



Financial Career Feature



Mutual Funds: an easy investment option

[By Shaileja Mammen]

The performance indicators of the last fiscal quarter contradict each other; the markets performed well, while economic indicators were weak. Most mutual funds perform well under situations like this and, over the last decade, mutual funds have found favor with investors who might use them to save for retirement, for example. A closer look at mutual funds will show why their popularity is increasing.

A mutual fund is a company that pools money to invest in any asset class-short-term money market instruments, bonds, stocks, real estate, derivatives, commodities, or a combination of these assets. The investors hold shares proportionate to the amount of money invested.

Small investors often take advantage of the buying power of a mutual fund. There are various categories of mutual funds to match the different needs and objectives of the investors according to their risk profile-popular ones include equity funds, bond funds, money market funds.

Equity funds invest a large portion of the funds into stocks. The two categories of equity funds are growth and dividend funds, which are based on the objective of the fund, and index and sector funds, which are based on the investment strategy. Equity funds have high risk and high returns associated with them, but historically, stocks have outperformed all other classes of investments.

Bond funds-corporate bonds, government bonds, and treasury securities-are considered to be safer, more stable investments than equity funds. The risks associated with bonds are credit risk, interest rate risk and prepayment risk.

Money market funds invest in high-quality money market or short-term instruments.

The returns are close to short-term interest rates, but there is a higher risk that inflation will erode these returns in the long run. These funds are suitable for very short-term investments.

The advantages of investing through mutual funds are:

- Professional management-qualified investment professionals research, select, and monitor the investments made by the fund.
- Diversification of risks-the investment is made in a wide range of companies and industry sectors, which reduces the risk if one of the companies fails.
- Affordability to small investors-small amounts of money may be invested, which makes mutual funds affordable to small investors.
- Liquidity-investors can withdraw when they wish to do so.

The drawbacks of mutual funds are:

- Shareholders do not have control over funds invested.
- Shareholders pay for the management of the funds even if the returns are negative.

- Share value cannot be constantly monitored, as it depends on the net asset value (NAV), which is calculated only once every day.

Mutual funds provide earnings through dividend payments and capital gains distribution, which may either be paid out or reinvested into the fund to buy more shares at the end of the year. Another form of earnings from the fund is increased NAV realized on sale of the shares.

Past performance of mutual funds is no indicator of future performance. Before you invest, consider some other factors: the investment strategy of the fund's managers, fees and expenses charged, and tax implications.

The investment strategy of the mutual fund should match the investor's investment objective and his risk tolerance. The prospectus of the fund gives details about the investment strategy and the level of risk and return expected.

The fees and expenses of fund lower the returns earned on the investment as they are directly or indirectly charged on the shareholders. These include investment managers' fees for managing the portfolio, fund's transaction costs (cost of buying and selling securities by the fund), and marketing and distribution expenses, which include advertising expenses and the broker's fee.



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The shareholders' transaction cost-also called the load-is charged every time the shareholder buys or sells shares. The purchasing fee-front-end load-must be factored into the amount of income generated over the life of the shares. When the shareholder sells the shares, a back-end load is charged, based on how long his money has been floating. Other fees, like redemption fees, exchange fees (charged when shareholders transfer the investment into another scheme within the same fund group), and account fees (charged for maintaining the account of the shareholders) are also charged.

Income tax is payable on the dividends and interest received during the year. Personal capital gains on mutual fund shares earned every year also attract taxes, which requires record keeping of the capital gains to avoid overpayment of taxes. In addition, selling shares will bring full capital gains tax due.

Therefore, before you select a mutual fund, review what the prospectus says about the investment strategy, expense ratio (expenses and fees), and tax implications. Remember also that past performance of mutual funds is no indicator of their future performance.

On the Net

Invest Wisely: An Introduction to Mutual funds
www.sec.gov/investor/pubs/inwsmf.htm

Mutual Fund Fees and Expenses
www.sec.gov/answers/mffees.htm

Motley Fool Mutual Fund Center
www.fool.com/mutualfunds/mutualfunds.htm