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Guide to Understanding and Investing in Mutual Funds

So you're looking to get into the investment game? Mutual funds are a good investment option. But before you invest, make sure to do your research. You would never go to a car dealership, hand over all your money, and say, "Take care of this please. I trust you'll give me a good car that will run forever without me having to worry about it." The same logic applies to your investments. Do not walk into a financial company and expect them to manage your money without your participation. Use this guide to help you understand the basics about mutual funds and investing in them.

What is a Mutual Fund?

A mutual fund is a pool of money from many different people that is invested in a variety of places (collectively called the "**portfolio**"). A **Fund Manager** decides where to invest the money based on the goal of the fund. Basically, there are three kinds of goals: 1) to provide you with income while your money is invested – called **"Income Funds;"** 2) to make money when you sell your shares – called **"Growth Funds;"** and 3) a combination of the two – called **"Growth and Income"** or **"Balanced"** or **"Blended"**

Based on one of these goals, money is invested in the following general funds (or a combination of the following types):

- **Stock (or Equity) Funds** – put money in stocks
- **Bond Funds** – put money in corporate and government bonds
- **Money Market Funds** – put money in stable short-term investments with the goal of saving money

For example, you may purchase a stock mutual fund that is growth oriented. This type of fund would invest your money in a variety of stocks. Hopefully the stocks will grow in value while you own them, so you can make money when you sell your shares. (However, remember the stock value can also decrease and cause you to lose money.)

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Why Mutual Funds?

Advantages

- You don't have to research the hundreds of funds you are investing in – that is the job of the fund manager. (However - this does not mean that you shouldn't research the mutual fund that you are investing in!)
- By pooling your money with other people, you all have more buying power. This allows everyone to buy stocks and bonds with less of their own money. For instance, some bonds sell for a minimum of $10,000. However, if your mutual fund was investing in the bond, you personally may only have to invest $500.
- By investing in a wide variety of places (called **diversification**), mutual funds reduce your risk. This is the "don't put all your eggs in one basket" theory. By putting your eggs (money) in lots of baskets (stocks, bonds, etc.), one dropped basket will not hurt you too badly.

Disadvantages

- You do pay someone to manage the mutual fund, and these fees are charged whether or not the fund makes a profit.
- Mutual funds need to be used for your long-term investments. If you use mutual funds for the short-term and the market isn't performing well when you need the money, you could lose money.

More Details About Mutual Funds

Stock Funds

Stock funds can be classified by their goal (as mentioned earlier) and by the size of the companies that the fund invests in. There are three sizes – Large Cap, Mid Cap and Small Cap. "Cap" refers to "capitalization." What you need to understand about the "cap" classifications is that it indicates the size of the company and its financial situation.

- **Large Cap Companies** – have billions of dollars, tend to be large, established companies (such as Microsoft, Home Depot, Apple and Walmart) and tend to offer more stable earnings and therefore smaller earnings (remember the risk v. reward tradeoff).
- **Mid Cap Companies** – have between hundreds of millions and billions of dollars and offer growth potential and stability.
- **Small Cap Companies** – have millions of dollars and have great growth potential but at an increased risk of **volatility** (see below). If you are going to invest in small cap companies, make sure you are many years away from retirement to protect yourself from a sudden downturn in the market.

It should also be noted that throughout history, stocks have performed better over the long term (i.e. 20 years or more) than other investments (such as bonds and money markets). However, there is no guarantee that this will always be true. Therefore, stocks should be used as long-term investments.

Bond Funds

To understand bond funds, first you must understand a little about bonds. Bonds are really just loans where you are lending money to a borrower. In return, the borrower promises to repay you your money (called the **principal** or **face value**) in addition to giving you regular payments at a stated interest rate (called the **coupon rate**) during the life of the loan. The borrower usually falls into one of three categories:

- Municipalities (local government organizations, such as cities, school districts, etc.)
- Government (U.S. Treasury and other federal agencies)
- Corporations

The **term** of the bond indicates the amount of time until the borrower pays you back. There are three types of terms:

- Short-Term – less than 1 year
- Intermediate – 2 to 10 years
- Long-Term – more than 10 years

Generally, the longer the term, the higher the risk, and therefore the higher the interest rate. The risk comes from tying up your money for long periods of time. Meanwhile, your investment is influenced by interest rate changes and inflation. *As interest rates go down, bond rates go up (and vice versa)*.

Bonds are also rated to let you know the credit-worthiness of the borrowers. The ratings scale ranges from AAA (the best) to C (the worst). Bonds from BBB or BAA and above are considered “investment grade;” they may produce lower earnings, but your earnings will be fairly reliable. Bonds below BBB or BBA are considered “**high yield**” or “**junk bonds**;” they might produce large earnings, but at an increased risk.

When considering whether to invest in a particular bond fund, it is also important to keep in mind whether the fund includes taxable or tax-free bonds.

- Taxable – interest from corporate and U.S. government bonds is taxed.
- Tax-free – interest from municipal bonds is not subject to federal taxes. If the investor lives in the municipality that issues the bond, there is no state or local tax on the interest.

Bond mutual funds group multiple bonds together. They tend to invest in certain classes of bonds, for example a variety of short-term corporate bonds. Because there is more than one bond, there is no one **maturity date** (date when the borrower must repay you). Instead, an **average portfolio maturity** is calculated; this is the average of all the maturity dates of the bonds in the fund. Unlike stock mutual funds, bond funds are mainly geared toward providing you with a steady stream of income from interest payments.

Money Market Funds

Money market funds are a mix of short-term investments, such as certificates of deposit (CDs), municipal notes and treasury bills. There are two main kinds – taxable (which generally involve short-term corporate or government bonds) and tax-free (which are mainly municipal bonds from high-tax states like New York and California). Money market funds are generally looked at as a way to save money, rather than invest money, due to their low interest rate. As you move closer to retirement, you may want to shift more of your money towards these accounts because they are easily accessible and lower risk. You can even write checks from your money market account.

Analyzing and Choosing a Fund

When analyzing a fund, you should consider the following factors:

Risk v. Reward

There is a direct relationship between risk and reward when investing. The higher the risk, the higher the reward; the lower the risk, the lower the reward.

Institutions that may not be financially secure and are seen as risky investments have to offer investors a bigger reward for taking a chance on their company. So, companies that are offering high earnings potential are often risky investment opportunities. You could make a lot of money – or – you could lose a lot of money. Higher risk equals *potentially* higher reward.

Institutions that are financially secure do not have to offer their investors big rewards because they know people regard their investments as *relatively* safe. Lower risk equals lower reward.

The amount of risk you are willing to take depends on three things:

- How far away you are from retirement. (The farther away you are from retirement, the more risk you can accept.)
- How comfortable you are with taking risk. (This varies from person to person.)
- Your current financial position. (The more financially secure you are now, the more comfortable you may be with risk.)

Your risk tolerance will influence the types of investments you make. As you are reading about the different types of investments, note the different risks involved.

Measuring Risk

One measure of risk is called **volatility**. Volatility describes how much the fund's value changes up and down. The higher the volatility, the greater the risk but the greater potential for a high reward. For example, a fund with high volatility may be worth $30 a share today, $100 per share next month and $10 per share the following month. If you sold your shares at $100, you would have earned a great reward. However, by the same token, if you needed to sell your shares when the value was $10, you would have lost a substantial amount of money.

Without getting into the specifics of how these numbers are calculated, below are descriptions of the common numbers used to describe volatility:

- **Standard Deviation** – this is the most common measure. It describes a particular fund's changes during a specific period of time (usually over the past 36 months). In general, the higher the standard deviation, the more volatile the fund. However, you can only compare the standard deviations of similar fund types.
- **Alpha Coefficient** – basically this tells you if your selection of one particular fund was a good choice. A positive alpha means that your fund is earning more than the market as a whole; a negative alpha score means that your fund is earning less than the market as a whole.
- **Beta Coefficient** – this measures one fund's volatility compared to the stock market as a whole over the last 36 months. The market as a whole is assigned a beta of 1.0. Funds with a beta higher than 1.0 are more volatile than the market, and those with a beta lower than 1.0 are less volatile than the market.
- **R-Squared** – this number indicates how reliable the information was that was used to calculate the alpha and beta. The lower the R-squared number (on a scale of 1 to 100), the less reliable the information.
- **Morningstar Ratings** - A fund earns stars (from high of 5 stars to low of 1 star) based on Morningstar's evaluation of a fund's risk-adjusted performance when compared to other funds within its same category. The ratings are listed for funds that are at least 3 years old and are recalculated at the end of every month. Star rankings are as follows: 5 stars = top 10%, 4 stars = next 22.5%, 3 stars = next 35%, 2 stars = next 22.5%, 1 star = bottom 10%.

Costs and Expenses

All mutual funds charge management fees to cover their costs of managing your fund. However, many also charge additional fees that you need to be aware of. These fees include:

- **Load Fund and Transaction Fees** – load funds are funds that have commission fees.
    - **Front-end Load** (or **Sales Charge Imposed on Purchases**) – a sales commission fee that you pay when you buy your shares.
    - **Back-end Load** (or **Contingent Deferred Sales Load**) – a sales fee charged if you sell your shares before a specified number of years. The load usually starts at 5% or 6% for selling your shares in the first year and decreases as years pass until it reaches 0%.
- **Management or Investment Advisory Fees** – a 0.5% to 1.0% fee to pay for fund managers.
- **12b-1 Distribution Fee** – covers commission, marketing and distribution expenses. This fee is common with load funds and ranges between 0.25% and 1.0% each year. No-load funds cannot charge more than 0.25% for 12b-1 fees. This fee **IS** avoidable, and you should avoid it if possible; many funds do not charge this fee.
- **Exchange Fee** – charged when you switch investments from one fund to another in the same fund family.
- **Redemption Fee** – another type of back-end charge that is charged when you sell your shares.
- **Other Administrative Fees** – cover administrative fees, such as toll-free numbers, printing, mailings, etc.

Mutual funds calculate an **expense ratio** that allows potential investors to see what their costs are going to be. This ratio is expressed as a percent and ***should generally be lower than 2%.***

Historically, ***no-load funds have performed as well as load funds***, so don't let someone convince you otherwise. And remember, if a fund costs you more to own, you are going to make less on your investment.

Often when investors choose to invest in a particular mutual fund, they are allowed to choose the fee schedule that they want. Everyone in the fund owns the same shares, but they may choose to pay fees differently. The types of fees charged are often broken down into classes, such as Class A, Class B, etc. For example, Class A may require front-end loads, Class B may require back-end loads and Class C may charge a **level load** (or a yearly flat fee).

Actively Managed or Not?

Mutual fund management tends to come in two categories: indexed funds and actively managed funds. Indexed funds "match" the stock market. Actively managed funds assign a person to hand-pick particular investments. At first glance, you might think that it would be better to have a person constantly watching and moving your money.

However, historically mutual funds that are indexed have done just as well as mutual funds that are actively managed by a professional. Furthermore, indexed funds do not have the extra management fees that actively managed funds have.

Where Do I Find Information About Mutual Funds and Their Fees?

The Prospectus

The **prospectus** is a small booklet that contains a wealth of information about a company's mutual funds. The SEC requires that every company produce a prospectus for potential and current investors, however don't forget that the companies use these as a marketing tool. While it may be challenging to read, the information contained is very important. Here are the key things to look for in a prospectus:

- **Goals** – is it a growth focused fund? Blend? Income-focused?
- **Investments** – where does the fund manager invest your money? Stocks? Short-term bonds? (Think about risk and reward and how comfortable you are investing your money in these places.)
- **Fees** – the fees discussed earlier will be listed, but they may be buried within paragraphs instead of in easy-to-read charts.
- **Past Performance Figures** – these indicate how the fund is being managed and are very important. Key figures include:
  - **Portfolio Turnover Rate** – this tells you how often the manager is buying and selling investments. In general, the higher the turnover rate, the higher your fees and taxes.
  - **Net Asset Value (NAV)** – this is the price for one share of the fund. Compare the NAV over the years.
  - **Total Return** – the amount your mutual fund has changed over a period of time (usually a year). This is the number you should compare to other funds. The higher the total return the better.
  - **Ratio of Expenses to Average Net Assets** – this is your expense ratio. It includes management, administration, 12b-1 and other fees but not load or redemption fees. You want this ratio to be less than 2% and it should be decreasing over the years.
  - **Ratio of Net Investment Income to Average Net Assets** – this is how much profit the fund made for every $1 it invested. For income focused funds, a typical ratio is between 2% and 4%. For growth focused funds, a typical ratio is around 1%.
- **Example Investment** – this tells you how much you would have to spend on fees if you invested a certain amount of money (usually $1,000 or $10,000).
- **Minimum Investment** – what is the minimum amount of money you need to invest to be a part of the mutual fund? This can range from $500 to thousands of dollars.

- **Reinvestment or Distribution (or Redemption) Options** – can you reinvest your earnings in the fund? Can you have your earnings put in your bank account via direct deposit?
- **Tax Information** – how your returns are taxed also affects the value of your investments.

For greater detail about all of the above topics, get a copy of the Statement of Additional Information (SAI) from the company. Be aware though that the language tends to be complex.

How Mutual Funds Pay You

When funds earn money, they can pay you in two ways.

- **Dividend/Interest Payments –** With income or blend focused funds, you may receive regular interest or dividend payments.
- **Capital Gains Distributions** – Capital gains result when your fund buys shares in an investment, the share value increases and then the fund sells the shares. The profit you make from the sale of the shares is called a **capital gain**.

With most mutual funds, you can choose to receive these profits in a check or direct deposit to your bank account or to have the fund manager reinvest the profits in the fund. Be aware that funds may charge a fee for these services.

Where Can I Buy Shares of a Mutual Fund?

To invest in a mutual fund, you can contact the fund company, a financial advisor, brokerage house or bank. Be aware that if you buy from anyone other than the fund company you may be charged a load (sales commission). A good place to start looking at fund companies is the Mutual Fund Education Alliance web site, **www.mfea.com/FundCompanies** or Morningstar, **www.morningstar.com**.

Monitoring a Fund’s Performance

Do not assume that because you have paid someone to “manage” your fund that you do not have track and analyze its progress. Read your statements. Read news articles regarding the market’s performance. Stay aware of how your money is being spent.