Know Your Mutual Fund: Definitions & Purpose

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Mutual Funds: Did You Know?

A multimillion-dollar mutual fund **can't invest** in a small stock without strongly moving shares higher. That would impact their returns, so they mostly ignore small names.

Almost 100 million Americans, representing about 44% of U.S. households, own mutual funds. Saving for retirement was the primary goal for 73% of investors; other goals included saving for college or a house, building an emergency fund, or providing current income.

47% of the assets of regulated open funds worldwide are concentrated in the US. (Statista)

BlackRock Funds is the largest mutual fund management company in the world by AUM. (MutualFundDirrectory)

•Luxembourg is the country with the second-largest mutual fund industry. (Statista)

•47% of all mutual fund assets in the US are held in retirement accounts. (ICI)

ACCORDING TO MORNINGSTAR, THERE ARE 25, 182 MUTUAL FUNDS AND 3,133 ETFS AVAILABLE IN THE MARKETPLACE.

Where does an investor start?

Why Should You Invest in a Mutual Fund?

The short answer is: to save money and try to earn returns that are higher than those associated with very low-risk investments, such as certificates of deposit, savings bonds, or Treasury bills.

Before you invest in mutual funds, be sure to identify your investment objective, which is the goal and time frame you have to invest. That will guide you in choosing the best funds for your purpose. In general, mutual funds are best used for time horizons of more than three years; preferably, you'll hold them for more than 10 years.

Top 10 Reasons to Invest in Mutual Funds

- Diversification
- Professionally Managed
- Many Types & Styles
- Accessible – Minimums typically $1,000 to get started
- Many Offer Systematic Investing and Withdrawals
- Many Offer Automatic Reinvestment of Dividends & Capital Gains
- Transparency
- Liquidity
- Audited Track Records
- Mutual Funds Build Wealth

Know Your Risk Tolerance

Most mutual funds provide greater returns over time than investments with guaranteed returns due to the risk premium rewarded to investors. This premium comes in the form of higher returns associated with accepting market risk, which is the risk of losing some or all of the amount you invested—called the "principal."

Risk tolerance refers to the amount of risk you are willing to accept in the form of loss of value or principal.

The most significant risks are likely to be your emotions, fear of loss, and desire for quick gains. Be careful of "chasing performance"—the tendency to continuously seek and buy the highest-performing funds while selling the under-performing ones. Remember that investing should not be thrilling; it should be boring. Like the old parable of the tortoise and the hare, slow and steady wins the race.

Diversify Your Portfolio

Mutual funds are like baskets of investments, because one single mutual fund can invest in hundreds of stocks or bonds. There are many mutual funds with enough diversity that you could invest a large portion of your hard-earned savings into one; however, it is a good idea to spread the risks across the different mutual fund types.

Some examples to choose from are stock funds, bond funds, or money market funds. Additionally, you could invest in two stock funds, but it would be essential to ensure that each fund had different holdings. Two separate funds with the same holdings neither diversify your portfolio nor reduce risk.

Know the Fund Load & Expenses

The costs associated with buying and selling mutual funds can be broken into four basic types:

Front Load: These are charged upfront (at the time of purchase) and can be up to 5% or more of the amount invested. For example, if you invest $1,000 with a 5% front load, the load amount will be $50.00; therefore, your initial investment will be $950.

Back Load: These are charged only when you sell a fund. Also called "deferred sales charges," back loads can be up to 5% and may even decline or be reduced to zero over five or more years.

No Load or Load Waived: As the name implies, this category of fund expense has no front load or back load.

Expense Ratio: Not all funds charge loads; however, there are underlying expenses in all mutual funds. Expense ratios can be more than 1% for stock mutual funds and are used for the ongoing management of the fund. Sometimes included in the expense ratio is an operational charge, called a "12b-1 fee," which covers the costs of marketing and selling the mutual fund's shares.

Past Performance is No Guarantee for Future Results

Everyone has seen the disclaimers about past performance. However, a mutual fund investor will still consider past performance in their initial evaluation before buying. Make sure to review longer periods, such as five and 10 years, and compare the performance with other funds in the same category.

While not a guarantee of returns or success, a fund with a long track record of performance through many market and economic conditions, like recessions or market bubbles, demonstrates good management practices.

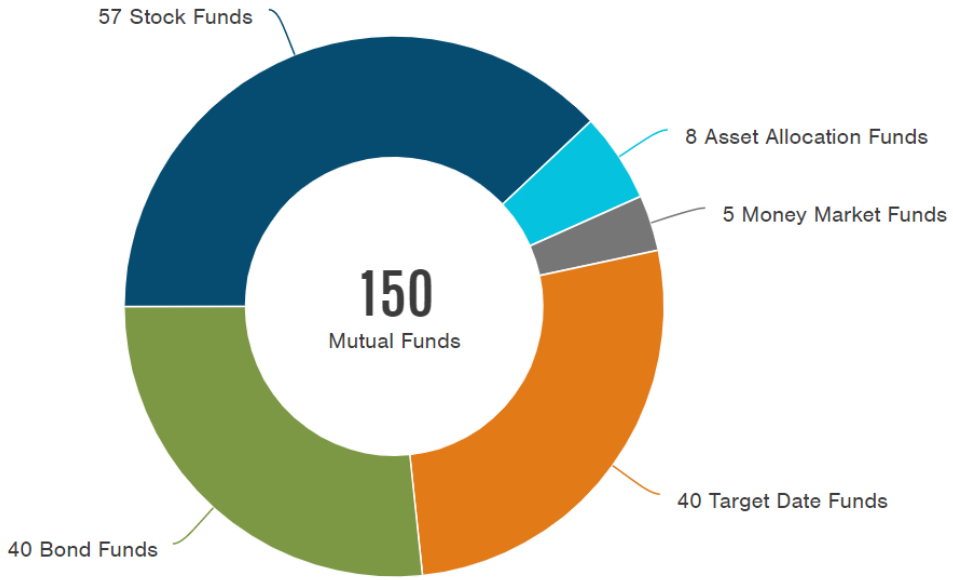
It is also essential to see how long the manager has been at the fund's helm. For example, suppose you find a mutual fund with an impressive five-year return, but the manager's time at the fund, called "manager tenure," is only one year. This new manager was not present for that five-year performance. Approach this fund with caution, or put it on your list of funds to watch.

What's the difference between a mutual fund and an ETF?

Mutual funds and exchange-traded funds (ETFs) have a lot in common.

- Both types of funds consist of a mix of many different assets and represent a popular way for investors to diversify.
- While mutual funds and ETFs are similar in many respects, they also have some key differences.
- A major difference between the two is that ETFs can be traded intra-day like stocks, while mutual funds only can be purchased at the end of each trading day based on a calculated price known as the net asset value.
- Mutual funds in their present form have been around for almost a century, with the first mutual fund launched in 1924. Exchange-traded funds are relatively new entrants in the investment arena, with the first ETF launched in January 1993; this was the SPDR S&P 500 ETF Trust (SPY).

What a mutual fund provider has on website:



DIFFERENT TYPES OF MUTUAL FUNDS & ETFS

Different Types of Mutual Funds & ETFs

Large-cap funds. These funds invest in large, widely held companies with market capitalizations usually worth $10 billion or more.

Small-cap funds. These funds tend to invest in companies with market capitalizations between $300 million and $2 billion.

Value funds. Value funds consist of stocks that are perceived to be undervalued. These are typically well-established companies, but are considered to be trading at a discount. These companies may very well have low price-to-earnings or price-to-sales ratios.

Growth funds. Growth funds largely invest in companies that are rapidly growing, and whose primary objective tends to be capital appreciation. They may have a high price-to-earnings ratio and have greater potential for long-term capital appreciation.

Income funds. Some funds pay regular income. This can come in the form of a dividend or interest, such as with dividend stocks and bond funds.

Different Types of Mutual Funds & ETFs continued

Bond Funds invest in various fixed income securities that include government, corporate or international bonds. Maturity ranges may be selected.

Asset Allocation Funds provide a simplified application of modern portfolio theory with varying allocations and combinations of assets for investors. One of the most common types of asset allocation funds is a balanced fund. A balanced fund implies a balanced allocation of equities and fixed income, such as 60% stocks and 40% bonds.

A target-date fund is a class of mutual funds or ETFs that periodically rebalances asset class weights to optimize risk and returns for a predetermined time frame. The asset allocation of a target-date fund is typically designed to gradually shift to a more conservative profile so as to minimize risk when the target date approaches.

A money market fund is a type of mutual fund that invests in high-quality, short-term debt instruments, cash, and cash equivalents. Though not quite as safe as cash, money market funds are considered extremely low-risk on the investment spectrum. A money market fund generates income (taxable or tax-free, depending on its portfolio), but little capital appreciation.

What is a Closed End Fund?

A **closed-end fund** is a type of investment vehicle that's similar to a mutual fund. It's created with a fixed number of shares that investors can trade on the open market rather than redeem with the fund company.

A closed-end fund is a type of investment vehicle that's similar to a mutual fund. The key difference between a closed-end fund and an open-end fund, such as a mutual fund or an exchange-traded fund (ETF), is that a closed-end fund is created with a fixed number of shares that you trade on the open market rather than redeem with the fund company. That's what gives a closed-end fund its name.

Unlike the more popular mutual fund, closed-end funds don't normally buy back shares from investors who want to sell. Closed-end funds sell their shares to investors in an initial public offering (IPO). Investors who want to sell their shares then do so on the open market, similar to the way a stock is traded.

Shares typically have higher expense ratios than mutual funds and ETFs along with greater price volatility.

What does Active and Passive Mean?

Active

An actively managed mutual fund, or exchange traded fund (ETF), is one that relies on the decisions of an investment manager or a team of managers to select the fund's holdings.

Passive or Indexed

Passive management is a reference to index funds and exchange-traded funds, that mirror an established index, such as the S&P 500.

Passive management is the opposite of active management, in which a manager selects stocks and other securities to include in a portfolio.

Passively-managed funds tend to charge lower fees to investors than funds that are actively managed.

The Efficient Market Hypothesis (EMH) demonstrates that no active manager can beat the market for long, as their success is only a matter of chance; longer-term, passive management delivers better returns.

Why is Asset Allocation the Most Important Decision?

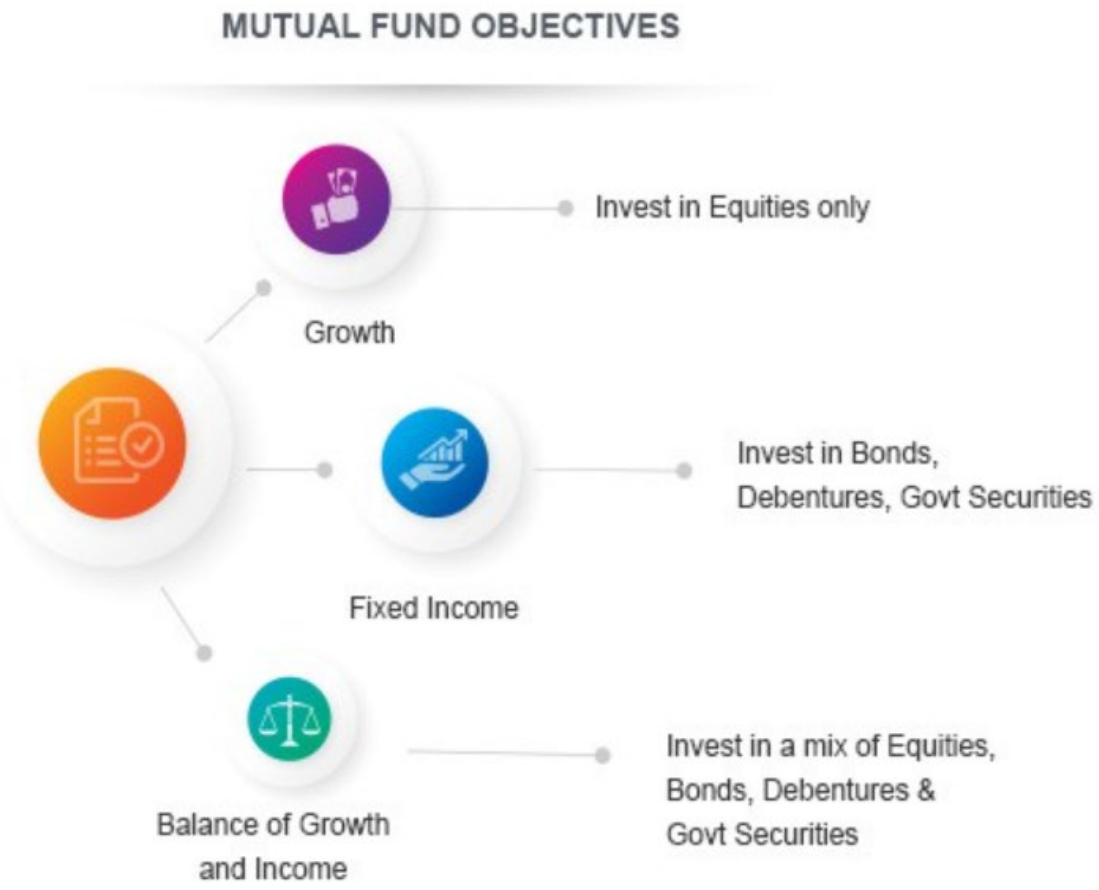
The Importance of Asset Allocation Asset allocation **helps investors reduce risk through diversification**. Historically, the returns of stocks, bonds, and cash haven't moved in unison. Market conditions that lead to one asset class outperforming during a given timeframe might cause another to underperform.

The selection of individual securities is secondary to the way that assets are allocated in stocks, bonds, and cash and equivalents, which will be the principal determinants of your investment results.

How do you select a Mutual Fund or ETF? 7 Tips

- Consider your investing goals and risk tolerance.
- Know the Fund's management style: is it active or passive?
- Understand the differences between Fund types.
- Look out for high fees.
- Do your research and evaluate past performance.
- Remember to diversify your portfolio
- Stay focused on long term growth.

MATCHING INVESTMENT GOALS & OBJECTIVES WITH MUTUAL FUNDS AND ETFS



Matching Funds with Goals & Objectives

Aggressive Growth Funds typically invest in higher growth, higher risk companies. Although some investments will be unsuccessful, others may do well over the long term.

Growth and Income Funds generally hold stocks of established companies that are expected to grow and currently are paying high dividends. These funds may offer more consistent returns than more speculative funds.

Growth Funds invest in stocks of growing companies, with the expectation that the companies — and the stocks — are likely to increase in value. Funds may invest in small, mid-size, or large companies, or in all three.

High Yield Funds invest in low-rated or unrated bonds — known as junk bonds — that may produce high income. Because such bonds have a higher likelihood of default than higher rated bonds, they're considered risky investments.

Income Funds hold investments that generate current income. They can be stock or bond funds, or balanced funds that invest in both.

Municipal Bond Funds invest in tax-exempt bonds issued by a single state or several states. Income is generally exempt from federal taxes.

Sector Funds focus on one area of the economy, such as technology, pharmaceuticals, utilities, etc. Performance generally depends on how well the sector is doing.

Value Funds invest in stocks of companies that are considered to be undervalued — that is, their stock prices are lower than they seem to be worth — in the belief that the stocks' true values will be recognized over time.

Risk, Fees & Expenses of Mutual Funds & ETFs

•The average expense ratio for an index ETF was 0.18% in 2020, according to industry research. 1

•The average cost for an actively managed mutual fund was 0.71%. For passive mutual funds, it was 0.27%.

•**Investment** management **fees** for **exchange-traded funds** (**ETFs**) and mutual funds are **deducted** by the **ETF** or fund company, and adjustments are made to the net asset value (NAV) of the fund on a daily basis. Investors don't see these **fees** on their statements because the fund company handles them in-house.

The potential risks associated with mutual funds and ETFs that invest in market-based securities include:

•Currency risk

•Inflation risk

•Interest-rate risk

•Liquidity risk

•Market risk

EXPENSE RATIOS BY CATEGORY – SOURCE MORNINGSTAR

Expenses Relative to Category

Expense Detail	Prosp Net Exp Ratio
Money Market-Taxable(FM, USD)	0.34
Large Blend(Fds, USD)	0.78
Mid-Cap Blend(Fds, USD)	0.84
Small Blend(Fds, USD)	0.90
Intermediate Core Bond(Fds, USD)	0.46
Foreign Large Value(Fds, USD)	0.90
Allocation--50% to 70% Equity(Fds, USD)	0.83
Target-Date 2025(Fds, USD)	0.55
Global Real Estate(Fds, USD)	1.15

How liquid are Mutual Funds & ETFs?

ETFs are generally considered to be more liquid than their mutual fund counterparts because they trade on an exchange like a standard stock at any point in the day, whereas mutual funds are typically locked into trades once a day at market close.

What are the responsibilities of a Fiduciary in choosing a Mutual Fund or ETF?

Fiduciaries are in a position of trust with respect to beneficiaries. A fiduciary's responsibilities include:

•acting solely in the interest of the beneficiaries;

•carrying out duties with the care, skill, prudence and diligence of a prudent person familiar with the matters;

•following the investment policy statements; and

•diversifying plan investments.

Where do you find Fund information such as holdings, fees, risks, etc?

A mutual fund prospectus is a **pamphlet or brochure that provides information about a mutual fund**. Mutual fund companies must give potential investors a prospectus, free of charge, before they invest. You can get a prospectus by calling the mutual fund company directly or by visiting the fund's website.

Mutual funds that are registered with the SEC must send reports to their shareholders on a semiannual basis. The semiannual report covers the **first six months of the fund's fiscal year**, while the annual report covers the fund's entire fiscal year. (within 60 days of period end)

Your mutual fund’s annual report contains a wealth of information about who is running the fund and how it has performed compared to its peers and benchmark in addition to its holdings. It also lists the fees and charges that it assesses and provides a breakdown of the types of risk the fund carries.

Keep In Mind:

The largest mutual fund in the world by AUM is the Vanguard Total Stock Market Index Fund Admiral Shares (VTSAX) with an AUM of $921.4 billion.

At the moment of writing, Fidelity Investments has the highest mutual funds number at 530, with an average expense ratio of 0.38%.

Average expense ratios for actively managed equity mutual funds worldwide fell by 25% between 2010 and 2020.

Combined active and passive fund expense ratios in the US are expected to decline by 22% by 2025.

The mutual fund ownership in the US in 2021 was the highest among Gen X at 53%..

Nearly 90% of mutual fund-owning households cite historical performance as a very or somewhat important criterion when choosing mutual funds.

Return Statistics

In 2021, the average return on mutual funds in seven major categories was about 11.54%.

For stock mutual funds, a good long-term return is 8%–10%.

US large-cap stock mutual funds had an average 15-year return of 9.73% as of 2021.

Long-term bond mutual funds had an average 15-year return of 6.75% as of 2021.

What do investors consider important?

Nearly 90% of mutual fund-owning households cite historical performance as a very or somewhat important criterion when choosing mutual funds.

22% of investors say the primary reason they avoid mutual funds is high management fees.

Mutual fund fees can reduce your returns anywhere from 0.5% to 8.5%

99% of funds that have outperformed the market in one decade fall to the average the following decade.

How Many Mutual Funds Should You Hold?

The ideal number advised by experts is 3 or 4. It also depends on the amount you are investing — for a small amount every month, even 2 might be enough.

Can I lose money in a mutual fund?

Yes, you can. Mutual funds are made up of securities that have risks associated with them. Since these underlying securities can increase or decrease in value over time, the returns can also be positive or negative over a certain period.

Acronyms of Mutual Funds

MF = Mutual Fund

ETF = Exchange Traded Fund

NAV = Net Asset Value = Per Share Value of Mutual Fund or ETF

NYSE = New York Stock Exchange = Where ETF may trade

SEC = Securities & Exchange Commission = Regulates Mutual Funds

AUM = Assets Under Management = Total Value of Assets Managed by a Fund

SIP = Systematic Investment Plan = Investments automatically made via payroll or checking acct