Mutual Fund

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What is a Mutual Fund

A mutual fund is an investment vehicle made up of a pool of money collected from many investors for the purpose of investing in securities such as stocks, bonds, money market instruments and other assets. Mutual funds are operated by professional money managers, who allocate the fund's investments and attempt to produce capital gains and/or income for the fund's investors. A mutual fund's portfolio is structured and maintained to match the investment objectives stated in its prospectus.

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An Introduction To Mutual Funds

BREAKING DOWN Mutual Fund

Mutual funds give small or individual investors access to professionally managed portfolios of equities, bonds and other securities. Each shareholder, therefore, participates proportionally in the gains or losses of the fund. Mutual funds invest in a wide amount of securities, and performance is usually tracked as the change in the total market cap of the fund, derived by aggregating performance of the underlying investments.

Mutual fund units, or shares, can typically be purchased or redeemed as needed at the fund's current net asset value (NAV) per share, which is sometimes expressed as NAVPS. A fund's NAV is derived by dividing the total value of the securities in the portfolio by the total amount of shares outstanding.

More on Mutual Funds

A mutual fund is both an investment and an actual company. This may seem strange, but it is actually no different than how a share of AAPL is a representation of Apple, Inc. When an investor buys Apple stock, he is buying part ownership of the company and its assets.

while a mutual fund company is in the business of making investments.

Mutual funds pool money from the investing public and use that money to buy other securities, usually stocks and bonds. The value of the mutual fund company depends on the performance of the securities it decides to buy. So when you buy a share of a mutual fund, you are actually buying the performance of its portfolio.

The average mutual fund holds hundreds of different securities, which means mutual fund shareholders gain important diversification at a very low price. Consider an investor who just buys Google stock before the company has a bad quarter. They stand to lose a great deal of value because all of their dollars are tied to one company. On the other hand, a different investor may buy shares of a mutual fund that happens to own some Google stock. When Google has a bad quarter, they only lose a fraction as much because Google is just a small part of the fund's portfolio.

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by an investment advisor and fund manager. The fund manager is hired by a board of directors and is legally obligated to work in the best interest of mutual fund shareholders. Most fund managers are also owners of the fund, though some are not.

There are very few other employees in a mutual fund company. The investment advisor or fund manager may employ some analysts to help pick investments or perform market research. A fund accountant is kept on staff to calculate the fund's net asset value (NAV), or the daily value of the mutual fund that determines if share prices go up or down. Mutual funds need to have a compliance officer or two, and probably an attorney, to keep up with government regulations.

Most mutual funds are part of a much larger investment company apparatus; the biggest have hundreds of separate mutual funds. Some of these fund companies are names familiar to the general public, such as Fidelity Investments, the Vanguard Group, T. Rowe Price and Oppenheimer Funds.

Kinds of Mutual Funds

Mutual funds are divided into several kinds of categories, representing the kinds of securities the mutual fund manager invests in.

other debt instruments. The idea is the fund portfolio generates a lot of interest income, which can then be passed on to shareholders.

Another group falls under the moniker "index funds." The investment strategy is based on the belief that it is very hard, and often expensive, to try to consistently beat the market. So the index fund manager simply buys stocks that correspond with a major market index such as the S&P 500 or the Dow Jones Industrial Average. This strategy requires less research from analysts and advisors, so there are fewer expenses to eat up returns before they are passed on to shareholders. These funds are often designed with cost-sensitive investors in mind.

If an investor seeks to gain diversified exposure to the Canadian equity market, he can invest in the S&P/TSX Composite Index, which is a mutual fund that covers 95% of the Canadian equity market. The index is designed to provide investors with a broad benchmark index that has the liquidity characteristics of a narrower index. The S&P/TSX Composite Index is comprised largely of the financials, energy and materials sectors of the Canadian stock market, with sector allocations of 35.54%, 20.15% and 14.16%, respectively. Performance of the fund is tracked as the percentage change to its overall adjusted market cap.

Balanced funds invest in both stocks and bonds with the aim of reducing risk of exposure to one asset class or another. Another name for this type is "asset allocation fund." An investor may expect to find the allocation of these funds among asset classes relatively unchanging, though it will differ among funds. Though their goal is asset appreciation with lower risk, these funds carry the same risk and are as subject to fluctuation as other classifications of funds.

Other common types of mutual funds are money market funds, sector funds, equity funds, alternative funds, smart-beta funds, target-date funds and even funds-of-funds, or mutual funds that buy shares of other mutual funds.

Mutual Fund Fees

In mutual funds, fees are classified into two categories: annual operating fees and shareholder fees. The annual fund operating fees are charged as an annual percentage of funds under management, usually ranging from 1-3%. The shareholder fees, which come in the form of commissions and redemption fees, are paid directly by shareholders when purchasing or selling the funds.

sales charges or commissions can be assessed on the front-end or back-end, known as the load of a mutual fund. When a mutual fund has a front-end load, fees are assessed when shares are purchased. For a back-end load, mutual fund fees are assessed when an investor sells his shares.

Sometimes, however, an investment company offers a no-load mutual fund, which doesn't carry any commission or sales charge. These funds are distributed directly by an investment company rather than through a secondary party.

Some funds also charge fees and penalties for early withdrawals.

Clean Share Mutual Funds

If you want to get the biggest bang for your buck, you might consider mutual funds with 'clean shares,' a relatively new class of mutual fund shares developed in response to the U.S. Department of Labor’s fiduciary rule. According to a recent Morningstar Inc. report, clean shares could save investors at least 0.50% in returns as compared to other mutual fund offerings. Even better, investors could enjoy an extra 0.20% in savings, as their advisors will now be tasked with recommending funds that are in investors' best interests, according to the report.

Clean shares were designed, along with low-load T shares and a handful of other new share classes, to meet fiduciary-rule goals by addressing problems of conflicts of interest and questionable behavior among financial advisors. In the past some financial advisors have been tempted to recommend more expensive fund options to clients to bring in bigger commissions. Currently, most individual investors purchase mutual funds with A shares through a broker. This purchase includes a front-end load of up to 5% or more, plus management fees and ongoing fees for distributions, also known as 12b-1 fees. To top it off, loads on A shares vary quite a bit, which can create a conflict of interest. In other words, advisors selling these products may encourage clients to buy the higher-load offerings.

Clean shares and the other new classes eliminate this problem, by standardizing fees and loads, enhancing transparency for mutual fund investors. “As the Conflict-of-Interest Rule goes into effect, most advisors will likely offer T shares of traditional mutual funds … in place of the A shares they would have offered before,” write report co-authors Aron Szapiro, Morningstar director of policy research, and Paul Ellenbogen, head of global regulatory solutions. “This will likely save some investors money immediately, and it helps align advisors’ interests with those of their clients.”

share fund, according to the analysis. The report also states that the T shares and clean shares compare favorably with "level load" C shares, which generally don't have a front-end load but carry a 1% 12b-1 annual distribution fee.

Good as the T shares are, clean shares are even better: They provide one uniform price across the board and do not charge sales loads or annual 12b-1 fees for fund services. American Funds, Janus and MFS are all fund companies currently offering clean shares.

Advantages of Mutual Funds

Diversification: Diversification, or the mixing of investments and assets within a portfolio to reduce risk, is one of the advantages to investing in mutual funds. Buying individual company stocks in retail and offsetting them with industrial sector stocks, for example, offers some diversification. But a truly diversified portfolio has securities with different capitalizations and industries, and bonds with varying maturities and issuers. Buying a mutual fund can achieve diversification cheaper and faster than through buying individual securities.

Economies of Scale: Mutual funds also provide economies of scale. Buying one spares the investor of the numerous commission charges needed to create a diversified portfolio. Buying only one security at a time leads to large transaction fees, which will eat up a good chunk of the investment. Also, the $100 to $200 an individual investor might be able to afford is usually not enough to buy a round lot of a stock, but it will buy many mutual fund shares. The smaller denominations of mutual funds allow investors to take advantage of dollar cost averaging.

Easy Access: Trading on the major stock exchanges, mutual funds can be bought and sold with relative ease, making them highly liquid investments. And, when it comes to certain types of assets, like foreign equities or exotic commodities, mutual funds are often the most feasible way – in fact, sometimes the only way – for individual investors to participate.

Professional Management: Most private, non-institutional money managers deal only with high net worth individuals – people with six figures (at least) to invest. But mutual funds are run by managers, who spend their days researching securities and devising investment strategies. So these funds provide a low-cost way for individual investors to experience (and hopefully benefit from) professional money management.

offer high liquidity; they are relatively easy to understand; good diversification even if you do not have a lot of money to spread around; and the potential for good growth. In fact, many Americans already invest in mutual funds through their 401(k) or 403(b) plans. In fact, the overwhelming majority of money in employer-sponsored retirement plans goes into mutual funds.

Style: Investors have the freedom to research and select from managers with a variety of styles and management goals. For instance, a fund manager may focus on value investing, growth investing, developed markets, emerging markets, income or macroeconomic investing, among many other styles. One manager may also oversee funds that employ several different styles.

Disadvantages of Mutual Funds

Fluctuating Returns: Like many other investments without a guaranteed return, there is always the possibility that the value of your mutual fund will depreciate. Equity mutual funds experience price fluctuations, along with the stocks that make up the fund. The Federal Deposit Insurance Corporation (FDIC) does not back up mutual fund investments, and there is no guarantee of performance with any fund. Of course, almost every investment carries risk. But it's especially important for investors in money market funds to know that, unlike their bank counterparts, these will not be insured by the FDIC.

Cash: As you know already, mutual funds pool money from thousands of investors, so every day people are putting money into the fund as well as withdrawing it. To maintain the capacity to accommodate withdrawals, funds typically have to keep a large portion of their portfolios in cash. Having ample cash is great for liquidity, but money sitting around as cash is not working for you and thus is not very advantageous.

Costs: Mutual funds provide investors with professional management, but it comes at a cost – those expense ratios mentioned earlier. These fees reduce the fund's overall payout, and they're assessed to mutual fund investors regardless of the performance of the fund. As you can imagine, in years when the fund doesn't make money, these fees only magnify losses.

Diworsification: Many mutual fund investors tend to overcomplicate matters – that is, they acquire too many funds that are highly related and, as a result, don't get the risk-reducing benefits of diversification; in fact, they have made their portfolio more exposed, a syndrome called diworsification. At the other extreme, just because you own mutual funds doesn't