OKLAHOMA COOPERATIVE EXTENSION SERVICE

T-4146

Mutual Funds

Family and Consumer Sciences

One way for beginning investors to simplify their investment decision is to buy shares in mutual funds. This publication will take some of the mystery out of investing in mutual funds.

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.

You can find each fund's objective in its prospectus. The prospectus is a booklet containing information about the fund. 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 a 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). It determines (along with any sales charges) the price you pay upon buying or receive upon selling mutual fund shares. NAVs of many mutual funds are published in *The Wall Street Journal, Barron's*, and some major daily newspapers.

Each share 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 from stockbrokers (and others authorized to buy and sell securities).

Net Asset Value

The net asset value (NAV) determines the price paid when buying or the price received when selling mutual fund shares. With a load fund, the purchase price is the NAV plus the load. When selling, the price received is the NAV 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 how the movement of the market and other factors 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.
- 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 a fund 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. 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. The investor's financial institution often can automatically transfer this amount each month.
- Investors who buy "no-load" funds 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 (including those mutual funds sold through banks—a fact of which, according to several recent surveys, few people are aware). While some funds are relatively safe, others are quite risky. For a discussion of the various types of risks faced by investors, see the Oklahoma Cooperative Extension publication T-4144 Getting Started: Saving and Investing.

Diversification helps guard against large losses of principal. However, many beginning investors do not have the knowledge or money to achieve such diversification on their own. 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 before investing.

- Various costs and fees are imposed when investing in mutual funds (see discussion on page 4). These costs affect the amount you invest and the total return you receive on your investment.

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. 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.

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 the Oklahoma Cooperative Extension publication T-4145 Financial Institution Deposits and U.S. Government Securities.

Equity Funds

Equity funds are those that primarily invest in shares of stock from various corporations. Depending on their objectives (which affect the securities contained in the portfolio), equity funds vary in their degree of risk.

- *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 temporarily "out of favor." The value of these funds can rise or fall very 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 somewhat risky.
- *Socially responsible mutual funds.* These funds invest in companies concerned with ethical or social issues. For example, they might avoid investing in companies involved with nuclear power, defense, gambling, tobacco, or alcohol; companies convicted of producing industrial pollution; and 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.

Bonds 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 in 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 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 creditableness of the issuer. U.S. government bonds are the safest because the full faith and credit of the federal government back them. Therefore, they form the standard of comparison for all other bonds. When selecting a bond fund, investors should pay close attention to the credit rating of the bonds in it.

- *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 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 in both up and down markets (that is, when interest rates have increased and when they have decreased).

- *Government bond funds.* 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 Oklahoma income taxes, however.
- *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 their investment goal is to keep principal intact, it is important to remember not to spend the total distribution check (containing both principal and interest).
- *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 Oklahoma taxpayers that are issued in Oklahoma 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. 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, Business Week, Forbes, Kiplinger's Personal Finance Magazine, and Money have articles on various funds' categories and objectives, past performances, and fee structures.

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. As you research your favorites, pay attention to the costs of ownership.

Call or write the fund company 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 discussion on page 5). Most funds have a toll-free number for requesting the prospectus, other reports, and forms for purchasing shares.

Cost and Fees

Mutual funds are not cost-free. When ownership costs are high, returns are smaller, and there is less money to reinvest. However, with careful shopping it is possible to keep fees to a minimum.

One strategy to increase your returns is to select a fund with the lowest total fees. Remember, however, that fees are not the only factor to consider.

- *Loads, redemption fees, and 12b-1 fees.* A mutual fund can be a load or 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."

A sales charge or redemption fee may also be imposed when you sell your shares. Some mutual fund companies charge a fee when an investor sells 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 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.

Fees and charges that investors pay to buy or sell mutual fund shares are not tax deductible. However, they usually affect the income tax 'basis' of your shares (and thus can reduce a capital gain or increase a capital loss).

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 (a percentage of the total investment each year) that compensates the portfolio manager(s). 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 expenses of operating the fund.

Dollar-cost Averaging

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).

Here 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.

	$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

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.

Reading the Prospectus

The prospectus provides much information. Many investors, particularly those unfamiliar with legal and financial terms, 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.

- *Dates 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 other funds you are considering?
___ What is your total cost of ownership over one, three, five, and ten 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 high 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 discussed 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, 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, the top manager and assistant make investment decisions. In others, a committee makes investment decisions. In still other funds, the star manager or several independent managers decide. 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 the fund 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 recognized by the fund each year. 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.

Reading *The Wall Street Journal* or business page of major newspaper

Mutual Fund Quotations

(1)	(2) Inv Obj	(3) NAV	(4) Offer Price	(5) NAV Chg	(6) —Total Return— YTD	13 wks	3 yrs	(7) 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.

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:

- Why did I buy into the fund?
- What kind of return did I expect?
- 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 have been in a fund for two or three years, and it is not doing what you expect, you may want to sell. However, mutual funds work best when given three to five 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.

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.

This publication is intended to provide an introduction to mutual funds and to help the beginning investor start to design and implement an investment plan.

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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