

Mutual Funds: From Mystery to Mainstay

With more than 10,000 mutual funds now available, and most working Americans contributing to them via their employer-sponsored plans, mutual funds are no longer the mystery they once were. Instead, they're the mainstay of many family's investment portfolios.



But if you're new to investing, you may have some questions. What is a mutual fund? And how do they work? This article is designed to answer these and other important questions.

Designed for the Smaller-Net-Worth Investor

So you want to invest in, say, the stock or bond market. But you don't have enough cash to diversify your investments. Mutual funds may be the answer.

At its most basic, a mutual fund is a financial intermediary that manages a pool of money from investors who share the same investment objectives. By pooling their money together, the investors can purchase stocks, bonds, cash, and other assets at far lower trading costs than they could on their own. What's more, rather than trying to manage their assets themselves - a daunting challenge even for experienced investors - a mutual fund is overseen by professional asset managers. These experienced managers are responsible for identifying and investing in the securities they believe will best help the fund pursue its investment objective.

A Range of Investment Objectives

When you invest in a mutual fund, you are essentially buying shares in the pooled assets and you become a shareholder in the fund.

One of the reasons for the popularity of mutual funds is that not only are they extremely cost efficient and easy to invest in, but you can choose from a wide range of investment options. Some mutual funds, such as money market funds and short-term bond funds, are quite conservative and offer a degree of stability and preservation of your principal. Others, such as aggressive growth funds, pursue above-average returns, generally with the volatility and risk that go along with them. And there are options all along the risk/reward spectrum.

The Added Benefit of Diversification

Earlier in this article, the topic of diversification was mentioned. Diversification is the concept of spreading out your money across many different types of investments to reduce the affect of any one investment on your overall returns. When growth stocks are declining, value stocks may be rising. When U.S. stocks are appreciating, international stocks may be falling. Diversifying your investment holdings across asset classes (stocks, bonds, and cash), sectors and industries, and geographic regions can significantly reduce your risk. However diversification does not protect against risk.

The most basic level of diversification is to buy multiple stocks rather than just one stock. A stock mutual funds generally holds many stocks, often between 50 and 100 but frequently many more. Achieving a similarly diversified portfolio on your own by purchasing individual stocks would not only be exponentially more difficult, but also more expensive as the trading costs for buying and selling stocks can quickly eat away a smaller portfolio's value.

Reading A Mutual Fund Prospectus

Before investing in any mutual fund, you should read its prospectus. This is a legally mandated document that provides specific information about the fund's investment objectives, managers, the types of securities it may buy, fees and costs, and other pertinent information. Recent legislation mandates that a prospectus must be written in clear, common-sense language that the general public can easily understand.

A mutual fund prospectus should outline these six factors that allow you to evaluate the fund and its potential place in your plan.

1. **Investment objective.** Is the fund seeking to make money over the long term or to provide investors with cash each month? You'll find the answers in this section of the prospectus.
2. **Strategy.** This section should spell out the types of stocks, bonds or other securities in which the fund plans to invest. It may look for small, fast-growing firms or large, well-established companies. If it's a bond fund, it may hold corporate bonds or foreign debt. This section may also mention any restrictions on securities in which the fund can invest.
3. **Risks.** The prospectus should explain the risks associated with the fund. For instance, a fund that invests in emerging markets will be riskier than one investing in the United States or other developed countries. A bond fund should also discuss the credit quality of the bonds it holds and how a change in interest rates may affect those holdings.
4. **Expenses.** Different funds have different sales charges and other fees. The prospectus will spell out those fees so you can compare them with the fees of other funds. It should also explain the percentage of the fund's return that is deducted each year to pay for management fees and operation costs.
5. **Past performance.** Although you shouldn't judge a fund solely by its past performance, this can show how consistently the fund has performed and give some indication of how it may fare in the future. This section of the prospectus will also show you the fund's income distributions and its total return.
6. **Management.** This section may do nothing more than list the fund manager or managers, or it may give specific information about the management team's experience. If the prospectus doesn't contain enough detail, you may be able to find this information in the fund's annual report.

Mutual funds provide investors with a convenient, effective tool for investing in the stock, bond, and cash-equivalent markets. Let us show you how they can apply in your specific situation.

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