Mutual Fund Basics Tutorial

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Introduction

As you probably know, mutual funds have become extremely popular over the last 20 years. What was once just another obscure financial instrument is now a part of our daily lives. More than 80 million people, or one half of the households in America, invest in mutual funds. That means that, in the United States alone, trillions (yes, with a "T") of dollars are invested in mutual funds.

In fact, to many people, investing means buying mutual funds. After all, it's common knowledge that investing in mutual funds is (or at least should be) better than simply letting your cash waste away in a savings account, but, for most people, that's where the understanding of funds ends. It doesn't help that mutual fund salespeople speak a strange language that, sounding sort of like English, is interspersed with jargon like MER, NAVPS, load/no-load, etc.

Originally mutual funds were heralded as a way for the little guy to get a piece of the market. Instead of spending all your free time buried in the financial pages of the Wall Street Journal, all you have to do is buy a mutual fund and you'd be set on your way to financial freedom. As you might have guessed, it's not that easy. Mutual funds are an excellent idea in theory, but, in reality, they haven't always delivered. Not all mutual funds are created equal, and investing in mutuals isn't as easy as throwing your money at the first salesperson who solicits your business.

This is why we've written this tutorial. We'll explain the basics of mutual funds and hopefully clear up some of the myths around them. You can then decide whether or not they are right for you.

It will be helpful for you to understand the basics of stocks and bonds before proceeding. If these subjects are a little bit foggy in your mind, check out our stock tutorial and bond tutorial.

What are Mutual Funds?

The Definition

A mutual fund is nothing more than a collection of stocks and/or bonds. You can think of a mutual fund as a company that brings together a group of people and invests their money in stocks, bonds, and other securities. Each investor owns shares, which represent a portion of the holdings of the fund.

You can make money from a mutual fund in three ways:
1) Income is earned from dividends on stocks and interest on bonds. A fund pays out nearly all income it receives over the year to fund owners in the form of a distribution.
2) If the fund sells securities that have increased in price, the fund has a capital gain. Most funds also pass on these gains to investors in a distribution.
3) If fund holdings increase in price but are not sold by the fund manager, the fund's shares increase in price. You can then sell your mutual fund shares for a profit.

Funds will also usually give you a choice either to receive a check for distributions or to reinvest the earnings and get more shares.

Advantages of Mutual Funds:

• Professional Management - The primary advantage of funds (at least theoretically) is the professional management of your money. Investors purchase funds because they do not have the time or the expertise to manage their own portfolio. A mutual fund is a relatively inexpensive way for a small investor to get a full-time manager to make and monitor investments.
• Diversification - By owning shares in a mutual fund instead of owning individual stocks or bonds, your risk is spread out. The idea behind diversification is to invest in a large number of assets so that a loss in any particular investment is minimized by gains in others. In other words, the more stocks and bonds you own, the less any one of them can hurt you (think about Enron). Large mutual funds typically own hundreds of different stocks in many different industries. It wouldn't be possible for an investor to build this kind of a portfolio with a small amount of money.
• Economies of Scale - Because a mutual fund buys and sells large amounts of securities at a time, its transaction costs are lower than you as an individual would pay.
• Liquidity - Just like an individual stock, a mutual fund allows you to request that your shares be converted into cash at any time.
• Simplicity - Buying a mutual fund is easy! Pretty well any bank has its own line of mutual funds, and the minimum investment is small. Most companies also have automatic purchase plans whereby as little as $100 can be invested on a monthly basis.

Disadvantages of Mutual Funds:
• Professional Management- Did you notice how we qualified the advantage of professional management with the word "theoretically"? Many investors debate over whether or not the so-called *professionals* are any better than you or I at picking stocks. Management is by no means infallible, and, even if the fund loses money, the manager still takes his/her cut. We'll talk about this in detail in a later section.
• Costs - Mutual funds don't exist solely to make your life easier--all funds are in it for a profit. The mutual fund industry is masterful at burying costs under layers of jargon. These costs are so complicated that in this tutorial we have devoted an entire section to the subject.
• Dilution - It's possible to have too much diversification (this is explained in our article entitled "Are You Over-Diversified?"). Because funds have small holdings in so many different companies, high returns from a few investments often don't make much difference on the overall return. Dilution is also the result of a successful fund getting too big. When money pours into funds that have had strong success, the manager often has trouble finding a good investment for all the new money.
• Taxes - When making decisions about your money, fund managers don't consider your personal tax situation. For example, when a fund manager sells a security, a capital-gain tax is triggered, which affects how profitable the individual is from the sale. It might have been more advantageous for the individual to defer the capital gains liability.

Different Types of Funds

No matter what type of investor you are there is bound to be a mutual fund that fits your style. According to the last count there are over 10,000 mutual funds in North America! That means there are more mutual funds than stocks.

It's important to understand that each mutual fund has different risks and rewards. In general, the higher the potential return, the higher the risk of loss. Although some funds are less risky than others, all funds have some level of risk--it's never possible to diversify away all risk. This is a fact for all investments. (You can learn more about this in our financial concepts tutorial.)

Each fund has a predetermined investment objective that tailors the fund's assets, regions of investments, and investment strategies. At the fundamental level, there are three varieties of mutual funds:
1) Equity funds (stocks)
2) Fixed-income funds (bonds)
3) Money market funds

All mutual funds are variations of these three asset classes. For example, while equity funds that invest in fast-growing companies are known as growth funds, equity funds that invest only in companies of the same sector or region are known as specialty funds.

Let's go over the many different flavors of funds. We'll start with the safest and then work through to the more risky.

Money Market Funds

The money market consists of short-term debt instruments, mostly T-bills. This is a safe place to park your money. You won't get great returns, but you won't have to worry about losing your principle. A typical return is twice the amount you would earn in a regular checking/savings account and a little less than the average certificate of deposit (CD). We've got a whole tutorial on the money market if you'd like to learn more about it.

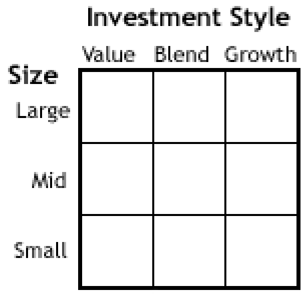
Bond / Income Funds
Income funds are named appropriately: their purpose is to provide current income on a steady basis. When referring to mutual funds, the terms "fixed-income," "bond," and "income" are synonymous. These terms denote funds that invest primarily in government and corporate debt. While fund holdings may appreciate in value, the primary objective of these funds is to provide a steady cashflow to investors. As such, the audience for these funds consists of conservative investors and retirees.

Bond funds are likely to pay higher returns than certificates of deposit and money market investments, but bond funds aren't without risk. Because there are many different types of bonds, bond funds can vary dramatically depending on where they invest. For example, a fund specializing in high-yield junk bonds is much more risky than a fund that invests in government securities; also, nearly all bond funds are subject to interest rate risk, which means that if rates go up the value of the fund goes down.

Balanced Funds
The objective of these funds is to provide a "balanced" mixture of safety, income, and capital appreciation. The strategy of balanced funds is to invest in a combination of fixed-income and equities. A typical balanced fund might have a weighting of 60% equity and 40% fixed-income. The weighting might also be restricted to a specified maximum or minimum for each asset class.

A similar type of fund is known as an asset allocation fund. Objectives are similar to those of a balanced fund, but these kinds of funds typically do not have to hold a specified percentage of any asset class. The portfolio manager is therefore given freedom to switch the ratio of asset classes as the economy moves through the business cycle.

Equity Funds
Funds that invest in stock represent the largest category of mutual funds. Generally, the investment objective of this class of funds is long-term capital growth with some income. There are, however, many different types of equity funds because there are many different types of equities. A great way to understand the universe of equity funds is to use a style box, an example of which is below. (Using a style box to classify mutual funds was popularized by *Morningstar*.)



The idea is to classify funds based on both the size of the companies invested in and the investment style of the manager. The term "value" refers to a style of investing that looks for high quality companies that are out of favor with the market. These companies are characterized by low P/E ratios, price-to-book ratios, and high dividend yields, etc. The opposite of value is growth, which refers to companies that have had (and are expected to continue to have) strong growth in earnings, sales, and cash flow, etc. A compromise between value and growth is "blend," which simply refers to companies that are neither value nor growth stocks and so are classified as being somewhere in the middle.

For example, a mutual fund that invests in large-cap companies who are in strong financial shape but have recently seen their share price fall would be placed in the upper left quadrant of the style box (large and value). The opposite of this would be a fund that invests in startup technology companies with excellent growth prospects. Such a mutual would reside in the bottom right quadrant (small and growth).

Global / International Funds
An international fund (or foreign fund) invests only outside your home country. Global funds invest anywhere around the world, including your home country.

It's tough to classify these funds as either more risky or safer. On the one hand they tend to be more volatile and have unique country and/or political risks. But, on the flip side, they can, as part of a well-balanced portfolio, actually reduce risk by increasing diversification. Although the world's economies are becoming more inter-related, it is likely that another economy somewhere is outperforming the economy of your home country.

Specialty Funds
This classification of mutual funds is more of an all-encompassing "etc. category" that consists of funds that have proven to be popular but don't necessarily belong to the categories we've described so far. This type of mutual fund forgoes broad diversification to concentrate on a certain segment of the economy.

Sector funds are targeted at specific sectors of the economy such as financial, technology, health, etc. Sector funds are extremely volatile. There is a greater possibility of big gains, but you have to accept that your sector may tank.

Regional funds make it easier to focus on a specific area of the world. This may mean focusing on a region (say Latin America) or an individual country (for example, only Brazil). An advantage of these funds is that they make it easier to buy stock in foreign countries, which is otherwise difficult and expensive. Just like for sector funds, you have to accept the high risk of loss, which occurs if the region goes into a bad recession.

Socially-responsible funds (or ethical funds) invest only in companies that meet the criteria of certain guidelines or beliefs. Most socially responsible funds don't invest in industries such as tobacco, alcoholic beverages, weapons, or nuclear power. The idea is to get a competitive performance while still maintaining a healthy conscience.

Index Funds
The last but certainly not the least important are index funds. This type of mutual fund replicates the performance of a broad market index such as the S&P 500 or DJIA. An investor in an index fund figures that most managers can't beat the market. An index fund merely replicates the market return and benefits investors in the form of low fees.

Costs
Costs are the biggest problem with mutual funds. These costs eat into your return, and they are the main reason why the majority of funds end up with sub-par performance.

What's even more disturbing is the way the fund industry hides costs through a layer of financial complexity and jargon. Some critics of the industry say that mutual fund companies get away with the fees they charge only because the average investor does not understand what he/she is paying for.

Fees can be broken down into two categories:
1. Ongoing yearly fees to keep you invested in the fund.
2. Transaction fees paid when you buy or sell shares in a fund (loads).

The Expense Ratio
The ongoing expenses of a mutual fund is represented by the expense ratio. This is sometimes also referred to as the management expense ratio (MER). The expense ratio is composed of the following:

• The cost of hiring the fund manager(s) - Also known as the management fee, this cost is between 0.5% and 1.0% of assets on average. While it sounds small, this fee ensures that mutual fund managers remain in the country's top echelon of earners. Think about it for a second: 1% of 250 million (a small mutual fund) is $2.5 million--fund managers are definitely not going hungry! It's true that paying managers is a necessary fee, but don't think that a high fee assures superior performance.

• Administrative costs - These include necessities such as postage, record keeping, customer service, cappuccino machines, etc. Some funds are excellent at minimizing these costs while others (the ones with the cappuccino machines in the office) are not.

• The last part of the ongoing fee (in the United States anyway) is known as the 12B-1 Fee. This expense goes toward paying brokerage commissions and toward advertising and promoting the fund. That's right, if you invest in a fund with a 12B-1 fee, you are paying for the fund to run commercials and sell itself!

On the whole, expense ratios range from as low as 0.2% (usually for index funds) to as high as 2.0%. The average equity mutual fund charges around 1.3%-1.5%. You'll generally pay more for specialty or international funds, which require more expertise from managers.

Are high fees worth it? You get what you pay for, right?

Wrong.

Just about every study ever done has shown no correlation between high expense ratios and high returns. This is a fact. If you want more evidence, consider this quote from the SEC's website:

"Higher expense funds do not, on average, perform better than lower expense funds."

Loads, A.K.A. "Fee for Salesperson"
Loads are just fees that a fund uses to compensate brokers or other salespeople for selling you the mutual fund. All you really need to know about loads is this: don't buy funds with loads.

In case you are still curious, here is how certain loads work:

• Front-end loads - These are the most simple type of load: you pay the fee when you purchase the fund. If you invest $1,000 in a mutual fund with a 5% front-end load, $50 will pay for the sales charge, and $950 will be invested in the fund.

• Back-end loads (also known as deferred sales charges) - These are a bit more complicated. In such a fund you pay the a back-end load if you sell a fund within a certain time frame. A typical example is a 6% back-end load that decreases to 0% in the seventh year. The load is 6% if you sell in the first year, 5% in the second year, etc. If you don't sell the mutual fund until the seventh year, you don't have to pay the back-end load at all.

A "no-load" fund sells its shares without a commission or sales charge. Some in the mutual fund industry will tell you that the load is the fee that pays for the "service" of a broker choosing the correct fund for you. According to this argument, your returns *will* be higher because the professional advice put you into a better fund. There is little to no evidence that shows a correlation between load funds and superior performance. In fact, when you take the fees into account, the average load fund performs worse than a no-load fund.

Buying and Selling Funds

Buying and Selling

You can buy some mutual funds (no-load) by contacting the fund companies directly. Other funds are sold through brokers, banks, financial planners, or insurance agents. If you buy through a third party there is a good chance they'll hit you with a sales charge (load).

That being said, more and more funds can be purchased through no-transaction fee programs that offer funds of many companies. Sometimes referred to as a "fund supermarket," this service lets you consolidate your holdings and record keeping, and it still allows you to buy funds without sales charges from many different companies. Popular examples are Schwab's OneSource, Vanguard's FundAccess, and Fidelity's FundsNetwork. Many large brokerages have similar offerings.

Selling a fund is as easy as purchasing one. All mutual funds will redeem (buy back) your shares on any business day. In the United States companies must send you the payment within seven days.

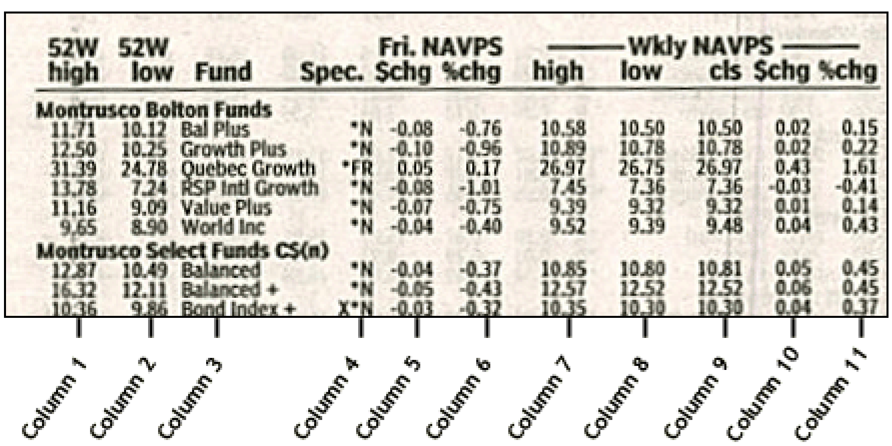
The Value of Your Fund
Net asset value (NAV), which is a fund's assets minus liabilities, is the value of a mutual fund. NAV per share is the value of one share in the mutual fund, and it is the number that is quoted in newspapers. You can basically just think of NAV per share as the price of a mutual fund. It fluctuates everyday as fund holdings and shares outstanding change.

When you buy shares, you pay the current NAV per share plus any sales front-end load. When you sell your shares, the fund will pay you NAV less any back-end load.

Finding Funds
The Mutual Fund Education Alliance™ is the not-for-profit trade association of the no-load mutual fund industry. They have a tool for searching for no-load funds at http://www.mfea.com/FundSelector

Morningstar is an investment research firm that is particularly well known for its fund information:
http://www.morningstar.com

How To Read a Mutual Fund Table



52W high	52W low	Fund	Spec.	Fri. NAVPS $chg	Fri. NAVPS %chg	Wkly NAVPS high	Wkly NAVPS low	Wkly NAVPS cls	Wkly NAVPS $chg	Wkly NAVPS %chg
Montrusco Bolton Funds										
11.71	10.12	Bal Plus	*N	-0.08	-0.76	10.58	10.50	10.50	0.02	0.15
12.50	10.25	Growth Plus	*N	-0.10	-0.96	10.89	10.78	10.78	0.02	0.22
31.39	24.78	Quebec Growth	*FR	0.05	0.17	26.97	26.75	26.97	0.43	1.61
13.78	7.24	RSP Intl Growth	*N	-0.08	-1.01	7.45	7.36	7.36	-0.03	-0.41
11.16	9.09	Value Plus	*N	-0.07	-0.75	9.39	9.32	9.32	0.01	0.14
9.65	8.90	World Inc	*N	-0.04	-0.40	9.52	9.39	9.48	0.04	0.43
Montrusco Select Funds C$(n)										
12.87	10.49	Balanced	*N	-0.04	-0.37	10.85	10.80	10.81	0.05	0.45
16.32	12.11	Balanced +	*N	-0.05	-0.43	12.57	12.52	12.52	0.06	0.45
10.36	9.86	Bond Index +	X*N	-0.03	-0.32	10.35	10.30	10.30	0.04	0.37

Columns 1 & 2: 52-Week Hi and Low - These show the highest and lowest prices the mutual fund has experienced over the previous 52-weeks (one year). This typically does not include the previous day's price.

Column 3: Fund Name - This column lists the name of the mutual fund. The company that manages the fund is written above in bold type.

Column 4: Fund Specifics - Different letters and symbols have various meanings. For example, "N" means no load, "F" is front end load, and "B" means the fund has both front and back-end fees. For other symbols see the legend in the newspaper in which you found the table.

Column 5: Dollar Change - This states the dollar change in the price of the mutual fund from the previous day's trading.

Column 6: % Change - This states the percentage change in the price of the mutual fund from the previous day's trading.

Column 7: Week High - This is the highest price the fund traded at during the past week.

Column 8: Week Low - This is the lowest price the fund traded at during the past week.

Column 9: Close - The last price at which the fund was traded is shown in this column.

Column 10: Week's Dollar Change - This represents the dollar change in the price of the mutual fund from the previous week.

Column 11: Week's % Change - This shows the percentage change in the price of the mutual fund from the previous week.

The Truth Revealed About Mutual Fund Ads

I'm sure you've noticed all those mutual fund ads that quote their amazingly high one-year rates of return. Your first thought is "wow, that mutual fund did great!" Well, yes it did great last year, but then you look at the three-year performance, which is lower, and the five year, which is yet even lower. What's the underlying story here? Lets look at a real example--I got the figures from the local paper (names withheld of course):

1 year	3 year	5 year
53%	20%	11%

Ok, last year the fund had excellent performance at 53%. But in the past three years the average annual return was 20%. What did it do in years 1 and 2 to bring the average return down to 20%? Some simple math shows us that the fund made an average return of 3.5% over those first two years: 20% = (53% + 3.5% + 3.5%)/3. Because that is only an average, it is very possible that the fund lost money in one of those years.

It gets worse when we look at the five-year performance. We know that in the last year the fund returned 53% and in years 2 and 3 we are guessing it returned around

3.5%. So what happened in years 4 and 5 to bring the average return down to 11%? Again, by doing some simple calculations we find that the fund must have lost money, an average of -2.5% each year of those two years: 11% = (53% + 3.5% + 3.5% - 2.5% - 2.5%)/5. Now the fund's performance doesn't look so good!

It should be mentioned that, for the sake of simplicity, this example, besides making some big assumptions, doesn't include calculating compound interest. Still, the point wasn't to be technically accurate but to demonstrate how misleading mutual fund ads can be. A fund that loses money for a few years can bump the average up significantly with one or two strong years.

Conclusion & Resources

Let's recap what we've learned in this tutorial:

- A mutual fund brings together a group of people and invests their money in stocks, bonds, and other securities.
- The advantages of mutuals are professional management, diversification, economies of scale, simplicity, and liquidity.
- The disadvantages of mutuals are high costs, over-diversification, possible tax consequences, and the inability of management to guarantee a superior return.
- There are many, many types of mutual funds. You can classify funds based on asset class, investing strategy, region, etc.
- Mutual funds have lots of costs.
- Costs can be broken down into ongoing fees (represented by the expense ratio) and transaction fees (loads).
- The biggest problems with mutual funds are their costs and fees.
- Mutual funds are easy to buy and sell. You can either buy them directly from the fund company or through a third party.
- Mutual fund ads can be very deceiving.

Related Links

As we mentioned, index funds can be an excellent way to invest in mutual funds without the high fees. We talk more about this in our tutorial called "**Index Basics**."

If you would like to learn more about how the mutual fund industry can hide instances of its poor performance, see our article called "**The Truth Behind Mutual Fund Returns**."