M U T U A L F U N D S

Quick Guide

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Features of Mutual Funds and Risk

When you purchase shares in a mutual fund, your dollars are invested in a large number of companies all at once, and your investment risk is spread out over many stocks of many companies, not just one. With mutual funds, your potential for risk is less. The ups and downs in the value of your investment are potentially less with a mutual fund than with an individual stock because you are more diversified.

Mutual funds make it easy for you to invest in stocks and bonds. The two main advantages of investing your money in mutual funds are 1) you receive professional money management and 2) you are able to truly diversify your holdings with a small sum of money.

Each mutual fund has one or more fund managers who are skilled in the principles of money management. They have access to a huge database of research—so basically, you're leaving the driving to them.

Each fund also has a particular objective. That objective is defined in the fund's prospectus, which describes a mutual fund and offers its shares for sale. The prospectus provides information such as investment objectives, charges, expenses, and operating policies. A prospectus must be provided to an investor at the time of sale. The investor should read it carefully before sending money or investing.

The objective could be, for example, long-term growth, current income, or a combination of income and growth. For example, the objective of XYZ fund is long-term growth. To accomplish the fund's objective, the fund manager invests the money received from its shareholders (that's you) by purchasing shares of many individual companies (or leaving a small portion in cash).

Some stock mutual funds can own shares of stock from a few hundred companies, thereby limiting their holdings in any one company to no more than 5–6 percent of all the assets in the mutual fund. This is true diversification and your risk may be less than if you invested in just one or two individual stocks.

Let's look at the different choices available.

Asset	Type of Fund	Expected Return	Risk
Other	**Specialty Fund**	**Higher**	**Most Risk**
International Stocks and Bonds	International Fund		
Global Stocks and Bonds	Global Fund		
Stocks	Aggressive Growth Fund		
Stocks	Growth Fund		
Stocks	Index Fund		
Mostly Stocks	Growth and Income Fund		
Mostly Stocks	Equity-Income Fund		
Stocks and Bonds	Asset Allocation Fund		
Stocks and Bonds	Balanced Fund		
Bonds	Corporate Bond Fund		
Bonds	Mortgage-Backed Bond Fund		
Bonds	Single-State, Tax-Exempt Bond Fund		
Bonds	Municipal Bond Fund		
Bonds	U.S. Government Bond Fund		
Cash	Money Market Fund		
		Lower	**Least Risk**

IMPORTANT NOTE: Seeking higher returns will be subject to great risks.

IMPORTANT NOTE: With all mutual funds, the value of your investment could decline, so you could lose money. Funds are subject to the general risks associated with the markets and securities in which they invest, including the risk that the value of a portfolio may be impacted gradually or sharply by general conditions of the market, changes in interest rates, or the performance of an individual company, industry, or economy. You should consider a fund's investment objectives, risk, charges, and fees carefully before investing. This and other important information about the investment company are contained in the prospectus, which can be obtained from your financial professional and should be read carefully before investing. Investment return and principal value may fluctuate so that shares, when redeemed, may be worth more or less than their original cost. Investing in mutual funds involves risk, including possible loss of principal.

Money Market Mutual Funds

Money market mutual funds hold short-term financial instruments like U.S. Treasury bills and the short-term debt of U.S. corporations, called commercial paper. The funds have a stated net asset value of $1.00 per share, and most offer check-writing privileges. They are instantly liquid. You don't have to wait for them to mature—you just write a check. The objective of a money market fund is to keep the value of a dollar constant while paying you some interest.

Money markets can be for:

- Emergency money
- Savings for short- and intermediate-term goals
- Providing diversity in the portfolio of a conservative investor

IMPORTANT NOTE: An investment in the fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. Although the fund seeks to preserve the value of your investment at $1.00 per share, it is possible to lose money by investing in the fund.

There are three basic types of money market funds:

1. **Prime funds**, which own commercial paper, CDs, and Eurodollar deposits. These are only as good as their underlying securities. Only buy funds owning the highest quality securities (AAA, Standard & Poor's; Moody's).
2. **Government funds**, which own either U.S. Treasuries or federal agency securities. The underlying securities carry the backing of the U.S. Government (not the fund itself), but the backing is "explicit" (stated) in the case of Treasuries, and "implicit" (assumed) in the case of agency bonds. You do not have to pay state taxes on the interest you receive.
3. **Tax-exempt funds**, which hold either municipal bonds from all over the country (national) or from just one state. National funds are generally exempt from federal taxes, but may be subject to the Alternative Minimum Tax (AMT). State funds are exempt from state taxes as well, if you live in the state. Look at funds containing the highest-grade issues with average rating by Moody's of at least MIG-1.

IMPORTANT NOTE: When researching money market funds, you may notice that some funds have a yield (interest rate after expenses are subtracted) much higher than others holding the same kinds of securities. This is typically because the funds are either new or trying to attract more investors. Read the fine print! If the fund says that it is "temporarily absorbing operating expenses," then these higher yields are bound to go away.

*An investment in the fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. Although the Fund seeks to preserve the value of your investment at $1.00 per share, it is possible to lose money by investing in the Fund.

Bond Mutual Funds

Municipal Bond Funds

Municipal bonds (munis) are issued by state and local governments and agencies to fund projects and pay bills. They are generally exempt from federal taxes. You can buy a municipal bond fund for just one state, and these are also exempt from state taxes if you live in that state. Munis should not be a part of tax-deferred retirement accounts like 401(k)s because you don't pay current taxes on the earnings in the account. Whether they should be part of your non-tax-deferred portfolio depends on your federal income tax bracket (the higher it is, the more favorable munis are).

There are risks associated with bond mutual funds that may include interest rate risk, credit rating risk, and default risk. For a more detailed explanation of risks associated with a particular fund, consult your financial professional.

Muni funds come in three maturity lengths: short, intermediate, and long; they also come in three qualities: high, medium, and junk or high yield.

Government Bond Funds

Government bonds are issued by the Treasury and by government agencies such as GNMA (Government National Mortgage Association) and FNMA (Federal National Mortgage Association). Those issued by the Treasury are called, logically enough, "Treasuries." Those issued by federal agencies are called "agency bonds" or "mortgage-backed bonds." That does not mean you can't lose money on them, however. Interest rate swings can dramatically alter the value of these bonds.

Government bond funds, especially Treasuries, are designed to form the bedrock of an investor's bond portfolio. They come in only one quality: high, because the risk of default is considered to be highly unlikely; they also come in three maturity lengths: short, intermediate, and long.

Corporate Bond Funds

Corporate bonds are issued by companies as a way of making capital investments and paying their bills.

They are generally only as secure as the company issuing them. Bonds issued by blue-chip companies generally get the highest ratings. Because they are regarded as very stable, they also pay the lowest percentage interest of any corporate bond. A company can also have bonds of different quality, depending on whether or not the debt is secured by an asset (in the same way that your mortgage debt is secured by a house) or where it stands in order of payment priority. The higher it stands, the better the rating.

Corporate bond funds come in three qualities: high, or investment grade; medium; and junk or high yield. They also come in three maturities: short-term, immediate-term, and long-term.

Global Bond Funds

Global, or foreign, or world bond funds, are composed of debt securities from foreign governments or corporations. Some funds include U.S. bonds. Foreign bonds are much harder to rate than U.S. bonds. Because foreign bonds are held in the currency of the country where they are issued, they rise and fall not only on the fortunes of the issuing organization, but also with the exchange rate.

Stock (Equity) Mutual Funds

Introduction

Stock (or "Equity") funds are mutual funds whose assets consist of shares of stock (ownership) in other companies. In other words, the mutual fund company gathers the funds from individual investors, pools these funds, then makes purchases of shares in many different publicly held corporations. So, with a relatively small investment, an investor is getting indirectly the potential benefit of owning shares of stock in many different companies. This diversification that mutual funds provide is one of the attractive features for many investors. Many investors also prefer to leave the choice of what company's shares should be purchased to a professional money manager.

Equity mutual funds are often categorized by the size of the companies they hold (the total value of their underlying stock) or by the style, or philosophy, of investing. The following sections will give an introduction into these fund classifications.

Funds Classified by Company Size

Large-Capitalization Funds

Large-cap funds hold stocks from companies with market capitalizations generally of $10 billion or more, which means that the companies have outstanding stock worth at least $10 billion. These are well-known companies such as IBM, Ford, and General Electric. Typically, large-cap funds offer generally consistent market fluctuation, however even for large-cap funds, the potential for high volatility still exists.

Medium-Capitalization Funds

Midcap funds hold stocks of companies with market capitalizations generally between $2 and $10 billion. As you might guess from the name, they are more volatile than large-cap funds, but less volatile than small caps.

Small-Capitalization Funds

Small-cap funds hold stocks of companies with a market capitalization generally of $2 billion or less. These are typically new companies. Many will fail, but some will grow exponentially. However, with greater growth comes greater volatility. Past performance is no guarantee of future results.

Funds Classified by Investing Style

Value Funds

Value funds hold the stock of companies that are believed to be undervalued in price. Think of them as "bargains." Large value funds are particularly suited to conservative investors. Potential risks of value funds include that a fund that was perceived as undervalued was in truth priced correctly at the time of purchase or that the fund doesn't increase in value over time as expected.

Growth Funds

Growth funds hold the stock of companies whose earnings are expected to increase faster than the rest of the market. These stocks will typically not pay much in dividends; instead, earnings are plowed back into the company. The objective for investors is long-term capital gains.

Blend Funds

Blend funds hold both growth and value stocks. If you are just beginning to invest in stock funds, this may be a good place to start. Blend funds combine the risks of both value and growth funds, but these may be somewhat mitigated by having the right balance of growth and value funds.

Index Funds

Index funds buy stocks to match certain market indices, like the S&P 500 (the 500 largest U.S. stocks) or the Wilshire 5000 (includes smaller stocks). They will attempt to track the index they follow. (One difference will be the costs of operating the fund, which should be less than the costs associated with actively managed funds.) The risk of index funds is that they take on the risk of the index they match, so if it loses percentage points, the fund's value drops as well. It's important to understand the index the fund is mirroring and consider how it fits your portfolio and financial goals. For an in-depth discussion of index funds, see the section *Mutual Fund Management and Costs*.

IMPORTANT NOTE: The S&P 500 index and Wilshire 5000 index are unmanaged indices widely regarded as indicators of domestic stock performance. The S&P 500 index and Wilshire 5000 index cannot be purchased directly by investors, and cannot depict or predict the performance of any investment. However, you may purchase an index mutual fund or Exchange Traded Fund (ETF) to closely mirror index returns.

Equity-Income Funds

Equity-income funds focus on stocks with dividends that are larger than average. These will be from large, established companies, especially utilities. They may include large or midcap value or blend stocks. Equity income funds may be more volatile than bonds or dividend-paying stocks, but they also may be less expensive to invest in. They are not considered well suited for short-term investors, but may pose less risk for those with time to ride out market losses.

Growth and Income Funds

Growth and income funds combine long-term appreciation with short-term income generated by dividends or interest payments. These funds often include a combination of stocks, bonds, and securities. Growth and income funds pose moderate risks, and they are popular with balanced investors.

International or Foreign Funds

International or foreign funds invest mostly in foreign securities. They carry an additional kind of risk because not only can the stocks go up or down, but the currency of the countries can also move in relation to the dollar. In addition, there may be risk due to political, social, or economic developments within the countries.

Global or World Funds

Global or world funds contain both foreign and U.S. securities.

Specialty or Sector Funds

Specialty or sector funds concentrate in a particular area. There are funds concentrating on biotech stocks, on health care stocks, on gold stocks, on real estate, or on utilities. Because they aren't diversified, these funds carry higher risk.

What Kind of Fund Should You Buy?

In a word, once again, diversify. While every individual situation will dictate investment selection, most investors should consider owning several different kinds of stock funds. You might want to start off with a large blend fund. This will give you some diversity of investing style. Then, you might add a small growth fund for capital gains over time. The next step might be an international fund. The U.S. is no longer the only major financial market, and when the stock market here tumbles, international funds may help minimize your overall portfolio loss. As you get more money to invest, look at midcap funds, and consider splitting your large blend fund into large growth and large value funds.

Hybrid Mutual Funds

Hybrid mutual funds have been around since the late 1920s. They are funds that are invested in common stock, preferred stock, bonds, and may have an international or a cash component as well.

Hybrid mutual funds may be suited for:

- Investors who are just starting out and want diversification within a single fund
- Investors who want a simplified portfolio of only one or two funds

One type of a hybrid mutual fund is called a "balanced fund."

The ratio of stocks to bonds is determined by the fund's objectives and the fund manager. Funds with "balanced" or "income" in the name normally have a fixed ratio from which they can't deviate. On average, their ratio of stocks to other investments is approximately 60:40. Managers of balanced funds can, however, shift this ratio one way or the other to take advantage of high interest rates or stock market growth. These funds may be equity-oriented and skewed toward stocks, or income-oriented and skewed toward bonds. "Asset allocation funds," however, have some freedom to change their mix depending on the manager's evaluation of market conditions.

Before you decide to buy a hybrid fund, think about your asset allocation, and see what your ratio of stocks to bonds should be. If you are just starting out, pick a balanced fund whose allocation fits yours. If you already own some funds, pick a hybrid fund that will fill in the cracks in your portfolio. And remember, keep diversifying.

Retirement Plans and Mutual Funds

Retirement accounts, such as a company 401(k), an Individual Retirement Account (IRA), Simplified Employee Pension-IRA (SEP-IRA), or Keogh, are well suited to mutual funds since the money in the account is invested for the long-term. Almost all of the thousands of mutual funds out there will accept IRA money.

With a 401(k), a company has chosen a number of funds to offer. Typically, they will include a money market fund, one or more bond funds, one or more stock funds, and company stock.

You may also be able to set up a self-directed brokerage account within a 401(k). This option is offered by a few companies, and is generally not well publicized. The money is taken out by means of payroll deduction, just as it is through your regular options, but you get to choose the investments. It can be a good idea if you like the flexibility this offers and if the 401(k) does not offer many choices. Funds in a brokerage account may not have the borrowing privileges normally available to 401(k) participants, though. If you do need to borrow money, and your plan has a loan provision, you may not be able to borrow money directly from your brokerage account. However, you may be able to transfer money from your brokerage account to one of the other accounts that allow loans.

Risks associated with 401(k) loans:

- Borrowed money is not subject to potential growth.
- If you fail to repay the loan, it will be treated as a withdrawal, and subject to income tax and potential early withdrawal penalties.
- If you leave your job, you may be forced to pay off your loan, which could limit your ability to change jobs.

IMPORTANT NOTE: There may be fees and expenses that may not normally apply in traditional 401(k)s.

A Note about Annuities and Mutual Funds

Annuities are another way to tax-defer your money until retirement. With an annuity, you put after-tax money in and the earnings grow tax-deferred. That is, the amounts in the annuity are invested and the earnings are not taxed until you make a withdrawal.

Generally, because monies in an annuity grow tax-deferred, they should be used outside a qualified retirement plan.

Mutual Fund Management and Costs

Day-to-day investment decisions are left to professionals who are trained to evaluate potential investments. How do you evaluate fund management? The following information will help you:

- **Manager Tenure.** See how long a fund's manager has been in place. Make sure that if you're impressed with a particular fund's five-year track record, that the current manager is the individual responsible for that performance.
- **Manager Freedom.** No matter how good the manager, has the fund's investment strategy been limited by policy? If so, a particular manager's investment decisions and decision-making savvy may not be as important as when potential investment choices are many.
- **Management Structure.** Many funds employ a team structure to manage a fund. No single manager makes investment decisions. This approach makes the influence of any single individual far less critical to fund performance.

One alternative to searching for managers is investing in index funds. These simply buy the exact stocks of various indices like the S&P 500 (the 500 largest U.S. stocks), the Wilshire 5000 (an index of the total stock market), the Russell 2000 (an index of small stocks) the Barclays Capital Aggregate Bond (an index of investment-grade bonds), and even the EAFE (an index of stocks in Europe, Australia, and the Far East). Their cost is low, there's no management needed because it is just an index, and you know what you're getting.

IMPORTANT NOTE: The S&P 500, Wilshire 5000, Russell 2000, Barclays Capital Aggregate Bond, and EAFE indices cannot be purchased directly by investors, and cannot depict or predict the performance of any investment. Indices are regarded as an indicator of the stock or bond market's performance.

Because index fund costs are lower than actively managed funds (funds run by fund managers), and if you agree with those people who feel you can't outperform the market anyway, index funds might be a good choice when deciding what kind of investments to include in your portfolio.

Costs

The cost structure of buying and owning a mutual fund is somewhat complicated. First, determine if the fund has a load or sales charge. No-load funds do not have a sales fee, however other fees and expenses may apply to a continued investment in this type of fund and are described in the fund's current prospectus.

Funds with a sales fee can structure the fee in a number of ways. The most common type of load is a front-end load. You pay a few percentage points to buy a fund. If you have $10,000 to invest, and your fund has a front-end load of 6%, then only $9,400 will go into your account and earn money.

There are also back-end loads, which are sales charges you pay when you withdraw money from a fund. Your fund may also have different classes of shares. These are usually called "A," "B," and "C" shares; they distribute their loads and charges in different ways, so that the exact same fund can be sold to different groups in different ways.

Many people are unaware that these fees exist until they try to sell, although these charges are disclosed in the fund's prospectus. 12b-1 fees represent money spent on sales and marketing and are passed along to the consumer. Both load and no-load funds may or may not have a 12b-1 fee.

Gaining popularity are redemption fees. These are charges levied against investors who leave a fund before a certain period of time, usually six months. A short-term redemption fee is an incentive for market-timers to practice a long-term investment strategy. It could work to your advantage by stopping you from making hasty moves. However, it is another fee to consider when investing in mutual funds.

At least as important as whether a fund has a load is your fund's expense ratio, which you can find in the prospectus. The expense ratio is the percentage of a fund's assets that is used to cover the costs of managing, administering, and operating a mutual fund. If a fund earns 6% before the expense ratio of 2%, then net earnings will be 4%. You may want to look for a fund with an expense ratio below 1.5%, and preferably below 1%, especially for bond funds, which are easier to research and manage. Keep in mind that a few percentage points can have a huge effect on your return. Limit your search to the best funds with reasonable expense ratios. Another type of cost that needs to be looked at when deciding which mutual fund to invest is the fund's trading cost.

Trading Costs

Every mutual fund loses some money every year to trading costs—money spent on brokerage commissions or lost to the bid-ask spread. (The bid-ask spread is the difference between the highest price a buyer is willing to pay and the lowest price a seller is willing to accept.) Trading costs are not reflected in the fund's expense ratio. That number only will tell you how much money you're paying every year for the management and operation of the fund. But any money spent on trading comes directly out of the fund's net assets. And unfortunately, it can amount to quite a lot.

Another unfortunate thing is that investors have no easy way to quantify the amount that is spent by the fund manager on trading every year. The number isn't disclosed separately for you in a fund's prospectus or annual report. One way to try to estimate the amount being spent on trading is to look at a fund's turnover for the year. The higher this number, the more a manager is trading in the portfolio and potentially losing money to those transaction costs. But one thing worth mentioning is that turnover is still a very imperfect way to figure out how much a manager is trading. Turnover is calculated by taking the lesser of purchases or sales and dividing by the average net assets. A fund could have zero sales and $500 million in purchases and still have turnover of 0%. But that fund is still spending money to buy securities. For now, the turnover ratio is the only thing you've got to estimate how much money your fund is losing every year to trading. ♦