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Mutual Fundamentals

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Mutual funds are among the most popular investments on the market. More than 12,000 different funds, holding in excess of $4 trillion dollars, exist. While most people choose mutual funds for their investment portfolio because of the funds' professional management, many people buy mutual funds because of their competitive returns. Others like them because they are easy to buy and sell. Still others cite the fact that mutual funds, because they hold several investments, can spread risk.

What is a mutual fund and how does it work?

A mutual fund is a company that invests in a diversified portfolio of securities. People who buy shares are called owners or **stakeholders**. Their investments provide the money for a mutual fund to buy securities, such as stocks or bonds. When those investments gain or lose value, you gain or lose as well. When they pay dividends, you get a share of them. Mutual funds also offer professional management and diversification. They do much of your investing work for you.

Mutual funds make saving and investing simple, accessible and affordable. The advantages of mutual funds include professional management, diversification, variety, liquidity, affordability, convenience and ease of recordkeeping — as well as strict government regulation and full disclosure.

Mutual funds may be open-end or closed-end funds. The term "mutual funds" is used most often to mean open-end funds. **Open-end funds** issue new shares continuously as investors buy them. Investors redeem their shares directly to the fund, which in turn must buy them back. **Closed-end funds** issue a fixed number of shares that the fund may redeem only upon termination of the fund's trust. However, shareholders in a closed-end fund may sell their shares through a broker on the secondary market to other investors but not back to the fund.

Mutual funds can contain many different types of investments – shares of stock that U. S. or foreign companies issue, bonds or short-term securities that the U. S. government and its agencies, U. S. corporations, and state and local governments issue.

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Mutual funds typically are grouped by investment objective. Objectives include:

- **Preservation of Capital and Liquidity –** achieved by investing in very short-term bonds
- **Income –** achieved by investing in bonds
- **Balanced –** achieved by investing in bonds and stocks
- **Growth –** achieved by investing in stocks

Buying and Redeeming Mutual Funds

You can buy mutual fund shares directly from the mutual fund company or from a stockbroker or registered representative investment adviser. Buying and redeeming are relatively easy.

To buy shares directly from a mutual fund, you send money to the fund company. Redeeming shares works the same way. In all cases, the customer (you) executes all transactions with the mutual fund company. Many funds allow you to redeem shares on the telephone. You also can set up an automatic investment plan to do your work for you.

Under this plan, you can have a fixed amount of money withdrawn monthly from your bank account and sent to the fund. Using this option requires you first to give authorization on your application form. Most mutual fund companies do allow this option. Many funds require initial investments of more than $500. However, many of them waive this requirement if you agree to an automatic investment plan that withdraws from your bank account.

Mutual Fund Expenses

Mutual funds charge fees for the costs of running the fund. All fees charged are found in the fund's prospectus, which describes the mutual fund to prospective investors. Every mutual fund has a **prospectus**. The prospectus contains information about the mutual fund's costs, investment objectives, risks and performance. You can get a prospectus from the mutual fund company (through its Web site or by phone or mail). Your financial professional or broker also can provide you with a copy.

Sales charges are the fees one may pay when purchasing or redeeming shares of a mutual fund. Funds with sales charges are called **load funds**. These may be front load or back-end load. Funds with no sales charge are called **no-load funds**.

Redemption fees are charges that also may be imposed when investors sell shares back to a fund.

All funds have **management fees** that range from 1 percent to 2 percent. Some mutual funds also have a sales fee (known as a "load") of 3 percent to 5 percent, and in some cases up to 8 ½ percent. By law, sales charges may not exceed 8.5 percent of the amount invested.

Finally, funds may charge their investors **"distribution fees"** or **"12b-1"** fees. These fees cover expenses such as advertising, brokers' costs and toll-free telephone lines. Marketing and advertising costs also are passed down to investors.

In addition, exchange fees may be charged if you transfer money from one fund to another within the same fund family.

Income and Distributions

Mutual funds pay their stakeholders dividends from the earnings of the stocks, bonds, etc., in the fund. **Dividends** from a mutual fund are your percentage of earnings from the company that distributed the stock to shareholders. You can receive dividends as cash, or you can reinvest them into the fund. Many funds automatically will reinvest your dividends if you have given them authorization. Any dividends are taxed at rates of 5 percent to 15 percent, depending on your tax bracket.

Another source of potential income in mutual funds is **capital gains**. When a security in a fund is sold, any gain (or loss) on it must be distributed to shareholders. You can receive your capital gains as cash, or you can have them reinvested. The taxation rules that apply to dividends also apply to capital gains.

Investors also may benefit from **share price increases**. This is the rise in value of a share of your fund. If the price of one share increases by $1, you have made a gain of $1 times the number of shares you own. This type of gain is called paper profit because you do not receive it until you sell shares.

All of these sources of gain make up the total return of a mutual fund.

Dollar Cost Averaging

One of the best ways to increase an investment is to invest a fixed dollar amount on a regular basis. When the price of a fund is low, you will be purchasing more shares. When the value rises, you will be purchasing fewer shares, but what you have in your portfolio will have risen in value. Although dollar cost averaging does not guarantee a profit, in most cases your average price per share will be less than the current price per share.

Advantages/Disadvantages of Mutual Funds

Every investment has advantages and disadvantages. But you must remember features that matter to one investor may not be important to you. Whether any particular feature is an advantage for you will depend on your unique circumstances. For some investors, mutual funds provide an attractive investment choice because they generally offer the following features:

- **Professional Management —** Professional money managers research, select and monitor the performance of the securities the fund purchases.
- **Diversification —** Diversification is an investing strategy that can be summed up neatly as, "Don't put all your eggs in one basket." Spreading your investments across a wide range of companies and industry sectors can help lower your risk if a company or sector fails.
- Some investors find achieving diversification is easier through ownership of mutual funds than through ownership of individual stocks or bonds.
- **Affordability —** Some mutual funds accommodate investors who don't have a lot of money to invest by setting relatively low dollar amounts for initial purchases, subsequent monthly purchases or both.
- **Liquidity —** Mutual fund investors can redeem their shares readily at the current net asset value (NAV) — plus any fees and charges assessed on redemption — at any time.

On the other hand, your mutual fund may perform worse than average. One reason is the variety of fees and expenses. In addition, determining if a fund is a good value at any particular point in time is nearly impossible. Unlike stocks, where you can tell if a stock is undervalued according to any one of a number of measures, determining if a mutual fund's net asset value represents a good value is much harder.

Are Mutual Funds Right for You?

Thinking about your long-term investment strategies and tolerance for risk can help you decide what type of fund is best suited for you. But you also should consider the effect that fees and taxes will have on your returns over time.

Now, with a better understanding of mutual funds, and having determined that mutual funds can help you meet your investment objectives, take these steps to find the right mutual fund.

- Identify types of funds you need to meet your goals.
- Do further reading about mutual funds.
- Read about specific funds in which you are interested.
- Determine your selection criteria and eliminate funds.
- Call or write for a prospectus, or go online to find one.
- Make your purchase.
- Continually buy more shares – use dollar cost averaging.

- **Costs Despite Negative Returns —** Investors must pay sales charges, annual fees and other expenses regardless of how the fund performs. And, depending on the timing of their investment, investors also may have to pay taxes on any capital gains distribution they receive — even if the fund went on to perform poorly after they bought shares.
- **Lack of Control —** Investors typically cannot ascertain the exact makeup of a fund's portfolio at any given time, nor can they directly influence which securities the fund manager buys and sells or the timing of those trades.
- **Price Uncertainty —** With an individual stock, you can obtain real-time (or close to real- time) pricing information with relative ease by checking financial Web sites or by calling your broker. You also can monitor how a stock's price changes from hour to hour — or even second to second. In contrast, with a mutual fund, the price at which you purchase or redeem shares typically will depend on the fund's NAV, which the fund might not calculate until many hours after you've placed your order. In general, mutual funds must calculate their NAV at least once every business day, typically after the major U.S. exchanges close.

References/Resources

Investing in Mutual Funds, *Denise Matejic, Rutgers*
www.rce.rutgers.edu/pubs/pdfs/e222.pdf

Investing for Your Future
www.investing.rutgers.edu/

Young Investor Guide for Parents
www.younginvestor.com/parents/investIt/

Ameritrade Mutual Fund Tutorial
www.ameritrade.com/education/html/ encyclopedia/tutorial4/index.html

A Guide to Understanding Mutual Funds, Questions to Ask, Frequently Asked Questions, Facts about Funds
http://ici.org/funds/inv/index.html#Mutual%20Funds

North American Securities Administrators Association
www.nasaa.org/investor_education/Financial_Education_Resources/

U.S. Securities and Exchange Commission
Invest Wisely: An Introduction to Mutual Funds
www.sec.gov/investor/pubs/inwsmf.htm

If You Have Problems

If you encounter a problem with your mutual fund, you can send your complaint using an online complaint form (www.sec.gov/). You also can reach the SEC by regular mail at:

Securities and Exchange Commission
Office of Investor Education and Assistance
450 5th St. N.W.
Washington, D.C. 20549-0213

Materials from the SEC

Mutual Fund Classes
www.sec.gov/answers/mfclass.htm

Mutual Fund Fees and Expenses
www.sec.gov/answers/mffees.htm

Mutual Fund Investing: Look at More Than a Mutual Fund's Past Performance
www.sec.gov/investor/pubs/mfperform.htm

Mutual Fund Prospectus, Tips for Reading One
www.sec.gov/answers/mfprospectustips.htm

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For more information on this and other topics, see: www.ag.ndsu.nodak.edu

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