An Introduction to Mutual Funds

A mutual fund is nothing more than a collection of stocks and/or bonds. You can think of a mutual fund as a company that brings together a group of people and invests their money in stocks, bonds, and other securities. Each investor owns shares, which represent a portion of the holdings of the fund.

You can make money from a mutual fund in three ways:

- Income is earned from dividends on stocks and interest on bonds. A fund pays out nearly all of the income it receives over the year to fund owners in the form of a distribution.
- If the fund sells securities that have increased in price, the fund has a capital gain. Most funds also pass on these gains to investors in a distribution.
- If fund holdings increase in price, but are not sold by the fund manager, the fund's shares increase in price. You can then sell your mutual fund shares for a profit.

Funds will also usually give you a choice either to receive a check for distributions or to reinvest the earnings and get more shares.

<u>Advantages of Mutual Funds</u>:

- ✓ Professional Management – The primary advantage of funds (at least theoretically) is the professional management of your money. Investors purchase funds because they do not have the time or the expertise to manage their own portfolios. A mutual fund is a relatively inexpensive way for a small investor to get a full-time manager to make and monitor investments.

- ✓ Diversification – By owning shares in a mutual fund instead of owning individual stocks or bonds, your risk is spread out. The idea behind diversification is to invest in a large number of assets so that a loss in any particular investment is minimized by gains in others. In other words, the more stocks and bonds you own, the less any one of them can hurt you. Large mutual funds typically own hundreds of different stocks in many different industries. It wouldn't be possible for an investor to build this kind of a portfolio with a small amount of money.

- ✓ Economies of Scale - Because a mutual fund buys and sells large amounts of securities at a time, its transaction costs are lower than what an individual would pay for securities transactions.

- ✓ Liquidity - Just like an individual stock, a mutual fund allows you to request that your shares be converted into cash at any time.

- ✓ Simplicity - Buying a mutual fund is easy! Pretty well any bank has its own line of mutual funds, and the minimum investment is small. Most companies also have automatic purchase plans whereby as little as $100 can be invested on a monthly basis.

<u>Disadvantages of Mutual Funds</u>:

- ✓ Professional Management - Did you notice how we qualified the advantage of professional management with the word "theoretically"? Many investors debate whether or not the so-called professionals are any better than you or I at picking stocks. Management is by no means infallible, and, even if the fund loses money, the manager still takes his/her cut!

- ✓ Costs - Mutual funds don't exist solely to make your life easier - all funds are in it for a profit. The mutual fund industry is masterful at burying costs under layers of jargon. These costs are so complicated that in this tutorial we have devoted an entire section to the subject.

- ✓ Dilution - It's possible to have too much diversification. Because funds have small holdings in so many different companies, high returns from a few investments often don't make much difference on the overall return. Dilution is also the result of a successful fund getting too big. When money pours into funds that have had strong success, the manager often has trouble finding a good investment for all the new money.

- ✓ Taxes - When making decisions about your money, fund managers don't consider your personal tax situation. For example, when a fund manager sells a security, a capital-gains tax is triggered, which affects how profitable the individual is from the sale. It might have been more advantageous for the individual to defer the capital gains liability or otherwise avoid it.