

Mutual Funds

Overview

There are dozens of magazines cluttering the shelves of your local book megastore with covers proclaiming "The Best Mutual Funds You'll Ever Find for This Year!", "Mutual Funds That Really Work in Crazy Markets Like This One!" and other equally over-capitalized headlines. Don't pay any attention to them. Almost everything that you'll ever need to know about mutual funds is contained in these four simple words: "Buy an index fund." If that seems too simple and not sufficiently attention grabbing, try it this way: "BUY AN INDEX FUND!"

Introduction to Mutual Funds

A mutual fund is simply a collection of stocks and/or bonds. Most mutual funds are "actively managed," meaning the mutual fund shareholders, through a yearly fee, pay a mutual fund manager to actively buy and sell stocks or bonds within the fund. Though you would think that mutual funds provide benefits to shareholders by hiring alleged "expert" stock pickers, the sad truth of the matter is that the vast majority of mutual funds underperform the average return of the stock market. Over time, because of their costs, approximately 80% of mutual funds will underperform the stock market's returns. Currently, most mutual funds do not make their fees very easy for shareholders to understand. (Founding Fool David Gardner testified in September 1998 before Congress on this very topic. Read his [testimony](#) here.)

On the whole, the average mutual fund returns approximately 2% less per year to its shareholders than does the stock market in general. The stock market's historical returns are roughly 11% per year, but managed mutual fund shareholders as a group can expect to see any return reduced by the approximate costs imposed by the funds.

Advantages of Mutual Funds

Diversification. Buying a mutual fund provides instant holdings of several different companies.

Liquidity. Like individual stocks, a mutual fund investment can be converted into cash upon your request.

Disadvantages of Mutual Funds

The Wisdom of Professional Management. That's right, this is not an advantage. The average mutual fund manager is no better at picking stocks than the average nonprofessional, but charges fees as though she is.

No Control. Unlike picking your own individual stocks, a mutual fund puts you in the passenger seat of somebody else's car.

Dilution. Mutual funds generally have such small holdings of so many different stocks that insanely great performance by a fund's top holdings still doesn't make much of a difference in a mutual fund's total performance.

Buried Costs. Many mutual funds specialize in burying their costs and in hiring salesmen who do not make those costs clear to their clients.

Fund Classification

Mutual funds now come in every possible size, shape, and color, and if you're in your company's 401(k) or 403(b) plan, you've probably noticed that already. Here are some of the general categories of mutual funds.

Bond Funds

Bond mutual funds are pooled amounts of money invested in bonds (see [Step 5. Bonds](#)). Bonds are IOUs, or

debt, issued by companies or by governments. A purchaser of a bond is lending money to the issuer, and will usually collect some regular interest payments until the money is returned. Usually the amount of interest paid (the coupon) is fixed at a set percentage of the amount invested, thus, bonds are called "fixed-income" investments.

Balanced Funds

Balanced funds mix some stocks and some bonds. A typical balanced fund might contain about 50-65% stocks and hold the rest of shareholder's money in bonds. It is important to know the distribution of stocks to bonds in a specific balanced fund to understand the risks and rewards inherent in that fund.

General Equity (Stock) Funds: Styles and Sizes

Stock or equity mutual funds are pooled amounts of money that are invested in [stocks](#). Stocks represent part ownership, or equity, in corporations, and the goal of stock ownership is to see the value of the companies increase over time. Stocks are often categorized by their market capitalization (or caps), and can be classified in three basic sizes: small, medium, and large. Many mutual funds invest primarily in companies of one of these sizes and are thus classified as large-cap, mid-cap or small-cap funds. For more information and definitions on how stocks and mutual funds are categorized (growth vs. value, income-oriented, etc.) see [Step 6. Analyzing Stocks](#).

International/Global Funds

International funds invest in companies whose homes are beyond the fair shores of this great nation. (There are, of course, many other great nations.) Global funds invest in both U.S. and international-based companies. In general, international and global funds are more volatile than domestic funds.

Sector Funds

Sector funds invest in one particular sector of the economy: technology; financial, computers, the Internet, llamas. (Just kidding. No one has yet started the Llama Fund, though it's only a matter of time.) Sector funds can be extremely volatile, since the broad market will find certain sectors very attractive and very unattractive - often in rapid succession.

Buy an Index Fund

Remember the overview to this step? Here's a reminder: "Buy an index fund."

Stock index funds seek to match the returns of a specified stock benchmark or index. An index fund simply seeks to match "the market" by buying representative amounts of each stock in the index, rather than paying a manager to make bets on individual stocks, sectors, or investment strategies. Index funds do not even attempt to beat the equities market, they simply seek to come as close as possible to equaling it. The key to the unquestioned superiority of index funds is their extremely low expenses - they charge very low fees for providing the market's returns.

Sound simple? Sound like aiming too low? It isn't. *Almost all actively managed equity mutual funds over time lose to the market averages.* And those funds that do beat the market's return typically do so for only a very short period of time, and then quickly reverse course.

The largest and most well-known index fund is the very first index fund, the Vanguard S&P 500 Index Fund. This fund, started by the Vanguard Group, nearly matches the returns of the [Standard & Poor's 500 Index](#), and over the last ten years it has beaten the performance of over 90% of all mutual funds. Many other mutual fund companies now offer S&P 500 index funds.

There are numerous other indices, however, and therefore numerous other index funds. There are funds to match mid-cap indices, small-cap indices, small-cap growth indices, foreign indices - you name it. These other index funds in all probability will outperform most managed funds that invest in the same sectors of the market.

One caveat though. Due to the recent popularity of index funds, several fund companies are charging higher fees than necessary. If you're considering an index fund (and you definitely should if you're investing in mutual funds), always remember to compare its expense ratio (see below) against other similar index funds.

What should you do if you're in a 401(k) plan and no index fund choice is offered? Make your voice heard! Tell your company that an index fund option is necessary for your company to live up to its commitment to its employees. We've got a [sample letter](#) you can send to your company.

In the meantime though, while you're waiting for your plan to change, you need to know how to find the fund that is most like an index fund, and that means finding the one with the lowest annual fees.

Understanding Fund Fees

Mutual funds charge fees. Huge fees. Outrageous fees. As a group (though there are certainly individual exceptions) managed mutual funds appear to charge the highest fees they can get away with, and they charge these fees in the most confusing manner possible. There is a solution for this, and, as you might have guessed, it goes something like this: "Buy an index fund."

Should you wish to explore the crazy and bizarre world of mutual funds beyond the index fund, make sure that you know exactly what fees you're paying. Here's the skinny on them.

A mutual fund's **expense ratio** is the most important fee to understand. The expense ratio is made up of the following:

The **investment advisory fee or management fee** is the money used to pay the manager(s) of the mutual fund. On average, this fee is about 0.5% to 1.0% annually of the fund's assets, and is seemingly necessary to make sure that the manager of the fund can be very well-dressed at all times and is able to go on exotic vacations and own a house in the Hamptons.

Administrative costs are the costs of recordkeeping, mailings, maintaining a customer service line, etc. These are all necessary costs, though they vary in size from fund to fund. The thriftiest funds can keep these costs below 0.2% of fund assets, while the ones who use engraved paper, colorful graphics, and phone answerers with high-falutin' accents might fail to bring administrative costs below 0.4% of fund assets.

Surely the fee that you as a mutual fund investor should be most outraged by is the **12b-1 distribution fee**. This fee ranges from 0.25% of a fund's assets all the way up to 1.0% of the fund's assets. This fee is spent on marketing, advertising and distribution services. Yup, that's right. If you're in a fund with a 12b-1 fee, you're paying every year for the fund to run commercials and try to sell itself. Can this in any way really help you? Do you enjoy seeing advertisements of your fund or your fund family on television? Unless you really do, you should avoid funds that carry a 12b-1 fee.

You don't really need to concern yourself with how these components of the expense ratio are divided. You just need to know the bottom line. Again, the most important question that you should always determine about your mutual fund is, "How high is the expense ratio?" And remember, for actively managed funds, the average number is about 1.5%.

Meanwhile, in the wonderful world of index funds, the expense ratio is typically around 0.25% and does get as low as 0.19% for the king of all index funds - the Vanguard S&P 500 Index Fund.

Finding the Expense Ratio. The expense ratio for each and every publicly traded mutual fund can be found at numerous web sites that are open, like this one, 24 hours a day, seven days a week. Try [searching online](#) to identify the expense ratios of any mutual fund you own, or are thinking of owning.

Loads. "Load" refers to the sales charge many funds use to compensate the broker for his or her "services" in selling the fund to an investor, and this is in addition to the annual expenses discussed above. "No-load" funds simply are those funds that are sold directly to the investor, rather than through a middleman. The recent explosion of no-load funds gives you all the fund choices you need to maximize your potential returns.

Front-End Load. Ack! A Fool would never buy a fund with any kind of a load. A front-end load is a chunk of money that a broker or other adviser pays to himself or his company for telling you to buy that fund. Front-end loads typically congregate around the 5% figure, but can go up to 8%. That means that if you were investing \$1000 in a 5% front load fund, \$50 is immediately taken out of your investment and put into the broker's pocket. Don't buy any front-loaded funds.

Deferred Load. Yikes! Deferred load or contingent deferred sale load (CDSL) funds (sometimes called back-end loads), often labeled "B" class shares, are just as expensive (read: bad) as front-end load funds, but they're not as clearly labeled. These funds defer the sales fee until you leave the fund, but end up being as bad to your financial future as if you paid them up front.

Level Loads. Double Yikes! Level load funds, or "C" shares, are a load of trouble. These charge small front loads, and level loads every year thereafter. Although "C" class shares might look like they aren't so bad to buy, they end up being very, very expensive to hold.

Turnover Rate and Taxes. A fund's turnover rate basically represents the percentage of a fund's holdings that it changes every year. A managed mutual fund has an average turnover rate of approximately 85%, meaning that funds are selling most of their holdings every year. Because buying and selling stocks costs money through commissions and spreads, a high turnover indicates higher costs (and lower shareholder returns) for the fund. Also, funds that have large turnover ratios will end up distributing yearly capital gains to their shareholders. Shareholders will have to pay taxes on these gains, and paying these taxes can be a real killer. Keep an eye on the turnover rate of any fund you own, and look to own funds with low (preferably no higher than 25%) turnover rates. (Index fund turnover is around 5% or lower.)

Load vs. No Load

If you're able to read these words, you're intelligent enough and have enough time to make your own investment decisions. (Psst. "Buy an index fund.") You don't need to pay any adviser to find a mutual fund for you. Studies show that no-load funds perform as well or better than load funds anyway, so make it from this day forward that you only buy no-load funds. If you're in a 401(k) or 403(b) plan, make sure that you know whether the fund choices offered are load or no-load, as that information may not be contained in any one-sheet summaries of fund choice performance.

Stars

Generally, you shouldn't pay too much attention to the "stars" that you often see associated with mutual funds and their advertisements. The premier mutual fund data provider, Morningstar, assigns stars on the basis of risk and return, attempting to compare one fund with other funds that have similar investment objectives. For more on Morningstar's star system, check out [Morningstar's website](#).

Selecting Funds

Selecting the best fund is relatively easy. ("Buy an index fund.") Index funds are available for international funds, growth funds, mid-caps, small-caps, and just about anything else you can think of. If you wish to go beyond buying an index fund, please make sure that you understand all the costs and fees associated with buying, and with owning, that fund.

Review the Prospectus

A mutual fund prospectus will provide most, if not all of the information that you need to determine, "What's up with this fund?"

Fees can be found in the Fees Table.

Objectives and Policies tell you more or less how the fund plans to invest your money.

Risk tells you the risk involved in owning the fund.

Selling Funds

If you currently own any managed mutual funds, the chances are very, very high that they are charging you more for their "service" than they are providing you for the risk you are taking in keeping your money in them. Over time, an index fund is extremely likely to improve your investment performance. Therefore, take the time to educate yourself about the long-term risks of holding any actively managed mutual funds and consider moving that money into passively managed index funds. You can educate yourself about your own mutual funds by posting a question about them on The Motley Fool's [Mutual Fund message board](#), [Index Fund message board](#), or [Foolish 401\(k\)s message board](#). On these message boards you can ask questions about specific funds and other Fools from around the globe will eagerly share their knowledge with you. Even better though, make sure that you do some online research about your funds on your own before buying or selling anything.

Online Research

There are a great many web sites where an investor can currently find virtually all of the information necessary to make an informed choice about her mutual funds. The information readily available at web sites includes expense ratios, turnover rates, styles and sizes, Morningstar star ratings, largest individual stock holdings, and 1-year, 3-year, 5-year, and 10-year performance.

The following sites have some very useful information, and they are all updated frequently, adding new features. Try each to see which you prefer:

Quicken.com

Smartmoney.com

Fundstyle.com

Summary and Next Steps

Should you sell any of your mutual funds based on this little introduction? Certainly not. You should only sell mutual funds, or buy mutual funds or stocks, or make any other financial decisions based on your own research. The more you research mutual funds, we are quite sure you will determine for yourself that actively managed mutual funds, taken as a whole, are something that you can improve upon.

Besides index funds, what might that preferable investment be? Generally, we think that purchasing individual stocks will provide you all of the upside of actively managed mutual funds, while costing less. Furthermore, unlike mutual funds, studying and following individual companies can be a lot of fun. In [Step 6. Analyzing Stocks](#), we'll show you how to start looking for good investments.