

Mutual Funds

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What is a mutual fund? It's not complicated. A dictionary definition of a mutual fund might go something like this: a single portfolio of stocks, bonds, and/or cash managed by an investment company on behalf of many investors.

The investment company is responsible for the management of the fund, and it sells shares in the fund to individual investors. When you invest in a mutual fund, you become a part owner of a large investment portfolio, along with all the other shareholders of the fund. When you purchase shares, the fund manager invests your funds, along with the money contributed by the other shareholders.

Every day, the fund manager counts up the value of all the fund's holdings, figures out how many shares have been purchased by shareholders, and then calculates the Net Asset Value (NAV) of the mutual fund, the price of a single share of the fund on that day. If you want to buy shares, you just send the manager your money, and they will issue new shares for you at the most recent price. This routine is repeated every day on a never-ending basis, which is why mutual funds are sometimes known as "open-end funds."

If the fund manager is doing a good job, the NAV of the fund will usually get bigger -- your shares will be worth more.

But exactly how does a mutual fund's NAV increase? There are a couple of ways that a mutual fund can make money in its portfolio. (They're the same ways that your own portfolio of stocks, bonds, and cash can make money).

- A mutual fund can receive dividends from the stocks that it owns. Dividends are shares of corporate profits paid to the stockholders of public companies. The fund might have money in the bank that earns interest, or it might receive interest payments from bonds that it owns. These are all sources of income for the fund. Mutual funds are required to hand out (or "distribute") this income to shareholders. Usually they do this twice a year, in a move that's called an income distribution.
- At the end of the year, a fund makes another kind of distribution, this time from the profits they might make by selling stocks or bonds that have gone up in price. These profits are known as capital gains, and the act of passing them out is called a capital gains distribution.

Unfortunately, funds don't always make money. If the fund managers made some investments that didn't work out, selling some investments for less than the original purchase price, the fund manager may have some capital losses.

Everyone hates to have losses, and funds are no different. The good news is that these losses are subtracted from the fund's capital gains before the money is distributed to shareholders. If losses exceed gains, a fund manager can even pile up these losses and use them to offset future gains in the portfolio. That means that the fund won't pass out capital gains to shareholders until the fund had at least earned more in profits than it had lost. (Although you might want to reconsider your decision to remain invested in a fund that's losing money if the rest of the market is growing).

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1. EQUITY (STOCK) FUNDS

Market Cap

Most mutual funds invest in stocks, and these are called equity funds. While mutual funds most often invest in the stock market, fund managers don't just buy any old stock they find attractive. Some funds specialize in investing in large-cap stocks, others in small-cap stocks, and still others invest in what's left -- mid-cap stocks.

"Cap" has nothing to do with hat size or what your spouse left off the tube of toothpaste (again). On Wall Street, cap is shorthand for capitalization, and is one way of measuring the size of a company -- how well it's capitalized. Large-cap stocks have market caps of billions of dollars, and are the best-known companies in the U.S. Small-cap stocks are worth several hundred million dollars, and are newer, up-and-coming firms. Mid-caps are somewhere in between.

Mutual funds are often categorized by the market capitalization of the stocks that they hold in their portfolios. But how big is a large cap stock? Formulas differ, but here is one guideline:

- Small-cap stocks < \$500 million
- Mid-cap stocks \$500 million to \$5 billion
- Large-cap stocks > \$5 billion

Equity fund managers usually employ one of three particular styles of stock picking when they make investment decisions for their portfolios. Some fund managers use a *value* approach to stocks, searching for stocks that are undervalued when compared to other, similar companies. Often, the share prices of these stocks have been beaten down by the market as investors have become pessimistic about the potential of these companies.

Another approach to picking is to look primarily at *growth*, trying to find stocks that are growing faster than their competitors, or the market as a whole. These funds buy shares in companies that are growing rapidly -- often well known, established corporations.

Some managers buy both kinds of stocks, building a portfolio of both growth and value stocks. This is known as the *blend* approach.

Growth, Value, and Blend

EVERY MANAGER is different, but there are three broad archetypes when it comes to investment strategy: growth, value and blend. The issue here is whether the manager a. is willing to chase popular (a.k.a. expensive) stocks, hoping to cash in on their momentum; or b. is seeking to "discover" cheap stocks, betting that the market will discover them, too.

Growth Funds

As their name implies, these funds tend to look for the fastest-growing companies on the market. Growth managers are willing to take more risk and pay a premium for their stocks in an effort to build a portfolio of companies with above-average earnings momentum or price appreciation.

For example, [Dell](#) and [Microsoft](#) are generally considered "expensive" stocks, because their prices have been bid high relative to their profits. But because they enjoy vibrant markets and have rapid earnings growth, managers like Scott Schoelzel of [Janus Twenty](#) have no qualms paying big prices. Schoelzel knows that investors crave these super-charged growth stocks and will keep piling into them as long as the growth keeps up. But if the growth slows, watch out -- the more momentum a stock has, the harder it is likely to fall when the news turns bad.

That's why growth funds are the most volatile of the three investment styles. It's also why expenses and turnover (which leads to tax liability) are also higher. For these reasons, only aggressive investors, or those with enough time to make up for short-term market losses, should buy these spooky funds.

Value Funds

These funds like to invest in companies that the market has overlooked. Managers like Marty Whitman of [Third Avenue Value](#) search for stocks that have become "undervalued" -- or priced low relative to their earnings potential.

Sometimes a stock has run into a short-term problem that will eventually be fixed and forgotten. Or maybe the company is too small or obscure to attract much notice. In any event, the manager makes a judgment that there's more potential there than the market has recognized. His bet is that the price will rise as others come around to the same conclusion.

Whitman, for instance, bought real-estate insurance company First American Financial early in 1997 before it was discovered by the Street. The stock rose 96% in 1998 and still traded at just 9.5 times the past 12-month earnings -- a steal when you consider the market average at the time was more like 22 times earnings.

The big risk with value funds is that the "undiscovered gems" they try to spot sometimes remain undiscovered. That can depress results for extended periods of time. Volatility, however, is quite low, and if you choose a good fund, the risk of doggy returns should be minimal. Also, because these fund managers tend to buy stocks and hold them until they turn around, expenses and turnover are low. Add it up, and value funds are most suitable for more conservative, tax-averse investors.

Blend Funds

These can go across the board. They might, for instance, invest in both high-growth Internet stocks and cheaply priced automotive companies. As such, they are difficult to classify in terms of risk. The [Vanguard 500 Index fund](#) invests in every company in the [S&P 500](#) and could therefore qualify as a blend. But because it's also a large-cap fund, it tends to be steady. The [Legg Mason Special Investment fund](#) is more aggressive, with heavy weightings in technology and financials. In order to determine if a particular blend fund is right for your needs, you'll probably have to look at the fund's holdings and make a call.

Foreign Stock Funds

SINCE THE ECONOMIES of the world's different regions tend to boom and bust in cycles that offset each other, international stocks can provide excellent diversification for a portfolio heavy on U.S. equities. And a fund with a good manager is often the best way to go, because research is scarce and foreign companies are notoriously hard for individual investors to track on their own.

Foreign-stock funds allow you exposure to overseas markets at varying levels of risk. Some are fairly tame. Others can make your hair stand on end. Consider the experience of the summer of 1998, when the Asian economies fell like dominoes and plundered stocks in the region. Funds like [Pioneer Emerging Markets](#) and Ivy Developing Nations, with heavy exposure to Asia, got hammered. Even when foreign economies are doing reasonably well, currency fluctuations can have a negative effect on stock prices.

Of course, economic and currency risk can also swing very strongly in a positive direction. So, as always, diversification is the key to managing risk. Funds investing overseas fall into four basic categories: global, international, emerging market and country specific. The wider the reach of the fund, the less risky it is likely to be.

Global Funds

Global funds are the most diverse of the four categories. But don't be fooled by their cosmopolitan-sounding name. They're able to invest in any region of the world, including the U.S., so they don't actually offer as much diversification as a good international fund. A prime example: IDEX Global, which is 26% invested in the U.S., 11% in Britain, 8% in France, 6% in Japan and 6% in Germany. Global funds tend to be the safest foreign-stock investments, but that's because they typically lean on better-known U.S. stocks.

International Funds

These funds invest most of their assets outside the U.S. Depending on the countries selected for investment, international funds can range from relatively safe to more risky. [Fidelity Diversified International](#), for instance, has its assets spread over 44 different countries, many of which are in Europe. [Oakmark International Small Cap](#), on the other hand, has significant exposure to some of the most volatile regions in the world: Thailand, South Korea, Hong Kong and Turkey. The best thing to do is to choose a fund with the best balance, or make damn sure the manager has done a good job of moving in and out of regions profitably.

Country-Specific Funds

These funds invest in one country or region of the world. That kind of concentration makes them particularly volatile. If you pick the right country -- Britain in 1998, for example -- the returns can be substantial. But pick the wrong one, and watch out. Only the most sophisticated investors should venture into this territory.

Emerging-Market Funds

Emerging-market funds are the most volatile. They invest in undeveloped regions of the world, which have enormous growth potential, but also pose significant risks -- political upheaval, corruption and currency collapse, to name just a few. Don't go near these funds with anything but money you are willing to lose.

2. BOND FUNDS

Bond funds are designed to give your portfolio its recommended dose of fixed-income investments so you don't have to go through the hassle of buying bonds yourself. These, too, come in various types.

Term Funds

All bonds are structured so you get paid your principal after a set amount of time. They're either short, intermediate or long term, depending on the number of years until they mature. Bond funds are the same way. A fund like [Scudder Short-Term Bond](#) is typical of its class, buying a mixture of corporate and government bonds with durations between one and 3.5 years. Intermediate funds like [Stein Roe Intermediate](#) range between 3.5 and 10 years, while [Vanguard Long-Term Corporate](#) only buys bonds with durations greater than six years.

Generally speaking, the longer the duration, the higher the risk and reward. Why? Because the longer you hold a bond before it matures, the greater the chance its value could be adversely affected by changes in interest rates. As a result, whatever company or government issued the bond has to promise a higher yield upfront.

Municipal Bond Funds

Muni-bond funds invest in bonds issued by state municipalities. Some funds, like [Eaton Vance National Municipal](#), invest in bonds offered throughout the country. Others, like [Dreyfus New York Tax-Exempt Intermediate](#), invest in one state only. Tax breaks are the big draw of muni-bond funds. If you own a national fund, you are exempt from federal income taxes on any income you receive from the fund. If you live in the state specified in a state-specific fund, you are exempt

from state and federal taxes. However, your lower taxes generally come with lower returns. Only investors in high tax brackets should buy these funds.

High-Yield Bond Funds

Bond funds invest in different grades of corporate bonds. High-yield, or "junk-bond," funds are the most well-known of the bunch, because they offer the highest rates. Unfortunately, since these funds invest in low-grade corporate issues, they also entail the greatest risk. Companies with credit ratings of BBB or less are the most likely to default on their coupon payments. In another words, although the income may be high on a fund like [Fidelity High Income](#), it's not guaranteed. Only the most risk-tolerant investors need apply.

3. MONEY MARKET mutual funds

MONEY-MARKET FUNDS are often touted as the safest kind of mutual fund, but that depends on your perspective. On the one hand, it's almost impossible to lose your principal in one of these things. On the other, their returns are so low -- 4% to 6% on average -- that they can't beat inflation over time. In the long term, your money loses its buying power and so actually becomes less valuable. Consequently, money-market funds are most useful for parking cash you need in the short term -- a car or house down payment, for instance, or next year's tuition.

The reason money funds are so stable is because they invest in ultra short-term securities like those issued by banks, the federal government or big companies with Grade A credit ratings. Your return comes in the form of a dividend. In these respects, money-market funds are very similar to a bank certificate of deposit. The advantage of a money fund is that it is completely liquid. Unlike a CD, which will lock up your money for at least six months, you can sell your shares in a money fund at any time. They also often offer perks like the ability to write checks against the principal. The advantage of a CD is that your deposit is usually insured by the federal government.

There are various types of money-market funds based on the type of securities they buy, but the most important distinction is whether your dividends are taxable or tax-free.