



Mutual Funds

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One way for beginning investors to simplify their investment decision is to buy shares in mutual funds. A mutual fund is an open-end investment company that pools its shareholders' money and invests these funds in stocks, bonds and other securities. Each investor buys shares of the total portfolio.

There are many mutual funds available, but selecting the best one can be challenging. Hopefully, this publication will take some of the mystery out of investing in mutual funds. Investors who lack the time, energy or inclination to research mutual funds before making their selection may wish to work with a competent investment adviser.

Understanding mutual funds

Every mutual fund has an objective. The objective guides and directs the mutual fund's manager(s) when choosing investments for the fund's portfolio. The objective is broken down into specific goals. These goals typically include stability, growth or income. Stability includes protection from loss of the amount invested and the degree of variability in the value of the shares. Growth is the increase in value of the principal or amount invested. Income is the amount the investor will receive from interest or dividends.



Investment Basics

You can find each fund's objective in its prospectus. The prospectus is a booklet that contains information about the fund. Directions for obtaining a fund prospectus are found on page 6. With the vast number of funds available, there should be many that will meet your needs, regardless of the amount of risk you are willing to assume.

The prices of the stocks, bonds and other investments in any mutual fund

vary each day. Therefore, the mutual fund company calculates a price per share of the total portfolio each business day. This calculation is called the net asset value (NAV). The NAV is what you will pay per share when you buy or what you will receive per share when you sell shares of the mutual fund.

Transaction costs may also be involved when buying or selling shares of the mutual fund. NAVs of many mutual funds are published in *The Wall Street Journal*, *Barron's*, and some major daily newspapers.

Each share of a mutual fund represents a portion of all the investments in the fund. An open-end fund creates and redeems shares daily. Investors can buy shares directly from the investment company or through stockbrokers (and others authorized to buy and sell securities).

Net asset value

The net asset value (NAV) determines the price paid per share when buying or the price received when selling mutual fund shares. With a load fund, the purchase price is the NAV per share plus the load. When selling, the price received is the NAV per share minus any redemption fees. Mutual fund companies compute the NAV at the close of each business day as follows:

$$\frac{(\text{Fund assets}) - (\text{Expenses and liabilities})}{\text{Number of shares outstanding}}$$

The NAV varies from day to day, depending on the movement of the market and other factors that affect the value of securities in the total portfolio.

Benefits and cautions for the investor

Benefits

Mutual funds offer many benefits for the average investor:

- The nature of a mutual fund makes it a diversified investment, which helps reduce risk to the investor. That is, they contain many different investments, often across a range of industries. Many new investors would lack the knowledge and money to achieve the same level of diversification on their own.
- The investor can choose from a wide variety of mutual fund portfolios, each with its own set of objectives, risks, returns, and investments. Some mutual fund companies offer multiple funds, each with a different objective. Investing in a variety of funds with the same company can simplify the selection process.
- Each fund is professionally managed. The fund manager(s) decide which securities to buy, sell, and hold (and when).
- Mutual fund shares can be easily purchased and sold (redeemed). Dividends, interest, and capital gains can be reinvested automatically.
- New investors can buy into many funds easily, often with little or no initial investment. Initial minimum investments can range from “no minimum” to \$2,500 or more. Some companies allow a small initial investment followed by a monthly payment as low as \$25 until you reach the required minimum. Often, the investor's financial institution can automatically transfer this amount each month.
- Investors who buy “no-load” funds

Closed-end investment companies

Closed-end investment companies (or closed-end funds), while similar to mutual funds, have some basic differences. These funds create a specific number of shares. The investment company does not continue offering to sell shares (or buy back shares from shareholders). Instead, investors buy and sell these shares in the secondary securities market. The price of closed-end shares can be more or less than the NAV, depending on a number of factors such as investor supply of and demand for shares.

Evaluating a closed-end fund is more difficult than evaluating a mutual fund. Not only must you judge it using the same criteria as for a mutual fund, but you must figure out how other investors will look at its prospects.

generally pay no sales fees on purchases. However, there could be a charge if you sell too soon.

- Investors regularly receive updates about the fund's objectives, performance, fees, and management team.

Cautions

There are some cautions to consider when investing in mutual funds, also.

- The safety of the invested principal and earnings is neither insured nor guaranteed. This is also true of mutual funds sold through banks, though many new investors may not be aware of that fact. While some funds are relatively safe, there is always some risk involved in any investment. For all of their benefits, mutual funds are not risk free. For a discussion of the various types of risks faced by investors, see MU guide GH 3520, *Getting Started Saving and Investing*, of this Investment Basics series. It is important that potential investors read and understand the fund's prospectus, know what securities are contained in the portfolio, and evaluate the fund's past performance to help minimize their risk.
- Various costs and fees are imposed when investing in mutual funds (see discussion on page 5). These costs and fees vary considerably from one

fund to another. Since the costs affect the amount you invest and the total return you receive, you will want to be aware of the costs before investing your money.

Types of funds

This discussion focuses on three of the four basic kinds of mutual funds:

- **Equity**
- **Balanced and total return**
- **Bond**
- **Money market**

Equity funds invest in stocks. Balanced and total return funds invest in stocks and bonds. Bond funds invest exclusively in bonds. Money market funds invest in short-term securities such as Treasury bills, certificates of deposit, and short-term business loans. Money market funds are discussed in MU guide GH 3521, *Financial Institution Deposits and U.S. Government Securities*, of this Investment Basics series.

Equity funds

Equity funds are those that primarily invest in shares of stock from various corporations. Depending on their objectives (which affect the securities selected for the portfolio), equity funds vary in their degree of risk. For more information about stocks, refer to MU guide GH 3522, *Stocks*, of this Investment Basics series.

■ Aggressive growth funds

These funds invest in companies where a rapid increase in stock value is expected, with little or no dividends. Stocks in aggressive growth fund portfolios are often of new companies, new industries, companies struggling to survive, and companies or industries that are temporarily “out of favor.” The value of these funds can rise or fall rapidly.

■ Growth funds

Growth funds invest in profitable, well-established companies where their stock value is expected to grow faster than average.

■ Growth and income funds

Growth and income funds invest in companies that pay higher dividends than most. Returns on these funds come from long-term growth in stock prices and a steady dividend income. Some growth and income funds contain only stocks. Others contain mostly stocks and a few bonds.

■ Equity-income funds

Equity-income funds focus on stocks that pay regular, steady dividends. Growth in value is secondary. These funds contain only stocks. The total return for equity-income funds tends to be similar to that for growth and income funds, only the approach is different.

■ Index funds

Index funds invest in stocks of one of the major broadly based market indexes, such as the Standard and Poor’s 500 Stock Index (S&P 500). A broadly based index is a group of stocks that are chosen to represent the entire stock market. Index funds should perform similarly to the underlying index.

■ International and global equity funds

These two fund types invest around the world. International funds invest only in foreign stocks. Global equity funds invest in a combination of U.S. and international stocks.

Stock markets in other countries do not rise and fall at the same rate as the U.S. stock market. However, even if the price of a foreign stock remains unchanged, U.S. investors can lose or gain because of exchange rate fluctuations between foreign currency and the U.S. dollar.

■ A fund of funds

A fund of funds invests in other mutual funds from the same management company. This allows investors to buy one fund with several objectives, thereby reducing risk on the total portfolio. Because of their diversity, these funds may be particularly useful for retirement accounts such as Individual Retirement Accounts (IRAs).

■ Sector funds

Sector funds focus on stocks in a single industry, such as utilities, energy, precious metals, health care, or transportation. The lack of diversification makes these funds more risky than some other types of funds.

■ Socially responsible mutual funds

These funds invest in companies that are concerned with ethical or social issues or they avoid investing in companies that produce certain products or follow certain policies. For example, socially responsible mutual funds might invest only in companies with a goal of improving the environment or they might avoid investing in companies that are involved with gambling, tobacco, or alcohol or companies known to discriminate against minorities. Because of these limitations, some of the most profitable and widely diversified companies are excluded from

these funds. Exclusion of these companies can reduce returns somewhat, but investors in these funds have social and ethical goals, as well as financial goals.

Balanced and total-return funds

Balanced funds and total-return funds invest in a mix of bonds, preferred stocks, and common stocks. These funds have three goals: to conserve principal, to pay current income, and to promote long-term growth of capital.

Bond funds

The purpose of a bond fund is to preserve principal and earn income. Investing in bond funds is not the same as investing in individual bonds. When individual bonds mature, investors get back what they have invested. In comparison, bond funds have no maturity date (even though the bonds within the fund do) because bond fund managers trade bonds continuously. This lack of maturity date causes problems if you need to sell your fund shares when interest rates are on the rise. The value of your fund could be less than when you invested.

Investors should be aware that all bonds are not created equal. Bonds are “graded” according to the creditworthiness of the issuer. U.S. government bonds are the safest because they are backed by the full faith and credit of the federal government. Therefore, they form the standard of comparison for all other bonds. For more information about bond ratings, refer to MU guide GH 3524, *Bonds*, of this Investment Basics series. When selecting a bond fund, investors should pay close attention to the credit rating of the bonds in the fund.

■ Corporate bond funds

These funds include investment-

grade bonds. Investment-grade bonds have one of the top four ratings: AAA, AA, A, or BBB (Standard and Poor) or Aaa, Aa, A, or Baa (Moody).

■ **High-yield or junk bond funds**

These funds invest in bonds that have ratings below those of investment-grade bonds, which indicate a greater chance that they will default. The titles of these funds usually have the words “high yield” in them. The difference between the return on junk bond funds and regular bond funds can be significant, but the risks associated with high-yield funds can also be significant.

If you are looking for higher income, be sure to consult financial magazines to see what has happened to the fund both when interest rates increased and when they decreased.

Government bond funds invest in a variety of government securities, including U.S. Treasury notes and Treasury bonds. Remember, while interest is guaranteed (except on some government agency securities), losses can occur when buying and selling U.S. securities in the secondary market. Because of the low risk involved in U.S. government securities, interest rates are lower than those for corporate bond funds. Distributions of interest on U.S. Treasury notes and bonds are exempt from Missouri state and local income taxes, which helps compensate for the lower interest rate.

■ **Ginnie Mae funds**

These funds contain mortgages guaranteed by the Government National Mortgage Association (GNMA) to pay timely principal and interest. Returns include both the principal and interest. Some investors do not automatically reinvest returns from Ginnie Mae funds. If the investor’s goal is to keep principal intact, reinvestment of earnings is an important strategy.

■ **Municipal bond funds**

Municipal bond funds focus on bonds issued by state and local governments. Distributions of interest, but not capital gains, are free from federal tax. Distributions of interest paid on bonds purchased by Missouri taxpayers that are issued in Missouri are generally free of both federal and state taxes. The return on these funds is lower than on U.S. government bond funds.

■ **International bond funds**

International bond funds invest in foreign bonds.

■ **Global bond funds**

Global bond funds invest in a combination of foreign and U.S. corporate bonds.

The above is not a complete listing of mutual fund types. There are others, such as precious metals/gold funds, flexible portfolio funds, and specialty funds.

Selecting a fund

Now that you know about the various types of mutual funds, you may be wondering how to select one. The highest returns over the long run are usually from funds that perform consistently from year to year. To find a fund that is consistent, consider those that annually have returns in the top half of mutual funds of that type.

Mutual funds can fluctuate dramatically with swings in the market and changes in interest rates, so a long-run (three or more years) approach to investing is important. When you start studying mutual fund results, you will probably find that the funds at the top of the list over one, three, six, or twelve months are not the ones at the top of the list over three to five years.

Magazines that specialize in personal finance are good sources for information on which funds offer the most consistent returns. For example, *Busi-*

Dollar-cost averaging

	\$ Invested	Share price (NAV)	# Shares purchased
Month 1	\$100.00	\$10.00	10.0
Month 2	100.00	9.50	10.5
Month 3	100.00	12.50	8.0
	\$300.00	\$32.00/3 = \$10.67	28.5

Dollar-cost averaging is a technique for purchasing mutual fund shares (or stocks) on a regular basis. It is one way to establish and follow a long-term investment plan.

By purchasing a specific dollar amount each time period (usually each month), you buy more shares when prices are down and fewer shares when prices are higher. This process actually leads to a greater return on your investment in the long-run (assuming share prices go up in the long-run).

Above is an example where an investor purchases \$100 worth of shares each month. The average price was \$10.67. If purchased at this price, the investor could have purchased 28.1 shares (\$300 / 10.67). However, the investor was able to purchase 28.5 shares at an average cost of \$10.53 (\$300 / 28.5) because of dollar-cost averaging. Over the long run, these differences can add up.

Reading *The Wall Street Journal*

Mutual Fund Quotations

(1)	(2)	(3)	(4)	(5)	(6)			(7)
	Inv Obj	NAV	Offer Price	NAV Chg	YTD	13 wks	3 yrs	R
Quast	GRO	13.80	NL	+ 0.02	+1.5	- 0.01	+8.8	A

- (1) Name of the mutual fund (may be shortened or abbreviated).
- (2) Investment objective, such as growth, growth and income, sector funds, and others.
- (3) Net asset value or dollar value per share as of the previous trading day.
- (4) Indicates this is a no-load fund (and thus, NAV is also offer price).
- (5) Change in the NAV between the closing quotation listed and that of the previous trading day.
- (6) Percentage return (+ or -), assuming all distributions are reinvested and excluding the sales charges. In this case, year-to-date, the last thirteen weeks, and the annual average over the last three years are given. YTD is calculated each business day; other time periods reported vary by day of the week, with expense ratios listed on Mondays.
- (7) Ranking of return performance, with "A" meaning the fund was in the top 20 percent over the last three years. Note: Various footnote symbols in *The Wall Street Journal* provide additional information/exceptions.

ness Week, Forbes, Smart Money, Kiplinger's Personal Finance Magazine, and Money have articles on various funds' categories and objectives, past performances, and fee structures. To see how funds have done over the past year, three years, and five years, you can consult the Mutual Fund Quotation section of the *Wall Street Journal* each Friday. Each fund's performance is given for those three time periods.

When you find several funds that match your specific goals and have consistent returns, get more information about these funds. Check your local library for mutual fund reference books, newsletters, and other information services that provide more in-depth information. Examples include those by Kiplinger, Lipper, Morningstar, Standard and Poor, Value Line, and Wiesenberger. These references list and describe hundreds of mutual funds.

Call or write the fund for a copy of the prospectus and the most recent annual or semiannual report. You may also want to get a copy of the company report and the statement of additional information (see later discussion). Most funds have a toll-free number for requesting the prospectus, other reports, and forms for purchasing shares.

Costs and fees

Mutual funds are not cost-free. When ownership costs are high, returns are smaller, and there is less money to reinvest. The fees and charges that investors pay to buy and sell shares of a mutual fund are not tax deductible. However, they usually affect the income tax "basis" of your shares and thus reduce a capital gain or increase a capital loss.

One strategy to increase your return is to select a fund with the lowest total

fees. Remember, however, that fees are not the only factor to consider.

■ Loads

A mutual fund can have a load or be a no-load fund. No-load funds generally charge no sales fees for purchases of shares. Load funds charge a sales fee or commission that occurs "up-front."

■ Redemption fee

A sales charge or redemption fee may also be imposed when you sell your shares. This is known as a rear-end load. Some mutual fund companies charge a fee when an investor sells shares in a fund soon after purchase (called a contingent-deferred sales charge). These charges typically decline with each year you own the fund and disappear after you own it for a specified number of years.

If you buy and sell shares through a stockbroker (or others who are authorized to buy and sell securities), there may be an additional sales charge from that professional.

■ 12b-1 fee

The Securities and Exchange Commission (SEC) also allows mutual funds to charge what is known as the 12b-1 fee to cover marketing and distribution costs. This fee helps pay the costs of buying and selling securities within the fund's portfolio (in lieu of sales charges or loads), advertising, and other costs. Currently, the combined total of sales charges (loads), 12b-1 fees, and redemption fees cannot be greater than 8.5 percent (in some instances, the limit may be lower).

■ Management and other fees

All mutual funds charge investors a management or administrative fee that compensates the portfolio manager(s). This management fee is typically stated as a percentage but may also be stated as a flat fee. Other fees cover the cost of

maintaining an office, fees paid to companies contracted by the mutual fund to provide services for shareholders, and other fund operating expenses.

The prospectus and company reports

A prospectus contains facts about an individual mutual fund and is available from the fund free of charge. The company report, also free, provides established investors with the results of their mutual fund's performance and activity. It offers useful information for prospective investors as well. You can order them by calling the mutual fund's toll free number or by writing the company with the request.

Reading the prospectus

The prospectus provides much information. Many investors, particularly those unfamiliar with legal and financial terms, may find it difficult to read. Here are some factors to consider when selecting mutual funds and ideas on where to find the information in the prospectus.

■ Date of the prospectus

You should have the most recent edition. By law, a company must update its prospectus at least once a year.

■ Minimum investment

This information is usually on the first page. If the minimum is more than you can afford, you do not need to read further.

■ Investment objectives

There will be a brief statement of objectives on the cover page and a more detailed statement inside the prospectus.

- ✓ How is the fund divided among each of its investments?
- ✓ Where are any remaining assets invested?

- ✓ What flexibility does the manager have to increase income on the portfolio?
- ✓ For bond funds, what is the quality (grade) of bonds in the fund?

■ Summary of expenses

The first chart in the prospectus is the summary of fund expenses.

- ✓ Does the fund have a sales fee or a 12b-1 fee?
- ✓ What are the total operating expenses? How do they compare with those of other funds you are considering?
- ✓ What is your total cost of ownership over 1, 3, 5 and 10 years? You can find this information in the prospectus table illustrating the costs of investing \$1,000 at 5 percent and redeeming shares at the end of each period.

■ Financial history

This table and related information must also appear in the beginning section of the prospectus. It has up to ten years of data on the fund.

- ✓ Does the average net asset value (NAV) vary greatly from year to year? Is the direction usually upward over time?
- ✓ What is the portfolio turnover rate? Funds pay brokerage fees when they buy or sell securities in the portfolio. Those with high turnover rates have higher expenses. Compare the turnover rates of funds with similar objectives.

■ Statement of fund organization

- ✓ How long has the fund been in business? New funds do not have a track record.
- ✓ How large is the fund financially? Very large funds are more difficult to manage and may not do as well as moderate-sized funds.

■ Investment risk

The prospectus discusses the risk level of the fund and often suggests the kind of investor who should invest. The location of this information varies.

- ✓ How much risk are you willing to assume? If the shares of your fund lose value, will you hold onto them until they go up again?
- ✓ Does your risk tolerance match the fund's risk level?

■ Shareholder services

This section may be called "How to Invest," "Shareholder's Manual," "Shareholder's Guide," or a similar title.

- ✓ Can you invest by telephone, Internet, mail, exchange of funds and wire?
- ✓ Can you invest automatically each month?
- ✓ How are earnings distributed to you?
- ✓ How do you get your money out of the fund?
- ✓ What is the minimum you must keep in your account?

Statement of additional information

This report, also called "Part B," contains the names, occupations, and salaries of the company's officers and a description of how the fund operates. For example, in some funds, investment decisions are made by the top manager and assistants. In others, a committee makes investment decisions. In still other funds, the star manager or several independent managers decide. You will want to know how long those managing the fund have been in that position and what level of performance have they achieved? You will not receive this statement with the prospectus. However, you may request one from the investment company without charge.

Semiannual and annual reports

Twice a year mutual funds must issue performance reports. These reports list the stocks, bonds, and other securities held in the portfolio. They also document current investment activity and discuss this activity within the context of the fund's history. The annual report also includes audited financial statements of the fund.

Managing mutual fund investments

Income taxes

You will pay income taxes on the annual return from your mutual fund, unless your fund account is an Individual Retirement Account or other tax-deferred retirement plan. That is, you will be taxed on the interest (unless tax-exempt), dividends, and capital gains realized by the fund each year. This is true even when you reinvest the income in the fund. Instructions are provided by your mutual fund on how to report earnings on your income tax return.

When you sell your shares, capital gains and losses must also be taken into account when filing your income tax returns. The Internal Revenue Service (IRS) specifies how to report your gain or loss. Check these rules in the IRS 1040 instruction book, a more in-depth IRS publication (such as Publication 564, Mutual Fund Distributions), or with your tax adviser. You will need the prices of all the shares you bought. Be sure to save all statements from the mutual fund company.

The four methods for reporting mutual fund sales on your tax return are too lengthy to discuss in this publication. However, it is important that you understand these rules because they may affect which shares you choose to sell.

Selling mutual fund shares

Being a wise investor not only involves knowing how to select a mutual fund, but it also includes knowing when to sell your shares. Many new investors sell for the wrong reasons. They sell when the market is declining, especially when it declines greatly in one day. They act on tips from friends or advisers that may not be in the investor's best interest. They forget that their goal is to increase their own net worth over the long term.

Before you sell your fund shares, be sure to answer the following three questions:

1. Why did I buy into the fund?
2. What kind of return did I expect?
3. What could make me change my mind about the fund I selected?

Once you have set certain standards for owning your fund shares, deciding when to sell becomes easier.

Begin to think about selling your fund shares when you need the money within one to three years. Markets move in cycles and you do not want to sell when the market is down.

If you've been in a fund for 2 or 3 years, and it is not doing what you expect, you may want to sell. However, mutual funds work best when given 3 to 5 years to grow.

If you are anxious about your investment, you may be in the wrong fund. If you sell for this reason, consider why you felt anxious before choosing another fund. Your anxiety may be related to the level of risk that you can comfortably tolerate. You will not decrease your anxiety by investing in another fund with the same level of risk.

Finally, consider selling your fund when your reasons for investing or the conditions under which you invested change. Common reasons for selling include a change in your goals, a change in the tax laws or a change in the fund's fees or manager(s).

This publication has discussed how to select, analyze, buy and sell mutual funds. Now it is up to you to decide how mutual funds fit into your overall investment plan.

The Investment Basics series is not intended to provide a complete and in-depth text on investments. Rather, it is designed to provide an introduction to common savings and investment alternatives and to help the beginning investor start to design and implement an investment plan. Investment alternatives more suited to a discussion on retirement planning or insurance, those which require greater expertise on the part of the investor, and those which generally involve a higher degree of risk are also not included in the series.

Information in this publication is based on the laws in force and information available on the date of publication.

The use of trade names is not intended as an endorsement, nor is criticism of unnamed firms and products implied.

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This publication was adapted, with permission, from:

Jones, Joyce. Investment Basics, Part 5: Mutual Funds. Manhattan: Cooperative Extension Service, Kansas State University, MF 2083, May 1995.



OUTREACH & EXTENSION
UNIVERSITY OF MISSOURI
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