectus available from the fund. Read it carefully before investing.*

According to Securities and Exchange Commission regulations, a mutual fund whose name indicates it has a particular focus--for example, the hypothetical XYZ Small Cap Fund--must normally hold at least 80 percent of its assets in that type of investment. However, don't select a fund based solely on its name. Categories of stock funds can overlap, and a fund may fall into more than one category. For example, a fund might be an open-end, diversified international large-cap growth stock fund.

Open-end vs. closed-end

Most stock funds are open-end or closed-end. Open-end funds continually offer shares to accommodate new money as it flows into the fund from investors, and stand ready to redeem shares when an investor wants to sell. An investor buys shares at the offer price and sells shares at net asset value (NAV), which is determined by dividing the total assets in the fund by the number of shares outstanding. Closed-end funds issue a limited number of shares and trade on stock exchanges, just like any other stock. Their value is determined not by the value of the securities a fund holds but by supply and demand for the fund among investors. With either type, your shares may be worth more or less than the price you paid when you sell them.

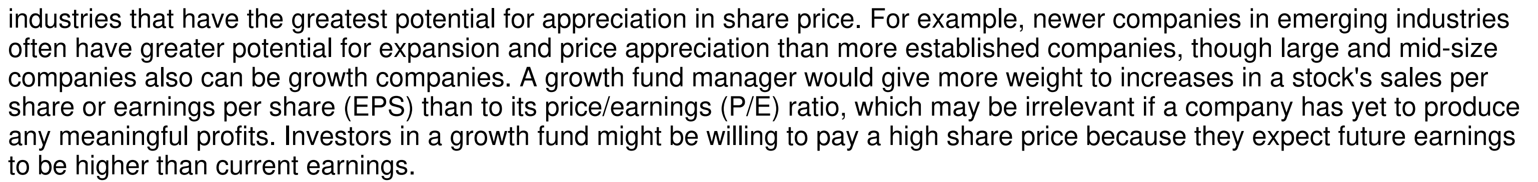
Diversified vs. nondiversified

Stock funds can be either diversified or nondiversified. A diversified fund invests its assets in numerous stocks that have different kinds of investment risk, in order to moderate the fund's overall risk of loss. To be considered diversified, it can have no more than 25 percent of its assets in a single security; with the remaining portion, no more than 5 percent can be invested in a single security. A nondiversified mutual fund, generally speaking, can make more targeted investments. It may hold fewer than 40 securities; some even hold fewer than 20. Nondiversified managers believe that concentrating their efforts on their strongest ideas and monitoring each of them very closely will produce better performance; managers of diversified funds place greater weight on their ability to better manage risk through greater diversity.

In general, a nondiversified fund can be expected to be more volatile than a diversified fund. Why would anyone choose a nondiversified fund when one of the advantages of a mutual fund is its diversification? Because diversification also can act as a drag on returns; it not only helps lessen the blow of poorly performing stocks, but also lessens the impact of stocks with outstanding performance. However, with relatively few stocks, the manager's stock picking ability is even more crucial than with a more diversified fund, since the performance of any individual security will have a greater impact on performance.

Growth vs. value

Among stock fund managers, there are generally two schools of thought about how to select stocks. Growth funds prefer companies that are growing quickly, and are less concerned with undervalued companies than with finding companies and



industries that have the greatest potential for appreciation in share price. For example, newer companies in emerging industries often have greater potential for expansion and price appreciation than more established companies, though large and mid-size companies also can be growth companies. A growth fund manager would give more weight to increases in a stock's sales per share or earnings per share (EPS) than to its price/earnings (P/E) ratio, which may be irrelevant if a company has yet to produce any meaningful profits. Investors in a growth fund might be willing to pay a high share price because they expect future earnings to be higher than current earnings.

The term "growth fund" also can be used to indicate that a fund is focused on capital appreciation--an increase in share price--as an investment objective rather than income. Rather than paying dividends, growth companies typically reinvest the bulk of their profits into the company to facilitate the company's expansion. Investor return comes from future earnings, which should push the company's stock price up and enable investors to sell their shares at a higher price. However, a growth fund can run the risk that its securities become overvalued, which would increase the risk of a loss if you buy at the wrong time.

By contrast, value-oriented funds focus on buying stocks that appear to be bargains relative to the company's intrinsic worth--stocks the manager believes will eventually increase in price to a more appropriate level. A value-oriented fund manager looks for stocks that might have been overlooked by other investors, or that might be struggling with temporary circumstances the manager expects will pass. A value manager takes into account a company's prospects, but is equally focused on whether it's a good buy based on such factors as its price-earnings ratio, price-to-sales ratio, dividend yield, price-to-book ratio, and rate of sales growth. However, a value fund also faces the risk that some securities perceived as a "value" have that low price for good reason and may never live up to expectations.

Some fund managers combine the two approaches, looking for good growth stocks that are selling at a reasonable price. Also, a fund may combine growth or value with another subset of the market. For example, there are both large-cap growth funds and large-cap value funds; the same is true for midcap and small-cap funds.

What are some common categories of stock funds?

Domestic stock funds--those that invest in companies based in the United States--are the largest category of mutual funds. As such, they represent the mainstay of most Americans' stock fund portfolios. However, a broad-based U.S. stock fund is by no means the only way to invest in stock mutual funds. Stock funds may be highly diversified or specialize in a particular strategy or type of stock. More targeted funds can be combined to produce greater diversification than you might be able to achieve in a single fund. Also, many combination funds, such as asset allocation funds, lifestyle/lifecycle/target date funds, distribution funds, and balanced funds include stocks as a major part of their holdings.

The following are some subsets of the stock fund universe to consider when reviewing your portfolio.

Large-cap, midcap, and small-cap funds

Stock funds can be grouped by the size of the companies they invest in, which is typically measured by market capitalization or market cap. A company's market capitalization is computed by multiplying the price of one share of stock by the total number of shares outstanding.

A large-cap fund invests in companies with a large market capitalization--generally greater than $10 billion. These funds own stocks of large, established companies (many are blue chips) such as IBM, Wal-Mart, and Coca-Cola. These companies play a significant role in driving the economy--the Dow Jones Industrial Average (DJIA) and the Standard & Poor's 500 Composite Index (S&P 500) are both composed of large-cap stocks. Because of their large size, large caps generally aren't expected to grow as rapidly as midcaps or small caps. However, large-cap stocks tend to be more stable and capable of providing a relatively consistent stream of earnings and dividends. (Extremely large-cap companies are sometimes known as megacaps and have market capitalizations of more than $200 billion.)

Midcap funds tend to offer greater growth potential than large-cap funds, but generally have less volatility than small-cap funds. Though the criteria for what constitutes a "midcap" stock vary widely, midcaps generally fall between $1 billion and $10 billion in market cap.

Small-cap funds seek to provide above-average long-term growth; the companies in which they invest typically do not pay dividends and have relatively low market caps (the smallest are sometimes known as nanocaps and may have market caps of less than $20 million). Because outlooks for these stocks are largely uncertain and the companies may be more vulnerable to prevailing economic conditions, funds that invest in small caps are generally among the most volatile stock funds.

Aggressive growth funds

Aggressive growth funds, sometimes known as capital appreciation funds or maximum capital gain funds, invest in stock of rapidly growing companies perceived to have above-average growth potential (e.g., small and microcap stocks). They tend to take greater risk in pursuit of higher returns than ordinary growth funds. An aggressive growth fund might, for example, buy initial public offerings (IPOs) of stock from small companies and then resell that stock very quickly to try to generate immediate profits. Some aggressive growth funds may even use derivatives, such as options, to try to maximize their gains. As a result of these strategies and the volatility of smaller companies, they often are more volatile than other stock funds. Small-cap funds sometimes are also referred to as aggressive growth funds.

If the market is going up, aggressive growth funds should benefit the most, because they have the greatest potential to grow more quickly than more established companies. Conversely, they also are normally the ones hardest hit in bear markets. Small companies are typically young companies, which can have a high failure rate, greater need for credit, and/or relatively few profits; therefore, funds that invest in their stock also have the potential for a greater loss than those that invest in more stable companies. A shareholder in an aggressive growth fund should expect the value of its shares to fluctuate sharply, and they may be most appropriate for investors with a long enough time frame to ride out those ups and downs. Aggressive growth funds typically do not invest in dividend-paying stocks, and therefore would not be appropriate for someone seeking an investment that supplies a steady source of income (except perhaps as a relatively small portion of a much larger income-oriented portfolio).

Because aggressive growth fund managers often trade frequently and because researching less well-known companies can be costly, aggressive growth funds may have relatively high expense ratios compared to other types of mutual funds. Also, frequent trading within the fund can generate capital gains and losses that are passed back to investors even if they have not sold any of their fund shares. That can affect an investor's tax liability.

Equity-income/growth and income funds

An equity-income fund seeks to provide shareholders with current income from equities (i.e., dividend-paying stocks). Stocks held by these funds are typically issued by companies that have strong market positions, as well as long records of positive earnings and regular dividend payments. Although some still have growth potential, these companies are usually proven industry leaders or fairly well established. As a result, a typical equity-income fund tends to pay larger and more consistent dividends than other types of stock funds over the long run (though there is no guarantee they will always do so). The established track record of the stocks it invests in and the dividends they pay make this a relatively conservative category of stock fund--particularly compared to an aggressive growth fund, which focuses on capital gains. Unlike a balanced fund, which invests in both stocks and bonds, an equity-income fund typically invests only in stocks.

A growth and income fund is somewhat similar to an equity-income fund in that it strives for both capital appreciation and income from dividends. However, where an equity income fund typically focuses more on a stock's dividends, a growth and income fund may put more weight on a stock's prospects for future growth as well as its dividends. Some growth and income funds may invest in stocks that pay substantial dividends but also are considered a growth company; others may combine growth stocks with others whose primary attraction is their dividends. Be sure you understand what strategy a fund you're considering pursues before buying.

Sector funds

A sector fund invests primarily in securities of companies that belong to a single industry, focus on one segment of business activity, or belong to a related group of industries. Examples of industries in which sector funds invest include agriculture, health care, financial services, communications, entertainment, biotechnology, and utilities, among others. These funds usually aim for growth, and they allow investors to invest in specific industries they believe have a bright future without being tied to one specific company.

Sector funds also can be used to hedge against other investments. Certain industries tend to move in the opposite direction of others, or of the stock market as a whole. For example, an energy shortage could hamper utility companies but be very beneficial for oil companies, while an oil glut could have the opposite effect. Though there are no guarantees, investing in one might help offset any losses in the other.

A sector fund has the potential to yield high returns if the industry in which it invests performs well. However, that relatively narrow focus also means that they involve more risk than more broadly diversified funds. Industries tend to move in cycles--some industries are particularly sensitive to economic changes--and they can come into or fall out of favor quickly. Also, in some industries, stocks may be thinly traded or relatively limited in number.

Global, international, and country/regional funds

Many of the world's best growth opportunities can be found in markets outside the United States, and mutual funds can make it easier for investors to take advantage of those opportunities in a variety of ways. Some of these opportunities arise because many solid, top-performing companies are located overseas; others come about in countries with potential for rapid growth. A fund that invests overseas can provide access to foreign markets that might either be closed to individual investors who aren't citizens, or that might be difficult to research on one's own. And investing through a mutual fund reduces your exposure to problems with a single company.

Investing internationally also can give a portfolio greater diversification. Because economies in various parts of the world may move in different cycles, some may benefit from circumstances that harm others. However, with increasing globalization, economies around the world have become increasingly interdependent; as a result, world markets tend to be more closely correlated now than in the past. Also, there are many flavors of foreign funds, and terminology may vary among investment firms, so don't invest based solely on a fund's name; make sure you understand a specific fund's investing parameters before investing.

Global or world funds generally tend to invest in any region of the world, including the United States. In fact, they may hold as many U.S. securities as some domestic stock funds. Some investors argue that because so many large companies--including U.S. companies--are multinationals with financial and business relationships around the world, they are in effect global companies regardless of where they're located. Because they are the most diversified with respect to countries and currencies, have the greatest flexibility to invest worldwide, and typically invest in large, well-established companies, global funds are viewed as generally the most stable of the foreign funds.

An international fund typically limits its investments to non-U.S. companies. If you already have substantial U.S. large-cap investments, a fund that excludes U.S. companies might provide greater diversification than a global fund whose U.S. holdings might overlap with your existing investments. However, an overseas-only fund would likely also have greater exposure to currency fluctuations.

Country/regional funds (sometimes known as geographic sector funds) limit investments to securities of companies in a specific country or geographic region. A fund that concentrates exclusively on Chinese companies is an example of a single-country fund; a fund that invests throughout Asia would be a regional fund. Other examples include Latin America funds and North America (either including or excluding the United States) funds. Be aware that an individual country or region may be heavily dependent on a very few industries or even a single commodity, and problems in that industry or resource could take a heavy toll on a single-country fund.

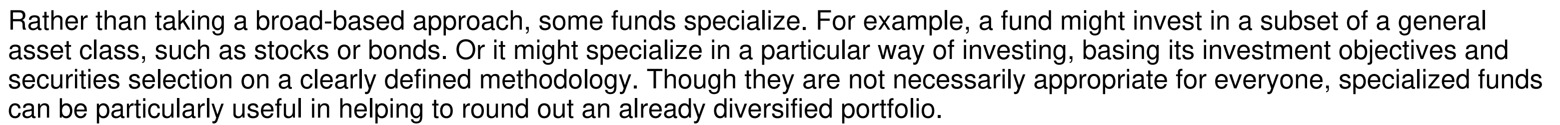
Emerging markets funds typically invest in countries that are not yet part of the developed world but that are either experiencing rapid growth or have above-average growth potential because of large populations of potential consumers, a wealth of natural resources, and/or increasingly stable economies. An example of an emerging markets fund would be one that invests in the countries collectively labeled BRIC (Brazil, Russia, India, and China). However, emerging market countries have traditionally experienced greater political and economic turmoil than more developed nations, and in some cases, their securities may be relatively thinly traded. As a result, emerging market funds can be expected to experience greater volatility than foreign funds that are more broad-based or that focus on economies whose futures are more predictable.

Caution: *In addition to the usual risks of any mutual fund, such as market risk, funds that invest overseas are subject to additional risks, such as potential political instability and differences in financial reporting. Another significant risk is the impact of fluctuations in currency exchange rates. A holding denominated in another country's currency would generally lose value if that currency fell relative to the dollar (although it might also gain value if the dollar weakened). Some funds use a variety of methods to hedge against such currency exposure. That can help reduce losses from currency fluctuation, though it also would limit any benefit from a weaker dollar.*

Caution: *In addition to the general tax issues that apply to most mutual funds, funds that invest overseas are subject to foreign income tax. Since these funds invest in foreign companies, they pay income tax to the countries in which those companies are based. The fund does not pay the foreign tax itself, but rather passes it through to the fund's individual investors. As a shareholder, you will generally have to pay your proportionate share of any foreign income tax, in addition to any U.S. taxes you might owe on dividends and/or capital gains distributed by the fund. However, you may be able to claim a deduction or a foreign tax credit on your federal income tax return for foreign tax paid. Consult a tax advisor for details.*

Tip: *Be aware that researching and investing overseas can be relatively expensive, particularly for single-country and emerging markets funds, and fund expenses may be higher than those of a domestic fund.*

Specialized funds



Rather than taking a broad-based approach, some funds specialize. For example, a fund might invest in a subset of a general asset class, such as stocks or bonds. Or it might specialize in a particular way of investing, basing its investment objectives and securities selection on a clearly defined methodology. Though they are not necessarily appropriate for everyone, specialized funds can be particularly useful in helping to round out an already diversified portfolio.

- Socially conscious funds sometimes known as socially responsible or ethical investing funds, are distinguished not by investing in a specific industry but by selecting investments according to a set of social, ethical, or religious priorities and guidelines. For example, a fund might avoid investing in particular companies, industries, or countries whose products, services, policies, or practices are at odds with the fund's social priorities. Examples of companies that often are excluded from socially conscious funds include those in the tobacco and gambling industries, those with significant interests in countries with repressive or racist governments, or those that contribute to environmental pollution. A fund also might actively seek as investment targets companies or industries that are perceived as supporting certain beliefs about religion, social justice, or ethical business practices. Like all investments, socially responsible investments (SRIs) entail risk, could lose money, and may underperform similar investments not constrained by social policies. There is no guarantee that an SRI will achieve its investment objectives. As with many investment strategies, SRIs may limit the total universe of available investments, and investors who want to diversify their portfolios among a variety of sub-asset classes may not find a SRI to fill each sub-asset class. Different companies offering SRIs may use different definitions of socially responsible investing.
- A tax-efficient mutual fund, also known as a tax-managed fund, is designed to minimize its shareholders' tax liability and maximize their after-tax return. Taxes are one of the most significant costs of investing, and tax planning can be a great concern for investors in mid to high tax brackets. Regardless of what specific investments a fund holds, its manager can employ a variety of strategies to avoid taxable distributions, including minimizing the number of trades it makes, offsetting capital gains with capital losses, and taking cost basis into account when deciding which securities to sell.
- Inverse/bear market funds are designed to mimic the performance of a particular market benchmark--except in reverse. Such a fund is inversely correlated to that benchmark (typically an index), and is designed to fall when its index rises, and rise when the index falls. In order to perform as a mirror image of an index, an inverse fund typically sells short futures contracts that are based on the chosen index. Not all funds geared toward bear markets are inverse index funds; some actively managed bear market funds may short individual stocks or invest part of the fund in defensive asset classes that are highly uncorrelated with the bulk of the portfolio. ***Caution:*** *An inverse fund may be designed to achieve its objective on a daily basis. However, any daily differences between the fund's performance and that of the benchmark index would compound over time; this is particularly true of a fund that employs leverage. Those differences can be magnified in volatile markets, and would tend to grow over time. If you're considering investing in such a fund, you should carefully assess the potential risks of holding it for an extended period of time.*
- Some mutual funds attempt to achieve returns that are independent of market movements, so that the fund in theory performs well regardless of whether a given market is up or down. Funds whose strategies try to neutralize the impact of market fluctuations are known as market-neutral funds (sometimes called absolute return funds). Their managers aim not for relative return (performance relative to an appropriate benchmark) but for absolute return that can be generated regardless of market conditions. Typically, that number is over and above what can be earned in a cash equivalent such as a Treasury bill.
- Most mutual funds are long-only funds; they try to avoid investing in securities that are likely to drop in value. For some mutual funds, such investments are part of the game plan. A long-short fund allows a fund manager to attempt to profit from negative information about an investment that would otherwise be useless if the fund were long-only. By investing long in some securities and selling others short, a long/short strategy allows a fund manager to try to mitigate the impact of a market downturn, since the short sales would be intended to benefit from a drop in price. Many long/short funds are run according to quantitative models that identify candidates for investing, both long and short. However, some also screen potential investments by using fundamental analysis. Long/short mutual funds are different from market neutral funds. A long/short fund typically has a greater proportion of assets in long investments than it does in short sales. By contrast, a market neutral fund's objective in investing both long and short is to actually decouple the fund's performance from that of a given market, and it usually balances long and short investments almost equally.

Index funds

Many mutual funds are actively managed--that is, a manager decides which securities represent the best investments given a fund's investment objective, and also may trade those securities based on his or her view of market conditions and a company's short- and long-term prospects. By contrast, an index fund attempts to closely track the performance of a particular stock index--for example, the S&P 500. To do so, it typically buys the stocks represented in the index and holds them as long as they continue to be part of the index. Because it trades relatively infrequently, an index fund's administrative expenses may be relatively low; however, those expenses also mean that a fund's performance may not match the index's performance exactly.

To schedule an appointment with Faye Sykes, click [here](#) .

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