Finance

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What is a Mutual Fund?

Most investors today have some exposure to mutual funds. They are the bread and butter of retirement plans and other organized investment platforms. This is a brief refresher on mutual funds and how they are priced.

A mutual fund is an open-ended investment company. Investment companies pool investors' money and invest in securities (stocks, bonds, cash equivalents, etc.) on their behalf. Investment companies raise money by selling shares of the investment company to the public. Thus, when you buy a mutual fund, you are buying a share of that investment company. By owning shares of that company, you participate in the gains and losses of their investment portfolio.

To buy a share in a mutual fund, the investor pays the net asset value (NAV) which is the public offering price plus a sales charge. The NAV is determined by dividing the total value of the investments in the portfolio by the total number of shares outstanding. Mutual fund shares are not traded on the open market, and the shares are sold and redeemed by the fund only at the close of the trading day.

Each mutual fund is managed by a money manager or managers, professionals who invest the fund's capital in a way that matches the investment objective of the fund. Thus, a fund may have an objective of investing in large US company stocks or foreign bonds or as a money market fund. Knowing the objective of a fund is key to choosing a suitable fund to meet your goals.

What are the benefits of mutual funds? Mutual funds are more cost effective than investing as an individual, may provide diversification of your investments, usually have reasonable investment minimums, are accessible and relatively liquid, and they provide investors access to professional money managers. The performance of the manager(s) and the fund is easily tracked as the aggregate performance of the underlying investments.

However, this professional management comes with a cost. Built into the price of the mutual fund is the expense ratio, which is the price of fund operation. These costs are taken out of the fund's assets and lower the return to investors. Some funds also charge a sales charge, also known as a load, which may be charged when the shares are purchased or sold. "No-load" funds have this fee waived, along with meeting other criteria. If you are invested in mutual funds it is important to understand what sales charges you pay and what the expense ratios are. Actively managed funds may have expense ratios greater than 1% while passively managed funds have expense ratios as low as 0.16 percent.

Index funds have become increasingly popular. These are funds essentially managed electronically that track the composition and performance of an index, such as the S&P 500. This straightforward approach allows for lower fees.

I often hear that mutual funds are "safer" investments, but they reflect the risks of the underlying investments.

In addition, the fund you choose should be suitable for your investment objectives as determined by your investment professional or using planning tools.

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