

# WISERWoman

A QUARTERLY NEWSLETTER FROM THE WOMEN'S INSTITUTE FOR A SECURE RETIREMENT

Specially Prepared for the Center for American Nurses

## Mutual Fund Investing: What You Need to Consider When Choosing Your Mutual Funds

Today, even Wall Street's money managers are concerned about *risk*: the threats of terrorism, war and a troubled economy that are crippling the stock market for the third year in a row. According to a recent monthly survey by a large financial company, money managers are as frozen as the average investor and afraid of making mistakes. If the managers of the mutual funds are frozen then what's the average investor to do? This report discusses some of the investment concepts and goals that you should consider when you invest in mutual funds.

### *Investment Basics*

Knowing key terms and concepts is important. There are two general concepts to consider when choosing mutual funds: total rate of return and risk.

### *Rate of Return*

The total **rate of return** indicates how much a fund has increased in value over time. The rate is figured on the change in value of the underlying stocks or bonds in a fund, plus the income generated from those stocks or bonds.

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.

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.



M.Scott

### *Risk or Volatility*

Selecting different funds with different rates of risk is an advised strategy. Usually, the more return a fund provides, the more risky (or volatile) it will be. Usually experts analyze and try to manage *risk* so they can balance their investments — for instance, some companies will do well no matter what is happening in the global world: such as companies who sell drugs, food and household products.

The investment community usually defines **risk** in a very mathematically technical way, known as standard deviation. Think of this type of risk as volatility per year. Say 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 probably choose the fund with lower volatility.

### *Diversification*

Perhaps the most important concept to understand and abide by in investing is **diversification**. Over any

## Mutual Fund Terms

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

**Risk or 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.

longer period of time, markets will not only increase and decrease in value but will change with regard to what style is “hot.” So, 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.

Many investors are angry about their poor investment results over the past three years. But some investors who have learned the basics and kept their money **diversified** are holding their own. Mutual fund investors who are concerned about risk need to take charge and monitor their funds closely. A new free service that allows you to monitor a fund's risk can be found at [www.riskgrades.com](http://www.riskgrades.com).

## Choosing Mutual Funds

*What might lead you to choose a mutual fund that had a certain rate of return and risk pattern?*

Three Basic Factors:

- ☒ **how many years to retirement**
- ☒ **your attitude about risking your money**
- ☒ **your overall financial position**

**How many years will it 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. If you are going to retire in 20 years, there will be many ups and downs in

the stock market (and your mutual fund), 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 return/lower risk funds, such as a mixed equity/bond fund or an all bond fund. Since you will need the money sooner rather than later, you cannot risk the potential loss that might occur if the stock market drops. 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.

## Life Cycle Funds

An easy way to diversify is choosing one of the life-cycle mutual funds labeled by date. For instance, if you want to retire in 2020, you buy into a 2020 fund.

**Life-stage funds** are similar but it's up to the investors to shift their money as they age.

**Balanced funds** also offer a mix of stocks and bonds. Many of the big families of funds such as Vanguard and T. Rowe Price offer these types of funds.

## Your attitude about risking your money

A second factor in choosing a risk/rate of return pattern might be **your own attitude toward risk**. Some people are very averse to risk and would rather accept lower return and sleep easier at night than to ride on the stock market's recent roller coaster trip. Some people are very accepting of risk. So take on only as much as you can handle.

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.

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## A word of caution

Having several mutual funds does not guarantee diversification. The more funds you own, the more likely you are to be holding the same stocks and paying more in fees.

## 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.

### 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 20 years until retirement, you might want to be invested 80% in stocks. On the other hand, if you are going to retire in two or three years, you may want to be 80% in bonds.

#### 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 relatively 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). Most of us invest through a 401(k)-type retirement account or an individual retirement account (IRA), which are already tax-deferred.

Once again, your rate of return/risk profile will determine what bond funds you may want. Short-term

#### Index Funds

Noted financial journalist Beth Kobliner has written for *WISERWoman* about one type of mutual fund — the S&P 500 Index fund, which tracks changes in the stock prices of 500 large companies. The S&P 500 has no fund manager and low fees. While these days it's difficult to know where to start, we still believe that index funds are an excellent place. But, a well-informed (& Wiser) investor should also understand the broader range of mutual funds.

#### Mutual Fund Terms


**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.

**Value funds** — Mutual funds that usually pay a portion of their earnings in a dividend. Over the long term, value investing has outperformed growth funds in which companies reinvest profits in their businesses to allow them to grow.

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. 