Chapter 15

Mutual Funds: An Easy Way to Diversify

Learning Objectives

- Weigh the advantages and disadvantages of investing in mutual funds.
- Differentiate between types of mutual funds, ETFs, and investment trusts.
- Classify mutual funds according to objectives.
- Select a mutual fund that is right for you.
- Calculate mutual fund returns.

Mutual Funds

- Pool investors' money, investing in stocks, bonds, and various short-term securities.
- Professional managers tend to the investments.
- Allow investors to diversify, even with a small investment.

Why Invest in Mutual Funds?

- Advantages of mutual funds:
  - Professional management
    - Access to the best research to evaluate investment alternatives.
  - Minimal transaction costs
    - Low commissions because of volume, which may translate into higher returns.
  - Liquidity
    - Easy to buy and sell on phone or online.

Why Invest in Mutual Funds?

- Advantages of mutual funds:
  - Flexibility – over 8,000 funds to choose from, covering many objectives and risk levels.
  - Service – provide bookkeeping, checking accounts, automatic additions or withdrawals.
  - Avoidance of bad brokers – avoid potentially bad advice, high sales commissions, and churning.

Why Invest in Mutual Funds?

- Disadvantages of mutual funds:
  - Lower than market performance – mutual funds underperform the market on average.
  - Costs – sales fee or load can be as high as 8.5% in addition to annual expense ratio at 3%.
  - Risks – not all mutual funds are safe; specialized funds may lack diversification outside a specific industry.

Why Invest in Mutual Funds?

- Disadvantages of mutual funds:
  - Systematic risk - mutual funds do not diversify away systematic risk. Even mutual funds will suffer in a crash.
  - Taxes – mutual funds trade frequently, so investors may pay taxes on capital gains. You cannot defer taxes.

Mutual Fund-Amentals

- A mutual fund pools money from investors with similar financial goals.
- You are investing in a diversified portfolio that's professionally managed according to set goals.
- Investment objectives are clearly stated.

Mutual Fund-Amentals

- Make money 3 ways in a mutual fund:
  - As the value of the securities in the fund increases, the value of each mutual fund share also rises.
  - Most pay dividends or interest to shareholders.
  - Shareholders receive a capital gains distribution when the fund sells a security for more than originally paid.

Mutual Fund-Amentals

- Organization of a mutual fund:
  - Fund is set up as a corporation or trust, owned by shareholders.
  - Shareholders elect a board of directors.
  - Fund is run by a management company.
  - Each individual fund hires an investment advisor to oversee the fund.
  - Contracts with a custodian, a transfer agent, and an underwriter.

Investment Companies

- A firm that invests the pooled money of a number of investors in return for a fee.
- Types of investment companies:
  - Open-End Investment Companies
  - Closed-End Investment Companies
  - Unit Investment Trusts
  - Real Estate Investment Trusts

Open-End Investment Companies

- These mutual funds are the most popular form of investment companies.
- Open-end means the investment company can issue an unlimited number of ownership shares.
- Shares do not trade in the secondary market, must buy or sell through the fund.
- Price based on net asset value (NAV).

Closed-End Investment Companies

- Has a fixed number of shares, cannot issue new shares.
- Shares sold initially by investment company, afterwards they trade like a common stock.
- Price based on demand, not NAV.

Unit Investment Trusts

- A fixed pool of securities with each unit representing a proportionate ownership in the pool.
- They are not managed.
- Fund purchases a fixed amount of bonds, holds them until maturity, then the trust dissolves.

Real Estate Investment Trusts

- Like a mutual fund specializing in real estate.
  - Has a professional manager.
  - Uses pooled funds.
  - Is actively managed.
- Must collect 75% of its income from real estate and distribute 95% of that income in the form of dividends.

Real Estate Investment Trusts

- Types of REITs:
  - Equity – buys property directly and manages it. Investors look for appreciation in value.
  - Mortgage – investment is limited to mortgages. Investors receive interest payments only.
  - Hybrid – a combination of the two. Invests in both property and mortgages, receiving both interest and capital appreciation.

Load Versus No-Load Funds

- A load mutual fund charges a sales commission. They are sold through brokers, financial advisors and financial planners.
  - Class A – front-end sales load
  - Class B – back-end load
  - Class C – pay coming and going
- A no-load fund doesn't charge a commission.

Management Fees and Expenses

- Invest in a fund with a low expense ratio
  - Ratio compares funds expenses to total assets.
- Look at the turnover rate
  - Measures the level of the fund's trading activity.
- 12b-1 Fees
  - Marketing expenses for advertising and sales promotion.

Money Market Mutual Funds

- Invest in Treasury bills, CDs, and other short-term investments, less than 30 days.
- Regarded as practically risk-free.
- Carry no loads, trade at a constant $1 NAV, and have minimal expenses.
- Tax-exempt money market fund invests only in short-term municipal debt.

Stock Mutual Funds

- Aggressive Growth Funds – maximize capital appreciation while ignoring income. Have wider price swings than other funds.
- Small-Company Growth Funds – similar to aggressive growth funds but limited to investments in small companies. Look to uncover and invest in undiscovered companies with unlimited growth potential.

Stock Mutual Funds

- Growth and Income Funds – provide a steady stream of income with the potential for increasing value. Less risky, stable dividends, less price movement.
- Sector Funds – specialized mutual fund investing 65% of its assets in securities from a specific industry. Less risky than an individual stock, but more risky than a traditional mutual fund.

Stock Mutual Funds

- Index Funds – try to track a market index, such as the S&P 500, by buying stocks in that index. Provide diversification at a low cost.
- International Funds – concentrate on securities from other countries, may have political and currency risks.

Balanced Mutual Funds

- Hold both common stock and bonds.
- Objective is to earn steady income and some capital gains.
- Aimed at those needing income to live on and moderate stability in their investment.
- Ratio of stocks to bonds varies.

Asset Allocation Funds

- Similar to a balanced fund, invest in stocks, bonds, and money market securities.
- Differ in that they move money between stocks and bonds to outperform the market.
- It is a balanced fund practicing market timing.

Life Cycle and Target Retirement Funds

- Life cycle is the newest type of funds. An asset allocation fund that tailors holdings to investor's characteristics, such as age and risk tolerance.
- Target retirement funds are managed based on when you plan to retire.

Bond Funds

Bond Funds

- $1000 investment buys a diversified portfolio.
- More liquidity
- Professional management
- Have automatic reinvestment

Individual Bonds

- Save mutual fund expenses
- Bond funds do not mature, individual bonds do

Bond Funds

Bond funds can be differentiated by the type of bond and by maturity.

Type of Bond	Maturity
• U.S. Government	• Short-term
• Municipal	• Intermediate-term
• Corporate	• Long-term

Bond Funds

U.S. Government Bond Funds or GNMA Funds

U.S. Treasury Bond Funds

- Specialize in Treasury securities.
- No default risk, but will fluctuate with changes in interest rates.

GNMA Funds

- Specialize in mortgage-backed securities.
- Carry interest rate risk and prepayment risk.

Bond Funds

- Municipal Bond Funds – interest is generally tax-exempt from federal taxes.
  - Aimed at those looking to avoid taxes.
- Corporate Bond Funds – invest in various types of corporate bonds, including high quality and junk bonds.
  - As interest rates rise, NAV goes down.

Bond Funds

- Bond funds and their maturities:
  - Short-term – 1-5 years in maturity
  - Intermediate-term – 5-10 years in maturity
  - Long-term – 10-30 years in maturity
- As interest rates change, long-term bonds fluctuate more than short-term.

ETFs or Exchange Traded Funds

- First issued in 1993, these are hybrids between a mutual fund and an individual stock or bond.
- Trade on an exchange and can be bought or sold throughout the day.
- QQQ tracks the NASDAQ 100 Index.
- SPDRS tracks the S&P 500.

ETFs or Exchange Traded Funds

- Advantages of ETFs:
  - Trade on an exchange and can be bought and sold throughout the day.
  - Can be sold short or bought on margin.
  - Allow an instant position in a sector or country.
  - Low annual expenses.
  - More tax efficient than mutual funds.

ETFs or Exchange Traded Funds

- Disadvantages of ETFs:
  - Pay a commission because they trade like stocks.
  - Don't necessarily trade at NAV.
  - Bid-ask spread because buying from another investor.
  - Expensive for those who trade often, incur brokerage costs.

Mutual Fund Services

- Automatic investment and withdrawal plans
- Automatic reinvestment of interest, dividends, and capital gains
- Wiring and funds express options
- Phone switching
- Easy establishment of retirement plans
- Check writing
- Bookkeeping and help with taxes

Buying a Mutual Fund

<u>Step 1: Determining Your Goals</u>

- Buying a mutual fund involves determining your investment goals and time horizon.
- Understand why you are investing:
  - To receive additional income
  - Supplement your retirement income
  - Save for a child's education

Buying a Mutual Fund

Step 2: Meeting Your Objectives

- Identify the fund's objectives by looking at objective classifications.
- Don't assume the fund's name reflects the strategy or objectives.
- *Morningstar* provides an investment style box to understand the investment style.

Buying a Mutual Fund

<u>Step 2: Meeting Your Objectives</u>

- Look in the prospectus for:
  - Fund's goals and investment strategy
  - Fund manager's past experience
  - Any investment limitations the fund may have
  - Tax considerations of importance to investors
  - Redemption and investment process
  - Services provided
  - Performance over past 10 years
  - Fund fees and expenses
  - Fund's annual turnover rate

Buying a Mutual Fund

Step 3: Evaluating the Fund

- Look closely at past performance and scrutinize their costs.
- Past performance does not predict future results, but it does give insight.
- Limit comparisons to funds with similar objectives.
- Investigate how the fund did during upturns and downturns.

Buying a Mutual Fund

Step 3: Evaluating the Fund

- Sources of Information:
  - *Wall Street Journal*
  - *Forbes* – annual mutual fund survey
  - *Kiplinger's Personal Finance* magazine
  - *Morningstar* www.morningstar.com

Buying a Mutual Fund

- Making the Purchase:
  - Buy direct – use phone or internet.
  - Buy through a mutual fund supermarket – such as Fidelity or Schwab.