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Invest

Mutual Funds — The Basics

One way to cushion investment risk is to include several different investments in the same portfolio — a strategy known as diversification. Because mutual funds* hold many different investments, they provide an opportunity for diversification even if a person has only a relatively small amount to invest.

A mutual fund may invest in a single asset class (stocks, bonds, or short-term investments) or in a combination of two or more. For example, a fund that's geared toward capital growth would typically hold only growth stocks. However, a fund that aims to produce some growth and some income could hold both stocks and bonds.

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How Do Funds Earn Money?

People who invest in a mutual fund receive a portion of the income generated by the fund's holdings. For instance, if some of the fund's investments pay dividends or interest, this income is distributed to the shareholders.

The fund may also sell some of its investments at a profit, resulting in capital gains. The fund then distributes the capital gains — minus any capital losses — to shareholders, usually at year-end.

Fund shareholders typically can choose between receiving distributions in cash or reinvesting the income to buy additional shares in the fund. Keep in mind that unless an investment is in an account that provides tax benefits (such as a tax-favored retirement plan), shareholders will owe tax on the income — even if it is reinvested.

The other way a mutual fund investment can generate a return is when the fund's net asset value (NAV) — that is, its per-share value — increases. A fund's NAV reflects the market value of the investments in the fund's portfolio minus liabilities. As with any investment, fund shareholders will realize a capital gain if they sell shares for a price that's higher than the purchase price.

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All Shapes and Sizes

There are three main categories of mutual funds: *stock* funds, *bond* funds, and *money market* funds. Money market funds are low-risk investments that are designed to preserve the value of the money invested in them. That stability, however, comes at a price: of the three basic fund types, money market funds typically offer the lowest potential returns. Bond funds offer a moderate degree of risk and moderate return potential. Stock funds are the most volatile — meaning they are the most likely to experience up and down swings in value — but they typically offer the potential for the highest returns.

Some mutual funds invest in a combination of investment types. *Balanced* funds, for example, invest in both stocks and bonds.

Stock Funds

Stock funds can be categorized in several different ways. One way is by their investment style. The two basic investment styles for stock funds are *growth* and *value*.

Growth funds invest in the stocks of companies that are expected to have above-average growth. Growth funds tend to outperform other investment types when the stock market is rising.

Value funds invest in undervalued stocks that have been overlooked by other investors and may be selling for less than they are worth. Value fund managers are the bargain shoppers of the stock market. They look for stocks that may increase in value as other investors realize the stocks' potential.

Calculating Capitalization

Some stock funds focus on companies of a certain size, referred to as their market capitalization — or "market cap." A company's market cap is simply the number of its outstanding shares multiplied by the current share price. For example, a company with 10 million outstanding shares selling for $50 per share has a market cap of $500 million.

Large-cap funds typically invest in the stocks of well-known companies with solid histories of growth and dividend payments. The companies usually have a capitalization of more than $5 billion.

Mid-cap funds usually focus on companies with a capitalization of between $1.5 billion and $5 billion. These funds tend to have more growth potential than large-cap funds, but they also carry more risk.

Small-cap funds favor the stocks of young companies that often are in the early stages of development. The market capitalization of small-cap companies is generally less than $1.5 billion. These funds offer strong growth prospects, but they may also involve above-average risk.

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A World of Opportunity

Some funds specialize in investing in the stocks of foreign companies. These funds can help diversify a portfolio since world markets often move in different directions. Keep in mind, however, that foreign investments are subject to risks, such as currency fluctuation and political instability, that can make them more volatile than U.S. investments.

International funds generally invest only in the stocks of foreign companies.

Global funds may combine foreign and domestic stocks.

The sheer number and variety of mutual funds currently available provides plenty of opportunities to diversify a portfolio.

Passive vs. Active Fund Management

Some mutual funds are *passively* managed, while others are *actively* managed.

Passively managed funds are called **index funds**. Their objective is to mirror the performance of a specific market index, such as the S&P 500 (an index of 500 large company stocks). Fund managers don't make decisions about which securities to buy and sell. Instead, they simply buy and hold the same securities that are included in the index the fund is tracking.

In contrast, in an *actively* managed fund, the goal is often to outperform the fund's benchmark index. The portfolio manager decides which securities to buy and sell based on research, analysis, and the specific objectives of the fund.

* *Investors should consider a fund's investment objectives, charges, expenses, and risks carefully before investing. More information about the fund is available in the prospectus, which should be read carefully before investing. Shares, when redeemed, may be worth more or less than their original cost.*

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