THE WOMEN'S INSTITUTE FOR A SECURE RETIREMENT

WISER Special Report

Mutual Fund Investing: What You Need to Consider

This special report discusses some of the investment concepts and goals that you should consider when you invest in mutual funds.

The first two general concepts to consider when you are choosing mutual funds are total rate of return and risk.

The historical total **rate of return** indicates how much a fund has increased in value over time. It is usually expressed as an average annualized percentage figure – that is, the percent of increase in value for a year, averaged for several years. The rate is calculated on the change in value of the underlying stocks or bonds in a fund, plus the income generated from those stocks or bonds.

For example, if a fund has an average five-year total rate of return of 10%, this means that for the last five years – if averaged out – it increased in value 10% per year. If $10,000 had been invested five years ago, it would now be worth $16,105. The value of the fund increased $6,105; $5,000 is the result of the straight 10% return, and the additional $1,106 is the result of compounding it earned a return on previous earnings.

The investment community usually defines **risk** in a very mathematically technical way, known as standard deviation. But you can think of this type of risk as volatility per year. A higher standard deviation means higher volatility and greater price fluctuation. Other things being equal, if you were choosing between several mutual funds, each of which had an average rate of return of 10%, but which had a range of standard deviations between, e.g., 8% and 20%, you would choose the one with lower volatility. Usually, however, the more return a fund provides, the more risky (or volatile) it will be.

Now, what might lead you to pick a mutual fund that had a certain rate of return and risk pattern?

To begin with, it depends on **how many years it will be until you retire**. In general, if you have more years until you are planning to retire you may choose a fund with higher return and higher risk. You can accept more volatility the further away it is to the time you need the money. If you are going to retire in twenty years, there will be many ups and downs in the stock market (and your mutual fund) before you need that money. Therefore, you can accept more risk in order to get more return.

On the other hand, if you are going to retire in three years, you may begin to move money away from higher return/higher risk funds into lower

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return/lower risk funds, such as a mixed equity/bond fund or an all bond fund. Since your need for that money is so near in time, you cannot risk the potential loss that might occur if there were a drop in the stock market. Specifically, if the market were to go into a down cycle when you needed to sell your mutual funds, you would have to sell at a lower rate than would be the case if you could wait a few years for the stock market to come back up. For this reason, the sooner you need access to the money you have invested, the more stable the investment funds should be.

A second factor in choosing a risk/return pattern might be **your own feelings toward risk**. Some people are very averse to risk and would rather accept lower return and sleep easier at night. Some people are very accepting of risk.

A third factor is **your overall financial position**. Obviously the greater your assets, or stream of future income, the more risk might be acceptable to you.

Stocks vs. Bond Mutual Funds

Most people probably think of stocks (equity) when they think of mutual funds. However, there are also bond mutual funds and balanced funds, i.e. mixtures of stocks and bonds. The same thoughts that apply to return and risk also apply to bonds versus stocks. The further away you are from retirement, the more equity you might want to have. For example, if you have twenty years until retirement, you might want to be invested 80% in stocks, or even 100%. On the other hand, if you are going to retire in two or three years, you may want to be 80% in bonds or higher.

Investment Objectives and Styles of Mutual Funds

Armed with this understanding of return versus risk, let's examine the different investment objectives and styles that mutual funds offer.

Bond Mutual Funds

Bond mutual funds invest in bonds that mature at different times – they range from short-term to intermediate-term to long-term. Bond funds invest in bonds that are either corporate or government. Finally, bond funds vary in terms of the quality of the underlying bonds – at one end of the scale are bonds that are very safe with relative low interest, and at the other end are "junk bonds" that pay high interest.

You should also note that bond funds can be either taxable or non-taxable (municipal). Because most of us invest through a 401(k)-type retirement account or an individual retirement account (IRA), which is already tax-deferred, we will focus on taxable bond funds.

Once again, your return/risk profile will determine what bond funds you may want. Short-term government or corporate bond funds will be the safest and return the least. Long-term corporate or government funds will be riskier and have a higher rate of return.

Stock Fund Investment Objectives

Stock mutual funds (also called equity funds) are often divided into three different types of fund objectives: growth, income, or a mixture of growth and income. Those with a **growth objective** seek capital appreciation – growth in the value of the fund – and tend to have higher returns and risk. **Income-oriented** funds emphasize dividends –

periodic payments to the stock or fund holders – over capital appreciation. These tend to have lower returns and risk. Many funds seek both growth and income, and have a corresponding array of return/risk profiles.

Stock Fund Investment Styles

The term "growth" also applies to the final way in which mutual funds differ, i.e. **investment style**. **Growth funds** invest primarily in growth stocks. These are the stocks of companies which have higher rates of earnings growth than average. Examples of such stocks would be technology or drug stocks. On the other hand, **value funds** invest in stocks that have slower, but generally more predictable, growth rates. Examples might be financial or utility companies. In general, growth funds tend to be riskier and have higher returns, and value funds tend to be less risky with lower returns.

Diversification

Perhaps the most important concept to understand and abide by in investing is **diversification**. Over any longer period of time, markets will not only increase and decrease in value but will change with regard to what style is "hot". Hence the most sensible approach to investing over time is to diversify, that is, to have a mixture of **growth** funds, **value** funds and **bond** funds. Or if you prefer, and your resources are small, invest in a fund or two that diversifies across style.

Let's take a few **examples**. Assume that you will retire in twenty years. You might invest 80% in equity funds and 20% in bond funds. Because your investment horizon is long you may be willing to accept more risk. So, you may put 20% of total assets into a high growth fund, 20% in moderate growth, 20% in a growth oriented growth and income fund (which might include some value stocks) and 20% in a value fund. You might invest all of the bond allocation, 20%, into a long-term government/corporate fund.

On the other extreme, let's say that you are a recent widow and now have an IRA/401(k) plan from your husband, as well as your own. Let's assume that you work and will retire in five years. You may want to structure the total portfolio as follows: 50% in an intermediate corporate/government bond fund, 20% in a moderate growth and income fund, 20% in a value fund and 10% in a more aggressive growth fund.

These above examples are just that – examples. However, they point the way to your general task, that is, to evaluate what return/risk profile is appropriate for you and to diversify across several funds in order to make that profile an investment reality.

Mutual Fund Glossary

Appreciation – Growth in value of the investment.

Average annualized percentage figure – The amount that a mutual fund has changed in value each year for several years, calculated as an average amount that the fund has changed over those years.

Bonds – IOUs issued by companies, governments and other institutions. The issuer agrees to pay back the face value of the bond (the principal) over a period of time, plus a fixed rate of interest.

Capital appreciation – An increase in the dollar value of the stock, which you will realize or cash in on, when you sell the stock.

Compound interest or earnings – The ability of an investment to reinvest interest or earnings, which then generate additional interest or earnings, so that the investment earns interest on the interest, as well as on the initial amount invested.

Dividends – Payments that companies or mutual funds pay to the individuals who own shares of its stock, either directly or through a mutual fund. Dividends are based on profits that the companies have made and are paid to all stockholders.

Equity – Investments in the stock market.

Growth funds – Mutual funds that invest primarily in stocks that are focused on increasing the value or price of the stock as the primary goal.

Income funds – Mutual funds that have the goal of providing stable income by investing in stocks and bonds that pay dividends and interest.

Rate of return - The amount that a mutual fund has increased (or decreased) in value, often calculated for one year or several years.

Stock – Represent ownership of a piece of a company, traded in units called shares, and can be bought and sold on exchanges. Many individuals also own stock through mutual funds that invest in stock.

Volatility – The degree of uncertainty about whether you will make or lose money, and how much, on a stock or mutual fund. With a more volatile stock, you have a greater chance for greater gains, but also for greater losses.