Mutual Funds

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WHAT'S COVERED

In this lesson, you will identify the benefits and options that mutual funds provide to investors. You will consider how strong problem solving skills can help you decide which investment is right for you. You will also better understand how investing in mutual funds could make you more productive with your finances. Specifically, this lesson will cover:

1. Overview of Mutual Funds

1a. How Mutual Funds Work

Mutual funds are investments that pool individual investors' money for the purpose of:

1. Hiring a professional investment manager to make investment decisions.
2. Providing sufficient investment capital to purchase a large investment portfolio, thereby reducing some investment-related risk. An **investment portfolio** consists of individual stocks, bonds, and other assets that collectively represent the total investment assets of an individual or entity.

> EXAMPLE Let's say that John would like to invest $1,000 in stocks. John understands the importance of owning profitable companies for long-term wealth creation, but he may lack the interest, time, and expertise to carefully evaluate any of the individual stocks available for purchase. With only $1,000 to invest, he may also lack sufficient money to purchase the stocks he wants to buy. But what if there were 100,000 individuals in John's situation, each with $1,000? Collectively, they have $100,000,000 to invest. These investors could then use some of this money to hire a professional investment manager, who would then purchase a variety of stocks, bonds, and other assets. This is how a mutual fund works.

TERMS TO KNOW

Mutual Fund
Investments that pool individual investors' money for the purpose of hiring a professional investment manager to make investment decisions and providing sufficient investment capital to purchase a large investment portfolio, thereby reducing some investment-related risk.

Investment Portfolio
Individual stocks that collectively represent the total investment assets of an individual or entity.

1b. Diversification

A significant advantage associated with mutual funds is that funds offer individual investors with limited investment dollars the opportunity to diversify. Diversification, the process of purchasing a variety of different securities, is essential to successful investing.

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2. Mutual Fund Management

One reason to purchase a mutual fund is that investment managers have the time and expertise to manage the portfolio. There are many strategies that mutual fund managers use to generate investment returns for fund investors. These can be broadly grouped into two categories: (1) active management, and (2) passive management.

2a. Active Management

Actively managed mutual funds attempt to earn rates of return that are higher than the stock market rate of return for a given level of risk. You can purchase an actively managed mutual fund that mimics almost any type of individual stock, bond, or other investment in the marketplace. For simplicity, let's focus on stock mutual funds. Actively managed mutual funds can be classified in a variety of ways.

- Generally, mutual funds are classified by the size of the companies the fund invests in and whether the price of the stock relative to the company's earnings is expensive or a bargain (similar to a stock classification table). The following table shows how mutual funds can be categorized this way.
- Value-oriented investors look for underpriced stocks or bargains.
- Growth-oriented investors seek stocks where the share price is quickly increasing; these stocks tend to be more expensively priced.

	Market Cap (More than $10 billion)	Medium Market Cap ($2–$10 billion)	Small Market Cap (Less than $2 billion)
Value-oriented (bargain-priced stocks)	Large-cap bargain	Mid-cap bargain	Small-cap bargain
Combination of value and growth (fairly priced stocks)	Large-cap combination	Mid-cap combination	Small-cap combination
Growth-oriented (expensively priced stocks)	Large-cap expensive	Mid-cap expensive	Small-cap expensive

2b. Passive Management

Passively managed mutual funds (also known as **index funds**), in contrast to those that are actively managed, seek to mirror the returns in the stock market.

- Passively managed mutual fund managers purchase stocks and other investments that mirror the stocks that are included in a market index. A **market index** is an unmanaged grouping of stocks that has been identified as representative of some aspect of the economy or stock or bond market. The table below includes some common market indices and their description.

- By seeking to replicate a certain market index, passive mutual fund managers seek investment performance that is equal to the underlying market index.
- This strategy significantly reduces the cost to manage a portfolio, giving index funds a significant advantage over actively managed funds.

Table: Common Indices and Descriptions

Standard & Poor's 500 Composite Stock Price Index	Stock Indices	• 500 stocks of leading U.S. companies. • Weighted-index based on company market capitalization. • Representative of large, fairly priced, and growth-oriented companies.
Russell 2000 Index		• 2,000 smallest companies based on market capitalization. • Weighted-index based on market capitalization.
Dow Jones Industrial Average (DJIA)		• 30 highly regarded U.S. stocks from a variety of sectors of the economy. • Not a good representation of the market or larger economy.
Barclays Capital U. S. Aggregate Bond Index	Bond Indices	• The broad bond market, including U.S. government bonds, corporate bonds, mortgage-backed securities, and foreign government bonds issued in the United States.

Source: U.S. Securities and Exchange Commission, "Market Indices,"https://www.sec.gov/fast-answers/answersindiceshtm.html.

Productivity: Skill Tip

Your time is valuable. Having an investment manager who handles your mutual funds can allow you to be more productive. You can utilize your time for other activities knowing your investments are being well managed.

TERMS TO KNOW

Index Fund
Passively managed mutual funds.

Market Index
An unmanaged grouping of stocks that has been identified as representative of some aspect of the economy or stock or bond market.

3c. Comparing Management Methods

As an investor, you have more than 9,500 different mutual funds to choose from, which is more than the number of U.S.-based stocks available for purchase! How can you choose one mutual fund from the thousands available?

If one of the two investment strategies just discussed (active compared with passive management) is better than the other, you can eliminate quite a few mutual funds from consideration. Here is a question to ponder:

THINK ABOUT IT

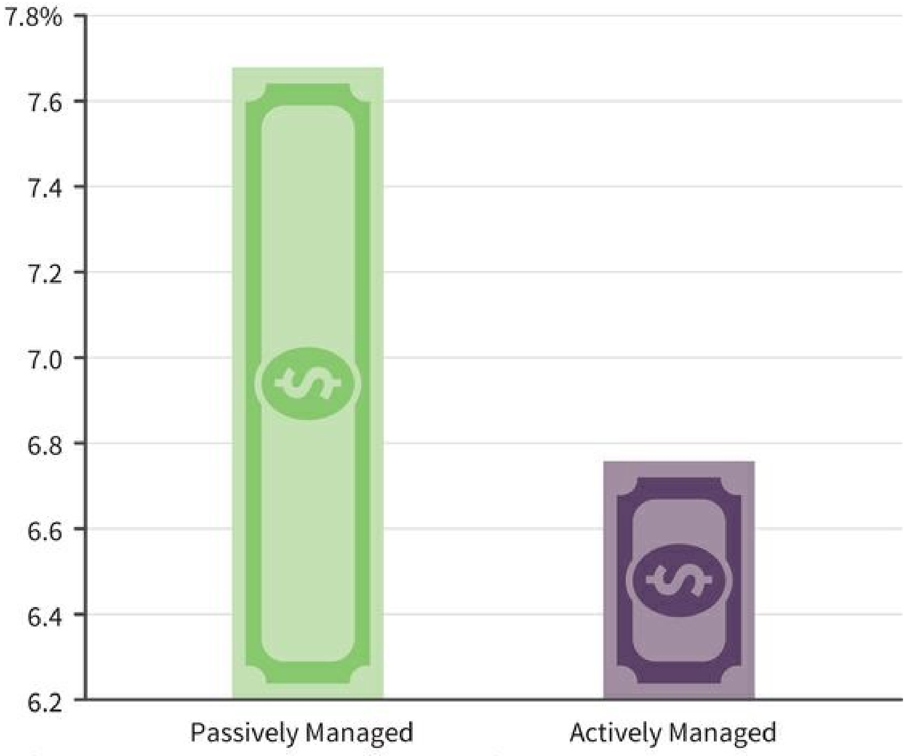
What type of manager will likely give you a higher return on your investment, a manager that tries to earn higher rates of return than the stock market while taking the same risk, or a manager that attempts to simply mirror the return of the stock market?

- The answer is surprising. As shown in the column chart below, over a 10-year period ending in 2016, the average returns in passively managed index funds tracking U.S. large-company stocks were higher than the average returns achieved by actively managed funds also investing in U.S. large-company stocks.

HINT

Remember, these are averages. Some mutual funds did better than the average, whereas others did worse.

- Passive investment managers trade less frequently and have lower investment research costs compared to active managers. These lower costs explain some of the difference in returns.



Source: Federal Reserve Bank of St. Louis, "Stock Market Indexes," https://fred.stlouisfed. org/categories/32255.

3. Purchasing Mutual Funds

Even after you have narrowed down your mutual fund options, you still have many factors to weigh before making your investment decision. Consider that different investment companies offer index mutual funds. For example, Fidelity, Schwab, T. Rowe Price, and Vanguard all offer a mutual fund that tracks the S&P 500 index. Each fund holds the same basket of stocks. Often, the only significant difference between index funds is the fee charged to investors.

Strong problem solving skills can help you make your decision. You can compare each company and make the choice that is best for you. Factors to consider may be your financial situation, fees, or reputation.

3a. Fees

BIG IDEA

Few things are certain in the investment world, but here is one that is always guaranteed: Higher fees will result in lower returns for investors over time.

Higher investment fees can cost you tens of thousands of dollars (and possibly much, much more) over your lifetime. This can be enough to throw your lifetime financial journey off course. Here's what you want to do:

1. **Avoid sales-loaded mutual funds.** A sales load is a one-time commission paid to an investment salesperson either when a mutual fund is purchased or sold. No-load mutual funds do not charge a sales load, which saves you money.
2. **Avoid paying 12b-1 fees, if possible.** A 12b-1 fee is an annual fund marketing expense that is passed on to shareholders in a mutual fund. Fees range from 0% to 0.20% and average around 0.13%.
3. **Buy the mutual fund with the lowest expense ratio.** A mutual fund's expense ratio is a measure of the total management fees and expenses charged by the mutual fund on an annual basis (including 12b-1 fees). The ratio expresses the percentage of the mutual fund assets that are used to pay these recurring expenses. Expense ratios range from less than 0.10% to more than 2.5%. The lower the expense, the higher your returns.

Keep in mind that the majority of mutual funds sold today charge a load. All mutual funds charge an annual management fee. Commission-based mutual funds typically are sold with one of three load structures:

1. **Class A shares:** These mutual funds charge a front-end **sales load**, but they tend to have a lower 12b-1 fee and lower annual expenses than other commission-based mutual funds. Some mutual funds reduce the front-end load as the size of the investment increases. These discounts are called breakpoints.
2. **Class B shares:** These mutual funds typically do not have a front-end sales load. Instead, these funds charge a deferred sales load that is paid when you sell the fund. Most require investors to pay an annual 12b-1 fee and a higher annual management fee. The deferred load often decreases the longer you own the fund.
3. **Class C shares:** These funds charge a lower commission to purchase shares but generally charge a higher annual 12b-1 fee and other annual expenses.

Paying a load to purchase a mutual fund only makes sense if you are relying on the professional advice of a financial planner to help manage your portfolio. If you are going to make your own investment decisions or purchase mutual funds through an employer-provided retirement plan like a 401(k) plan, you will likely do better avoiding loads and high fees.

TERM TO KNOW

Sales Load

A one-time commission paid to an investment salesperson either when a mutual fund is purchased or sold.

3b. Distributions

When you own a stock, bond, or other investment asset, you pay taxes only when you recognize a capital gain or receive interest or a dividend. Mutual funds are different. You may be required to pay taxes on mutual fund earnings even in years when you do not receive money from the mutual fund. This is a disadvantage associated with mutual fund ownership.

The current tax law requires mutual funds to distribute any net capital gains on the sale of portfolio securities to shareholders. When a mutual fund manager sells securities in the fund, this can trigger a tax liability for you. When a fund does distribute gains, you have several options:

- You can take the distribution directly and save or spend the money.
- You can reinvest the distribution in additional shares of the mutual fund.
- You can do a combination of these strategies.

Most investors, who are saving for a future goal, reinvest all distributions – interest, dividends, and capital gains – back into the mutual fund. This ensures that the power of compounding can be maximized.

HINT

Keep in mind that no matter what you do with a mutual fund distribution, you must report the distribution for tax purposes.

SUMMARY

In this lesson, you looked at an **overview of mutual funds** and **how mutual funds work**. By including mutual funds in your investment portfolio, you'll be moving one step closer to fund **diversification** which can reduce some of the inherent risk of investing. You could also be increasing your productivity. There are two types of management for mutual funds: **active management** and **passive management**. The goal of active management is earning higher returns than the stock market. The goal of passive management is simply to mirror the returns of the stock market. When **comparing management methods**, studies have shown that, on average, passively-managed accounts tend to outpace actively-managed accounts by a small margin over the long term. Strong problem solving skills can help you decide what is right for you.

If you're interested in **purchasing mutual funds**, you need to know about the sales load and **fee** structure. You may be required to pay taxes on earnings if your mutual fund experiences gains. In such cases, many investors reinvest their **distributions** back into the fund. You might choose to do the same.

REFERENCES

Federal Reserve Bank of St. Louis. "Stock Market Indexes."
www.fred.stlouisfed.org/categories/32255

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