Mutual Attraction

Nature of Mutual Funds

Objective

Why Mutual Funds?

Every smart investor should have a thorough knowledge of mutual funds. Mutual funds are everywhere, and they're an important part of a successful investment plan. As a matter of fact, over $6 trillion is currently invested in them. So what are mutual funds, exactly?

Mutual funds offer an alternative to investing in individual securities. A **mutual fund** is a collection of shareholders' money that is invested (by professional fund managers) in an assortment of different securities, such as stocks or bonds. Each shareholder then owns a small slice of the fund's entire investment portfolio.

Mutual funds are distributed by investment companies, such as Vanguard or Fidelity. You aren't actually investing in the investment company—you're investing in the mutual fund itself. The investment company is responsible only for marketing and managing the fund.

Objectives:

Discuss reasons individuals choose to invest in mutual funds.

Explain how to buy/sell mutual funds.

Investing in mutual funds can help you reach a variety of financial goals. Each mutual fund has a specific objective, described in its annual **prospectus** (document containing all vital information about the fund). The fund's objective is the result it is trying to achieve through the investments it makes, and to meet that objective, the fund managers will formulate a specific strategy.

Net Asset Value

The price of a mutual fund's shares is determined by its NAV, or net asset value. NAV is the total value of a fund's investment portfolio, minus its liabilities (debts or obligations), divided by the number of its outstanding shares (the number of shares the fund has issued). It sounds confusing, but it's not so bad.

Let's say you've invested in a mutual fund with a total investment portfolio value of $50 million. Its liabilities are $5 million, and it has issued 9 million shares. Plug those numbers into the NAV equation to figure the value of each share:

$$\frac{\$50 \text{ million (total portfolio value)} - \$5 \text{ million (liabilities)}}{9 \text{ million (shares)}} = \$5 \text{ per share}$$

Mutual fund managers calculate NAV at the close of each business day. Because these prices are determined only once per day, mutual fund shares may be traded (bought or sold) only once per day, unlike individual stocks and other securities, which trade all day long.

Four Big Advantages
(...And a Couple of Disadvantages)

There are several reasons mutual funds are so popular among today's investors. The biggest advantage of investing in mutual funds is **diversification**. Diversification means spreading out your investment dollars among a number of different securities. Let's say you have $10,000 to invest. If you invested all $10,000 in one stock, and the stock went bust, you'd lose everything. It's smarter to invest in several different stocks and other types of securities. But doing so on your own would require a lot more time, effort and money than you would probably be able to give. Investing in mutual funds takes care of the problem for you, since mutual funds contain many different securities, often 100 or more.

Another advantage of investing in mutual funds is access to professional money management. When you invest in a mutual fund, you're handing your money over to well-trained professionals whose full-time jobs are to make smart investment decisions for you. These managers spend all day, every day, researching and analyzing all the factors that have potential impact on your money.

Mutual funds are also very convenient. They're fairly simple to trade, and they also provide you with easy access to your money because you can cash out of them at any time. The ability to easily convert your investment back into cash is known as **liquidity**.

Yet another advantage of investing in mutual funds is minimal risk. The United States Securities and Exchange Commission (SEC) (www.sec.gov) regulates mutual funds very carefully to make sure they're managed properly. And because mutual funds invest in a variety of different securities, their risk of bankruptcy is virtually nonexistent. However, that doesn't mean that certain mutual funds aren't riskier than others. There are thousands of mutual funds to choose from, so you can decide for yourself how much risk you're willing to take with your investment dollars, and then choose the types of mutual funds that suit your goals.

Mutual funds have disadvantages as well. They cost money to manage (you'll learn more about fees later), and you also will be required to pay taxes on your gains. If you do your homework, though, you can plan smart strategies to make your mutual fund investments as tax efficient as possible.

Types of Mutual Funds

Open-End Funds and Closed-End Funds

Mutual funds are classified in a number of different ways. The first way involves distinguishing between open-end funds and closed-end funds. Most mutual funds are open-end funds. **Open-end** means that there is no limit on the amount of shares the fund can issue or the amount of money it can hold. An open-end fund issues as many (or as few) shares as investor demand calls for.

Closed-end means that the fund has a set number of shares it can issue, determined before it's ever established. After all the shares in a closed-end fund have been sold, the only way to buy them is from an existing investor who is ready to sell. Open-end mutual funds are preferable to closed-end because they are less expensive to operate and their shares are easier to trade.

Stock Funds

Also called equity funds, stock funds are the most popular type of mutual fund. As the name suggests, stock funds invest in stocks. As with investing in individual stocks, investing in stock funds offers both greater risk and greater return than investing in other types of securities. However, the risk of investing in a stock *fund* is significantly less than investing in individual stocks. That's because of diversification. Since a stock fund invests in many different stocks, sometimes across a variety of industries, you won't take as big of a hit if one of those stocks drops significantly in value.

There are several different types of stock funds, including:

- **Growth funds.** Growth funds invest in stocks that are most likely to appreciate in value over the *short term*. Because the NAV of growth funds often sways drastically up and down, they are ideal for aggressive investors who are willing to accept greater risk for greater short-term returns.
- **Value funds.** Value funds invest in stocks that seem to be undervalued or overlooked. These stocks tend to be "good bargains" and sell at low prices. Value fund managers choose stocks they think will appreciate in value over the *long term*. These funds are ideal for more conservative investors who want to avoid risk.
- **Blend funds.** Blend funds contain both growth and value stocks.
- **Sector funds.** Sector funds invest in stocks from one specific industry, such as oil.
- **International funds.** International funds invest in stocks from overseas companies and are often viewed as the highest risk stock funds because of political and currency fluctuation in foreign markets.

There is another way to categorize stock funds as well. Many times, these funds are grouped according to the stock market value of the companies they invest in, or cap size. Large-cap funds invest in companies with market values of greater than $8 billion; mid-cap funds, companies with market values of $1 billion to $8 billion; and small-cap funds, companies with market values of under $1 billion.

Bond Funds

Researching and investing in a variety of individual bonds takes lots of time and effort. That's why bond funds are a great way to invest in bonds—in exchange for a fee, investors in bond funds get access to the expertise and buying power of a professional fund manager. Bond funds work the same way stock mutual funds do, except that shareholders' money is pooled to invest in a variety of different bonds rather than stocks. Investing in bond funds can provide a steady stream of income for the investor.

The most important variables in bond funds are the **rate** at which your money grows, the average **maturity** of the bonds in the fund, and the **credibility** ratings of the bonds in the fund. Shares in a bond fund are purchased with principal, earn income over time from the interest or coupon rate, and then give principal back. Since it has invested in dozens and dozens of bonds, the fund continuously has bonds maturing. These returns are typically reinvested in even more bonds.

The three general maturity categories for bond funds are short-term (mature within one year), intermediate-term (mature in 1–10 years), and long-term (mature in 10–30 years). Bond funds also differ according to issuer, such as government, municipal, and corporate bonds.

Balanced Funds

Balanced mutual funds, also called hybrid funds, invest in both stocks and bonds. The advantage of investing in balanced funds is the combination of stock growth and bond income in one mutual fund. While balanced funds may not offer the same high rates of return as stock funds, most people consider them to be somewhat "safer." Be sure to keep in mind that, even though they're called "balanced," these funds do not necessarily invest in 50 percent stocks and 50 percent bonds.

Money Market Funds

Some people consider money market funds (also called money funds) to be among the most conservative investments you can make. Unlike other mutual funds, shares in money market funds do not fluctuate in value. Money market funds invest in a variety of different securities that provide relatively higher rates of return over the short term. Money market funds are ideal for investors with short-term savings goals or who are near retirement and can't afford much risk.

Index Funds

Index funds are a unique type of stock mutual fund that copy the performance of a particular stock market index, such as the Standard and Poor's 500 (S&P 500) or the Nasdaq 100. The index fund purchases all the stocks listed on that particular index, in the same percentages as the index. Sector index funds invest in stocks across a certain industrial sector and are designed to copy the performance of that industry's segment of the stock market.

One advantage of index funds is that they're much cheaper to manage than other types of mutual funds. It takes a much smaller staff to manage an index fund because the fund copies a stock market index instead of researching and choosing individual stocks. A computer can do most of this work.

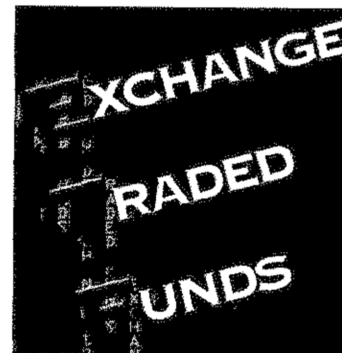
Another advantage of index funds is the reliable performance of most stock market indices. Results show that, over the long term, the S&P 500 gets better returns than 80 percent of actively managed funds. Index funds are perfect for investors who want to sit back, relax, and watch their money grow without making a lot of aggressive investing moves.

Exchange-Traded Funds

Exchange-traded funds, or ETFs, are "cousins" of mutual funds that trade like individual stocks. When you invest in an ETF, you buy shares in an entire stock portfolio, like a stock fund; however, you can trade those shares just as you would individual stocks. Like stocks, the prices of ETFs depend on supply and demand rather than NAV.

ETFs have many similarities to index funds and are another way that investors can match the performance of a particular group of stocks. One popular ETF is a Standard and Poor's Depository Receipt, also known as a SPDR, or "spider." "Spiders" represent ownership in the S&P 500. Another ETF, the Nasdaq 100 Trust, is known as "cubes," after its ticker symbol, QQQ. "Cubes" trades over 70 million shares per day.

ETFs have many advantages over traditional mutual funds that make them attractive to investors. Like index funds, ETFs are cheaper to manage than most mutual funds because they are passively managed rather than actively managed. And ETFs trade all day long, whereas mutual funds only trade once per day. But there is one big disadvantage to ETFs as well. You pay commissions to your broker every time you trade ETF shares, just like you do when you trade individual stocks.



Objective 3

How to Trade Mutual Funds

Where to Trade

When deciding whether or not a certain mutual fund is right for you, consider the investment company that distributes the fund. Choose a company with a good reputation and a reliable track record. You can't go wrong with established organizations such as Fidelity, T. Rowe Price, or Vanguard. It's even better if you choose a few good investment companies among whom to diversify your portfolio.

Do your homework. Just because mutual funds are professionally managed doesn't mean you shouldn't carefully consider which ones you choose to invest in. You should approach trading mutual funds just as you would individual stocks or bonds.

Where *Not* to Trade

There are many places you *can* trade mutual funds, but that doesn't necessarily mean that you should. Avoid trading mutual funds through bank representatives, insurance agents, or financial planners. Oftentimes, these employees are instructed to "push" certain funds, regardless of your individual needs. And all of these places will charge you commission, called "load," of up to 5.5 percent for trading mutual fund shares.

Despite these warnings, many people still choose to invest in mutual funds through a broker. Doing so eliminates the investor's responsibility for the research and paperwork involved in the process. And many brokerage firms also offer "perks" for trading with them, such as checks and debit cards attached to your account, so you can draw on your money with greater convenience.

Costs

Remember that mutual funds are managed by a full-time staff. And that staff doesn't work for free! All funds charge managerial fees, covered by shareholders. Your objective is to find mutual funds with the lowest costs possible. First, you can avoid paying "load" or commission fees by eliminating the middleman and purchasing "no-load" mutual funds directly from the investment company. Second, you can look for funds with low managerial fees (also called operating expenses). A fund's expense ratio, the percentage of assets used to pay for expenses, is required in its prospectus. Look for funds with expense ratios of less than 1.5 percent.

Buying and Selling Direct

There are a number of ways that you can trade mutual fund shares directly and avoid "load" fees. First, you can do so over the phone and through the mail. By looking in the financial section of your local newspaper, you can find toll-free numbers for the funds you're interested in. When you call, fund representatives will be available to help you and answer your questions. You can request a copy of the fund's prospectus and an application to open an account. When you receive your application, fill it out, write a check, and send it back. The fund opens an account for you and sends you periodic statements in the mail. It's as simple as that.

You can also trade mutual fund shares online with investment companies. Click on the company's web site, such as www.troweprice.com, and find the link to register for a new account. At T. Rowe Price's mutual fund account page, you can download each fund's prospectus as well as all relevant forms for your account. Trading mutual funds is so easy, you have no excuse not to make it a regular part of your personal investment plan!