What is a mutual fund?

A mutual fund pools money from different investors in order to invest in a large group of assets (also known as securities) such as stocks and bonds. Professionals manage the holdings that make up the fund's portfolio; investors buy shares that rise or fall in value based on the performance of the fund's underlying securities.

Mutual fund investors own shares in a company whose business is buying shares in other companies (or in government bonds, or other securities). Mutual fund investors don't directly own the stock in the companies the fund purchases, but share equally in the profits or losses of the fund's total holdings — hence the "mutual" in "mutual funds."

Mutual fund benefits

Mutual funds are one of the top tools Americans use to grow their wealth and save for retirement. About 100 million individual Americans had $18.9 trillion invested in mutual funds in 2018, according to the Investment Company Institute.

Why do so many investors consider mutual funds a good investment? There are five primary benefits to investing in mutual funds:

- **Simplicity.** Once you find a mutual fund with a good record, you have a relatively small role to play: Let the fund managers do all the heavy lifting.
- **Professional management:** Fund managers make daily decisions on buying and selling the securities held in the fund, decisions that are based on the fund's goals. For example, in a fund whose goal is high growth, the manager might try to achieve better returns than that of a major stock market like the S&P 500. Conversely, a bond-fund manager tries to get the highest returns with the lowest risk.
- **Affordability.** Mutual funds often have a required minimum somewhere between $500 and $5,000, but many brokers waive minimums if you make monthly direct deposits to buy more fund shares.
- **Liquidity.** Compared to other assets you own (such as your car or home), mutual funds are easier to buy and sell. (Note: Selling mutual fund shares held in tax-advantaged accounts such as a 401(k) or IRA before the age of 59 1/2 may be subject to early withdrawal penalties).
- **Diversification.** This is one of the most important principles of investing. If a single company fails, and all your money was invested in that one company, then you have lost your money. However, if a single company fails within your portfolio of many companies,

then your loss is constrained. Mutual funds provide access to a diversified portfolio without the difficulties of having to purchase and monitor dozens of assets yourself.

Mutual fund disadvantages

The main disadvantage to mutual funds is that, because the fund is managed, you'll incur fees no matter how the fund performs.

Fund investors usually pay an annual fee for the running of the fund, known as an expense ratio, which is based on a small percentage of the total value of your shares (typically between 1% and 3%). Paying attention to account minimums and fees can be an important way to choose among mutual funds. (We'll cover more on fees below.)

Also, some people don't like the lack of control with a mutual fund; you may not know the exact makeup of the fund's portfolio and have no say over its purchases. However, this can be a relief to some investors, who simply don't have the time to track and manage a large portfolio.

Mutual fund types

Some mutual funds focus on a single asset class, such as stocks or bonds, while others invest in a variety. These are the main types of mutual funds:

1. **Stock (equity) funds** carry the greatest risk alongside the greatest potential returns. Fluctuations in the market can drastically affect the returns of equity funds. There are several types of equity funds, such as growth funds, income funds and sector funds. Each of these groups tries to maintain a portfolio of stocks with certain characteristics. Equity funds are the most popular type of mutual fund, accounting for 55% of all mutual funds owned in 2017, according to the Investment Company Institute.
2. **Bond (fixed-income) funds** are less risky than stock funds. There are many different types of bonds, so you should research each mutual fund individually in order to determine the amount of risk associated with it. About 22% of all U.S. mutual funds are bond funds, ICI stats show.
3. **Balanced funds** invest in a mix of stocks, bonds and other securities. Balanced funds (also called asset allocation funds or hybrid funds) are often a "fund of funds," investing in a group of other mutual funds. One popular example is a target date fund, which automatically chooses and reallocates assets toward safer investments as you approach retirement age. Hybrid funds make up 8% of the mutual fund market, according to the ICI.
4. **Money market funds** have the lowest returns because they carry the lowest risk. Money market funds are legally required to invest in high-quality, short-term investments that

are issued by the U.S. government or U.S. corporations. These funds make up 15% of the mutual fund market.

How do mutual funds work?

No matter which category a mutual fund falls into, its fees and performance will depend on whether it is actively or passively managed.

Passively managed funds invest according to a set strategy. They try to match the performance of a specific market index, and therefore require little investment skill. Since these funds require little management, they will carry lower fees than actively managed funds.

How mutual funds make you money

When you invest in a mutual fund, cash or value can increase from three sources:

- **Dividend payments:** When a fund receives dividends or interest on the securities in its portfolio, it distributes a proportional amount of that income to its investors. When purchasing shares in a mutual fund, you can choose to receive your distributions directly, or have them reinvested in the fund.
- **Capital gain:** When a fund sells a security that has gone up in price, this is a capital gain. (And when a fund sells a security that has gone down in price, this is a capital loss.) Most funds distribute any net capital gains to investors annually.
- **Net asset value (NAV):** As the value of the fund increases, so does the price to purchase shares in the fund (known as the NAV per share). This is similar to when the price of a stock increases — you don't receive immediate distributions, but the value of your investment is greater, and you would make money should you decide to sell.

Mutual funds can lose money, too

All investments carry some risk, and you could lose money in a mutual fund. But diversification is inherent, meaning you'll spread risk across a number of companies or industries. Investing in individual stocks, on the other hand, can carry a higher risk. If you put all your money in Apple stock, for example, a bad quarter could have a disastrous impact on your savings. But with a mutual fund that's invested across the technology sector, gains by other companies could help offset any single company's loss. So, are mutual funds safe? Comparatively, yes.

Time is a crucial element in building the value of your investments. Don't invest cash you will need in five years or less, because you'll want to ride out the inevitable peaks and valleys of the market.

Mutual fund fees

Mutual fund investors pay two basic types of fees: expense ratios and sales commissions, which are known in the industry as sales loads.

Mutual fund expense ratios are the cost of ongoing expenses — such as fund administration and operating costs. They are paid annually as a percentage of your total assets in the fund. As noted above, passively managed funds have lower expense ratios compared to actively managed accounts, as they require fewer financial professionals and other overhead costs.

So it pays to shop around, and statistics show more mutual fund investors are doing just that. For example, in 2017 the average equity mutual fund charged an expense ratio of 1.25%, but the average equity-fund investor paid only 0.59%, according to the Investment Company Institute. That might not seem like a big difference, but over time it can add up to tens of thousands of dollars in lost retirement savings.

Another common expense are sales loads. These are commissions paid at the time of share purchase (front-end loads) and when redeemed (back-end loads). Sales loads are compensation paid to financial professionals, such as a broker or investment advisor, to buy mutual fund shares.Mutual funds come in four different structures that will impact fees you'll pay:

- **Open-end funds:** Most mutual funds are this variety, where there is no limit to the number of investors or shares. The NAV per share rises and falls with the value of the fund.
- **Closed-end funds:** These funds have a limited number of shares offered during an IPO, much as a company would. There are far fewer closed-end funds on the market compared to open-end funds.

Whether or not funds carry commissions are expressed by "loads," such as:

- **Load funds:** Mutual funds that pay a sales charge or commission to the broker or salesperson who sold the fund in addition to the NAV share price.
- **No-load funds:** Also known as "no-transaction-fee funds," these mutual funds charge no sales commissions for the purchase or sale of a fund share. This is the best deal for investors, and brokers such as TD Ameritrade and E-Trade have thousands of choices for no-transaction fee mutual funds.

How do I buy mutual funds?

If you have a 401(k), a pension, a traditional individual retirement account or a Roth IRA — really, any kind of brokerage account to invest your cash — there's a good chance your portfolio includes mutual funds.

In 2018, 80% of mutual fund owners held funds within an employer sponsored retirement plan like a 401(k), while 43% owned mutual funds both inside their work plan and with outside accounts like a traditional or Roth IRA, according to the ICI. Most investors owned shares in four or more mutual funds.

You can purchase through your employer-sponsored retirement account or directly from a fund provider such as Vanguard, Fidelity or American Funds. Both options, however, can limit your choice of funds. Unlike the stock market, in which investors purchase shares from one another, mutual-fund shares are purchased directly from the fund or, more often, a broker who purchases shares for investors.

You'll have more choices if you open a brokerage account to begin investing. There may be a minimum deposit requirement, but some providers offer $0 minimum if you invest through an IRA or if you set up automatic monthly deposits.