

FINANCIAL FEATURE



## Mutual Funds: Keeping Your Eggs in Multiple Baskets

[By Kyle Hagen]

The typical investment column seems geared towards people who are already experienced investors. But what about those of us who don't know the first thing about the LIBOR, periodicity, or cash flow statements? Financial literacy is hardly universal, and if there's any truth to [various news reports](#), millions of Americans don't know diddly about saving for the future.

This one's for the beginners, then, and you can file it under "Investing 101." If you're just getting started in the investment game, there are few options as sensible and as easy as mutual funds. In the present article, I mean to tell you why.

### First Things First

But let's not rush into this. The first thing we really need is a definition. What is a mutual fund? Well, [Dictionary.com's](#) first definition reports that a mutual fund is "an investment company that issues shares continuously and is obligated to repurchase them from shareholders on demand." Uh...okay. But I don't think that really answers the question very well. Let's try again.

The fifth definition on the same page says that a mutual fund is "a security that gives small investors access to a well-diversified portfolio of equities, bonds, and other securities. Each shareholder participates in the gain or loss of the fund. Shares are issued and can be redeemed as needed." Hmm...a little better, but still not great.

Let me try to combine and translate the countless definitions I've read into something approximating simple, straightforward English. Basically, a mutual fund is a company that brings together a large

number of investors, pools their money, and invests it in some combination of stocks, bonds, and other securities.

### Lots of Eggs, Lots of Baskets

Because of what they are, mutual funds offer a lot of potential advantages to the novice investor. Using the combined resources of hundreds, if not thousands, of participants, a mutual fund is able to invest in a wide variety of securities. Why is this good? In short, diversification.

Okay, but why is diversification good? Well, an example would probably help here. Let's say you're a beginning investor with \$1,000 to invest. Now, let's say you decide to put that money directly into stocks instead of a mutual fund. You cross your fingers and buy a thousand bucks worth of stock in Company A. Several months later, however, an accounting scandal comes to light, and Company A files for bankruptcy. The stock price plunges, and you lose all of your money. The problem: you put all your eggs in one basket, and that basket got dropped.

That's far less likely to happen with a mutual fund. When you buy into a fund, you get shares of the fund. The price of a share fluctuates with the value of the fund's holdings. Now, those holdings might very

well include some stock in Company A, but they might also include stocks in companies B through Z.

In any case, the point is that a mutual fund will have its investments spread out over a variety of investment options. And so if the fund *is* invested in Company A, when Company A's stock tanks, the fund will lose some value too, but because the fund is also invested in numerous other securities, the hit should be far less substantial. In fact, because some of the fund's other holdings might be rising in value even as Company A's stock falls, the overall value of your shares in the fund might hold steady or even increase.

In short, the diverse holdings of a mutual fund offer some protection from the huge losses you might incur from a single bad stock pick.

### Okay, I'll Just Buy Lots of Different Stocks

Yes, you might be inclined to think, "Who needs a mutual fund, then? I can do this diversification thing on my own." Well, that's true; you could do it on your own, at least to some extent. You could, for example, buy stocks in 20 different companies. But unless you've got a lot to invest, this is a pretty bad strategy.

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Here's why: when you buy a stock, your broker is going to charge a trading fee. And when you sell that stock, he's going to charge another fee. Even on the low end, this fee will probably not be less than about \$10. And, of course, for every stock you buy, you will incur a fee. So if you buy 20 different stocks, and the transaction fee is \$10, you will be charged \$200 just to get those stocks, even if you buy them all at the same time. If, as in our earlier example, you started with \$1,000, you'd be spending 20% of your money to get \$800 worth of stocks. Obviously, those stocks are going to have to do very well as a group just to make up the money you paid in transaction fees.

Of course, \$200 isn't such a big percentage if you've got \$100,000 to invest, but then, most novice investors don't have that kind of money to throw around. Assuming you're closer to the \$1,000 mark, a mutual fund is a far more cost-effective way to achieve the protection of diversification.

### Alright Then, What's This Going to Cost Me?

Of course, mutual funds do have costs of their own, but if you pick the right sort of fund, the cost should be substantially lower than the amount the average novice investor would incur by buying stocks directly.

What is the "right sort of fund"? Well, there are a variety of fund types in terms of investment strategy, but for the moment, I'm simply talking about the cost of investing in a fund, and when it comes to this issue, there are two main points to consider: the MER and whether the fund is a load or no-load fund.

MER stands for "management expense ratio," and all funds are going to charge one. The question, of course, is "How big is it?" [Investopedia.com](http://Investopedia.com) reports that fund fees "range from as low as 0.2%...to as high as 2%." So should you be willing to pay a full 2% for a given fund, reasoning that the fee is higher because the fund's managers are somehow better?

Probably not. As the same Investopedia page notes, the Securities and Exchange Commission has included the following quote on its website: "Higher expense funds do not, on average, perform better than lower expense funds." Accordingly, as a rule of thumb, you should avoid funds that charge high MERs.

Now, what about loads? Well, first of all, what is a load? Basically, a load is a commission that *some* funds charge, either when you buy into the fund or when you sell your shares back to the fund. Some funds, however, charge no such commissions and are hence known as "no-load funds."

Which sort of fund should you join? Well, consider the following quote from the aforementioned article: "There is little to no evidence that shows a correlation between load funds and superior performance. In fact, when you take the fees into account, the average load fund performs worse than a no-load fund." So why pay for something that gets you nothing? If a fund charges a load, you're probably better off investing elsewhere.

In a nutshell, get a fund with a decent MER and avoid those that charge loads. Of course,

you'll want to do some more research to find a fund (or funds) with a strategy that fits your risk tolerance and goals, but the foregoing are some basic guidelines to bear in mind that will help you narrow down the field.

### Disclaimers and Summation

In the end, of course, all investment options entail some measure of risk and some potential for reward, and there's no surefire way to predict which investments will turn out to be good and which will turn out to be bad. It's conceivable, for example, that if you put all of your money into a single company's stock, that company might turn out to be the next Microsoft or IBM, giving you huge returns. Likewise, while most mutual funds are less risky than direct investment in the stock market, it's certainly possible to pick a fund that performs so badly that you'd have been better off keeping your money under a mattress.

All of that said, however, most mutual funds provide a relatively safe and sensible way for the novice investor to get started on the road to financial security.

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Mutual Funds: Introduction  
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