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Understanding Mutual Funds

Mutual Funds

What is a mutual fund?

A mutual fund is an investment company that pools money from many people and invests it in stocks, bonds, or other securities. Each investor owns shares; each share represents a tiny portion of each individual security held by the fund. An investment professional handles the purchase and sale of individual securities in the fund, based either on an index or on his or her professional expertise. Investors may buy shares (or portions) directly from the fund or through brokers, banks, or financial planning or insurance professionals.

With the majority of mutual funds, when you buy shares, you pay the current net asset value (NAV) (the value of one share in a fund), plus any sales charge (known as a sales load). As with individual stocks, the share price of mutual funds fluctuates and the value of an investment may be more or less than its original cost.

Caution: *Mutual funds are not guaranteed or insured by any bank or government agency--even mutual funds sold by banks. Before investing in a mutual fund, carefully consider its investment objectives, risks, fees, and expenses, which are included in the prospectus available from the fund. Read it carefully before investing. The return and principal value of a mutual fund fluctuates with changes in market conditions. Shares when sold may be worth more or less than their original cost.*

How do investors make money with mutual funds?

Money is made from a mutual fund when the stocks, bonds, or other securities held by the fund increase in value or pay dividends or interest.

- The price of the securities a fund owns may increase. When a fund sells a security that has increased in price, the fund has a capital gain. At the end of the year, most funds distribute these capital gains (minus any capital losses) to investors.
- If a fund does not sell but holds on to securities that have increased in price, the fund's NAV increases. In that case, you could make a profit when you sell (capital gain).
- A fund may receive income in the form of dividends and interest on the securities it owns, and pass that income along to the fund's shareholders.

Usually, you can accept payment of distributions and dividends, or you can reinvest them in the fund, often without paying an additional sales load.

Advantages of mutual funds

Mutual funds can be a great way to invest because:

- They are a collection of many stocks and/or bonds, so your investment risk is spread out. The impact of problems with any one security is much less with a mutual fund than it would be if you had all your money in that security. (Keep in mind that, as with all investments, mutual funds carry risks and diversification does not ensure a profit or guarantee against a loss.)
- Costs associated with the underlying securities are often lower than what you would pay on your own because the fund buys and sells large amounts of securities at a time.
- Mutual funds can be a convenient, cost-effective way to purchase a variety of securities with a relatively low initial investment.
- In the case of an actively managed fund (see below), you are getting the services of an investment professional to make decisions about the selection and timing of securities purchases and sales.
- With an open-end mutual fund (see below), you can redeem your shares with the fund company at any time. As a result, such funds are relatively liquid (though you may experience a loss if you redeem your shares when the NAV is down).

Tradeoffs with mutual funds

- Some funds can have high expenses that can have a substantial impact on your net return.
- A fund may keep a portion of its assets in low-paying cash alternatives to allow the fund to meet investor redemption

requests. If that amount is substantial, it can reduce a fund's returns to its other investors.

- A fund manager's judgment about certain securities may be incorrect, and a manager may or may not have better results than a benchmark index.
- Your investment can be affected by the actions of other investors. For example, if the fund experiences a sudden increase in redemption demands, it might have to sell investments at a bad time to meet those demands; that could affect the fund's NAV. If a fund has a sudden influx of money, it might have difficulty finding worthy investments, or it might have to change its investing style.
- A fund's diversification also can be a negative. Poorly performing holdings can act as a drag on the performance of more successful individual securities within the fund.
- Most mutual funds involve annual expenses that individual stocks or bonds do not.
- Some funds impose a redemption fee if you redeem your shares before a certain length of time has passed.

What are the costs associated with mutual funds?

Like taxes, mutual fund fees and expenses are important because they have an impact on your net returns. Here are some of the common costs associated with mutual funds:

- Sales loads and transaction fees (paid when you buy, sell, or exchange your shares)
- Ongoing expenses, such as 12b-1 fees and management fees (paid while you remain invested in the fund)

Caution: *High expenses do not ensure superior performance, and in fact can have a substantial impact on your net return.*

Tip: *A fund's costs are laid out in the fee table near the front of the fund's prospectus. You can use the fee tables to compare the costs of different funds.*

What types of mutual funds are there?

As mutual funds have become the investment vehicle of choice for many investors, the variety of funds offered has grown dramatically. There are many ways to categorize the array of funds available, and one fund may fall into multiple categories. For example, a fund could be an actively managed, diversified, open-end stock fund. The diversity of mutual funds is one reason why it's important to define your investing goals and then select a specific fund or funds that match them, rather than simply choosing a fund because of its recent performance or a friend's recommendation.

Funds by investment objective

Whether a fund's investment objective is capital appreciation, income, or preservation of capital will determine the type of securities it purchases. As a result, that objective will also help you determine how a given fund might fit into your overall portfolio.

Most stock funds have capital gains as a principal objective (though they may also have others). Bond funds are usually invested to produce current income. A fund also may combine multiple objectives. For example, a bond fund might have current income as its primary objective, with preservation of capital as a secondary goal. An equity-income or growth and income stock fund might aim primarily at growth of principal, with income from stock dividends as a secondary goal.

Funds by asset class

Many mutual funds invest primarily in a single type of investment (asset class), such as stocks, bonds, or cash alternatives. The major categories of single-asset funds include:

- Stock (equity) funds may be organized by size or market capitalization of the stocks in which it invests (large cap, midcap, small cap), by investment style, by sector, by geographic region, or by type of stock (preferred/convertible). Stock funds also may hold a relatively small percentage of their assets in money market instruments to provide liquidity.
- Bond funds hold a portfolio of debt instruments and are generally designed to provide interest income in the form of dividends for shareholders. Unlike the individual bonds held by a bond fund, the fund itself has no redemption date and never matures. A fund's manager adds new bonds to the portfolio as old ones mature or are sold. Because a fund invests in many different bonds, it reduces default risk, since the impact of an issuer defaulting on a individual bond would be much less than if your money was invested in a single bond. Bond funds may be organized by the average maturity of the bonds it holds (short-term, intermediate, long-term); by type of bond issuer; by tax status; by bond rating; and by region. As with stock

funds, a small percentage may be in cash alternatives to allow the fund to handle fund redemptions and facilitate trading. A bond fund is subject to the same inflation, interest-rate, and credit risks associated with their underlying bonds. As interest rates rise, bond prices typically fall, which can adversely affect a bond fund's performance.

- Money market funds, unlike most mutual funds, try to maintain a $1 per-share price (though there is no guarantee one will always do so, and it is possible to lose money invested in a money market fund). Money market funds invest in short-term, fixed-income securities that mature in less than one year.
- Natural resources funds invest in securities of companies, either foreign or domestic, that are connected to such industries as oil, coal, natural gas, timber, precious and base metals, and chemicals.
- Precious metals funds invest in gold, silver, platinum and other precious metals, and/or securities related to them--for example, mining companies that may be either domestic or foreign.
- Commodities funds may invest in agricultural products such as corn, wheat, soybeans, coffee, cocoa, and orange juice. Some commodities funds also invest in some of the same substances as natural resources or precious metals funds, such as oil or gold.
- Real estate funds typically invest in real estate investment trusts (REITs) and/or stocks related to the real estate industry, such as homebuilders, developers, and real estate management companies. There are inherent risks associated with real estate investment and the real estate industry, each of which could have an adverse effect on the financial performance and value of a real estate fund. Some of these risks include: a deterioration in national, regional, and local economies; tenant defaults; local real estate conditions, such as an oversupply of, or a reduction in demand for, rental space; property mismanagement; changes in operating costs and expenses, including increasing insurance costs, energy prices, real estate taxes, and the costs of compliance with laws, regulations, and government policies. Real estate investments may not be appropriate for all investors.

Funds by redemption policy

The vast majority of mutual funds are open-end funds, which will redeem (buy back) your shares on any business day and must send you the payment within seven days. Shares are issued on an ongoing basis, and the number of shares may vary from day to day as new money is invested in the fund and other investors redeem their shares. The value of a share is determined by dividing the total assets in the fund by the number of shares outstanding.

However, some funds are closed-end funds. The number of shares in a closed-end fund is determined at the time the fund is launched in an initial public offering, and does not vary over time. Also, a closed-end fund is traded on a major exchange, as an individual stock or bond would be. Investors cannot redeem their shares with the fund company, but must sell them to another investor. Finally, a closed-end fund's share value is determined not by the value of the securities it holds but by supply and demand for the fund among investors; unlike an open-end fund, a closed-end fund may trade at a discount or a premium to its NAV.

Funds by management style or investment strategy

Most mutual funds fall into one of two categories: actively managed or passively managed (though there are some that attempt to blend aspects of the two styles). An actively managed fund attempts to earn better-than-average returns through the manager's judgment in selecting individual securities and deciding when to buy and sell them. By contrast, a passively managed fund attempts to minimize investing costs by replicating the performance of a given stock, bond, or other index. It includes only the securities included in that index, and generally buys or sells based on changes in the index itself, not on a manager's judgment.

Another example of funds classified by management style or strategy are funds that combine multiple asset classes in a single fund--sometimes by investing in individual securities, but often by investing in other funds. The fund's investment strategy is often driven by an attempt to tailor a single fund to match a broad financial need, goal, investing personality, or time frame. Prominent examples of combination funds include:

- Asset allocation funds, which generally combine the three major asset classes based on a specific asset allocation strategy. As a hypothetical example, an asset allocation fund might allocate 60 percent of its holdings to stocks, 30 percent to bonds, and 10 percent to cash.
- Lifestyle/lifecycle/target date funds, which have a target asset allocation that is based on how conservative or aggressive an investor is or a targeted time horizon. That allocation may or may not shift over time. The target date is the approximate date upon which an investor plans to withdraw their money. For example, typically, target date funds are based on a date that corresponds to the date when an investor expects to retire or needs access to their funds. The mix of investments in the target date fund becomes more conservative as the date grows closer. For example: typically the funds are sold by date,

such as a 2030 fund. The farther away the date is, the greater the risks the fund usually takes. As the target date approaches, the fund should change its balance of investments to emphasize conserving the value it has built up and to shift toward more conservative income-producing investments. The principal value is not guaranteed at any time, including at the target date. There is no guarantee that a target date fund will meet its stated objectives. It is important to note that no two target date funds with the same target date are alike. Typically they won't have the same asset allocation, investment holdings, turnover rate, or glide path. So it is important for an investor to look beyond the target date to determine if a particular target date fund is an appropriate investment.

- Distribution funds, which typically focus on providing income by periodically distributing a portion of the fund's assets along with its earnings.
- Balanced funds typically invest in both stocks and bonds to try to balance the goals of capital appreciation and income.

Some funds are managed specifically to minimize shareholders' income tax liability and maximize after-tax returns. A so-called tax-efficient fund may minimize the amount of trading, trade strategically to offset capital gains with realized losses, or take cost basis into account when deciding which securities to sell.

Most mutual funds are long-only, meaning they try to invest in securities that are likely to rise in value. However, some funds use sophisticated financial instruments to try to benefit from downturns in the market or specific securities by selling those securities or an index short. Examples of such funds include inverse/bear market funds, absolute return/market neutral funds, long/short funds, and 130/30 funds.

Caution: *Leveraged and inverse funds are complex, carry substantial risks, and are intended for short-term trading. Most reset daily and seek to achieve their objectives on a daily basis, but there is no guarantee that the stated objectives will be met on any given day. Due to compounding, performance over longer periods can differ significantly from the performance of the underlying index. Leveraged and inverse funds may be more costly and less tax-efficient than traditional funds.*

Socially conscious funds select securities according to a set of ethical, religious, or social priorities and guidelines.

Caution: *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.*

Funds by level of diversification

Though all mutual funds hold multiple securities, the level of diversification can vary dramatically. To be considered a diversified mutual fund according to SEC standards, a fund cannot invest more than 25 percent of its assets in any single security; of the remaining amount, no more than 5 percent can be put into a single holding. By contrast, a nondiversified mutual fund can invest as much as 50 percent of its assets in a single security. A nondiversified fund may hold fewer than 40 securities; some even hold fewer than 20. Nondiversified managers believe that concentrating their efforts on their strongest ideas will produce better performance; managers of diversified funds place greater weight on their ability to better manage risk through greater diversity.

Caution: *Diversification alone cannot guarantee a profit or prevent the possibility of loss, including the potential loss of principal.*

A fund also may achieve greater diversification by investing not in individual securities but in other mutual funds. For example, a target-date or lifecycle fund often is what is known as a "fund of funds."

Some stock funds hold a wide variety of stocks; others choose to focus on companies in a specific industry or geographic region. These more specialized funds may be known as sector or regional funds.

Funds by investment philosophy

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. The most aggressive of these, known as aggressive growth funds, typically buy stocks for their potential for capital appreciation and often are more volatile as a result. 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. Some fund managers combine the two approaches, looking for good growth stocks that are selling at a reasonable price.

Caution: *All investing involves risk, including the potential loss of principal, and there can be no guarantee that any investment strategy will be successful.*

How do you choose a mutual fund?

Each kind of mutual fund has different risks and rewards. Generally, the higher the potential return, the higher the risk of loss. Shop around. Compare a mutual fund with others of the same type, and with any other funds you may already have in your portfolio before deciding whether the goals and risks of any fund you are considering are a good fit for you. Ideally, you should strive for some diversification to avoid having too many funds that have the same goal or invest in many of the same securities. Don't hesitate to get expert help if all the information leaves you overwhelmed, or if you'd prefer to have someone else do the detailed research for you.

How can taxes affect mutual funds?

Taxes can significantly reduce the net returns on your mutual fund investment, so you should pay close attention to them. Here are a few of the specific tax planning issues associated with mutual funds you'll want to consider:

- Whether a fund is designed to minimize shareholders' tax liability. Some funds, such as municipal bond funds, are designed to avoid federal taxation altogether. Others, commonly referred to as tax-efficient funds, are managed to try to minimize trading that generates capital gains, which would require shareholders to pay taxes if the fund is held in a taxable account.
- How the timing of a purchase or sale of a mutual fund can affect your tax liability. If you're selling to harvest losses in a mutual fund but intend to repurchase the same fund, make sure you wait at least 31 days before buying it again. Otherwise, the trade is considered a "wash sale." The tax loss will be disallowed, though you can include the loss as part of your cost basis for the most recently purchased shares. Also, before buying a mutual fund for your taxable account, find out when it will distribute any dividends or capital gains. Consider delaying your purchase until after that date, which is often near year-end. If you buy just before the distribution, you'll owe taxes this year on that money, even if your own shares haven't appreciated. And if you plan to sell a fund anyway, you may minimize taxes by selling before the distribution date.
- Whether to hold a given fund in a taxable or tax-advantaged account. The tax advantage of tax-free investments, such as a municipal bond fund, is wasted if the fund is held in tax-deferred accounts such as 401(k)s or IRAs. And if you have mutual funds that trade actively and therefore generate a lot of short-term capital gains, consider holding them in a tax-advantaged account to defer taxes on those gains, which can occur even if the fund itself has a loss. Finally, distributions from a tax-deferred retirement plan do not qualify for the lower tax rate on capital gains and dividends; factor this into your thinking when deciding where to hold specific investments.
- How to calculate the cost basis of your shares when selling. Typically, fund companies will calculate your cost based on the average cost per share. However, you can also request that specific shares be sold--for example, shares bought at a certain price. Which shares you choose depends on whether you want to book large capital losses to offset gains elsewhere, or to keep your capital gains to a minimum to reduce the tax bite. (Obviously, this only applies to shares held in a taxable account.) Think carefully about the method you choose, since fund companies are now required to report to both you and the IRS the cost basis for any fund shares purchased after January 1, 2012. ***Example(s):*** *You have invested periodically in a mutual fund for 10 years, paying a different price each time. You now want to sell some shares. To minimize the capital gains tax you'll pay on them, you could decide to sell the least profitable shares, which were only slightly lower when purchased. Or if you wanted large losses to offset capital gains, you could specify sale of the shares bought at the lowest prices. Be aware that you will then need to use the same method whenever you sell the rest of your shares in the fund.*

In addition to such issues, which affect most types of mutual funds, individual categories of funds may have specific tax planning issues. For example, dividends paid on bond mutual funds are technically interest, subject to tax at ordinary income tax rates. These dividends do not qualify for capital gains tax treatment under the Jobs and Growth Tax Relief Reconciliation Act of 2003. Again, tax planning can help you avoid mistakes that can reduce your after-tax returns.

To schedule an appointment with Faye Sykes, click here .

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