Why Buy a Mutual Fund?

Since their emergence nearly a century ago, mutual funds have proven to be a popular investment vehicle. Their simplicity along with other recognized attributes provide a host of benefits to a wide range of investors, from the uninitiated to the sophisticated. Even given the wide range of alternatives available to investors—from individual stocks and bonds to ETFs—mutual funds have retained their appeal. Although some of the advantages of mutual fund investing are likely familiar to many investors, we chose to review them for the purpose of helping you determine when mutual funds may be the best choice for you.

Key points:

- Investors have a number of choices when it comes to investment vehicles, but mutual funds offer many advantages, including built-in diversification, economies of scale, low minimums, and liquidity.
- Some mutual funds provide access to areas of the market otherwise difficult for individual investors to reach.
- Investors can choose between passively managed index funds or actively managed funds that strive to outperform indexes.
- The ease and convenience of mutual funds can help investors avoid the risk that comes with inertia, getting and keeping them invested with a long-term focus.

Diversification

Diversification, a key tenet of investing, encourages investors to manage their risk by spreading their investments across a large number of securities. That way, weakness in one holding, sector, or geographic region can typically be offset by strength in another. Diversification can be measured against a number of yardsticks, including industry, country or region, market cap (the number of shares outstanding multiplied by a company's share price), and style characteristics, such as value or growth. Because mutual funds generally comprise a large number of individual securities, they provide inherent diversification, particularly for investors who may not have the means, knowledge or interest to buy and manage a portfolio of individual securities.

With mutual funds, investors have the ability to build a diversified portfolio by purchasing a variety of funds that focus on different areas of the market, such as large-cap or small-cap U.S. stocks or bond funds. For example, international funds can be particularly useful, because international and domestic stocks tend to respond differently to various market cycles and events, so their movement is often uncorrelated, offering investors added portfolio diversification. In addition, international investing adds another layer of diversification and return potential in the form of currency exchange. Within international equities are further breakdowns, including funds that focus on large developed country markets, emerging markets, or even smaller geographic areas such as a specific region or country. Mutual funds offer an easy way to access a range of market areas, particularly those that may not otherwise be readily accessible to individual investors. And this example is replicated across any number of categories or investment strategies.

Economies of Scale

Buying a sufficient number of individual securities to provide a reasonable level of diversification can be costly, incurring transaction costs and commissions; and minimum purchases sometimes apply. Although all funds incur some type of cost, the costs of purchasing a mutual fund are generally much lower than those that would be incurred by buying each of the fund's underlying securities individually—costs that would diminish future potential investment gains. And that doesn't even take into consideration the ongoing buying and selling that typically occurs within actively managed funds. On top of that, many mutual funds have no loads or transaction fees.

Low Minimums

Most mutual funds offer low investment minimums, often as low as $2,500. Low minimums allow investors to take advantage of what's known as dollar-cost averaging—regular, periodic purchases on a monthly or quarterly basis that essentially result in more shares purchased when prices are low and fewer when they're high. Low investment minimums provide investors a means to start investing as well as the ability to effortlessly grow their portfolio.

Liquidity

Mutual funds allow their investors to redeem their fund shares at any time. While frequent buying and selling is generally discouraged—sometimes by the imposition of a short-term redemption fee if shares are sold within a specified time frame—mutual fund investors are generally provided the ability to buy or sell shares with relative ease. Because funds are priced only once per trading day, after the close of trading—unlike stocks, which can be bought or sold throughout the trading day—investors' mutual fund buy or sell orders are filled after the close of the trading day on which they were placed.

Access

While many funds are broadly diversified across large swaths of the market, others are more specialized, addressing a small niche or geographic area. Often, those specialized areas can be difficult for investors to reach—for instance, stocks that trade only on foreign exchanges or small, focused bond issuances. Mutual funds can often provide such access. In addition, some specialized funds offer access to institutional-quality investment managers who are otherwise inaccessible to individual investors.

Professional Management

For all mutual funds, professional money managers bring their expertise to the investment process, providing research, analysis, and portfolio construction and monitoring. Although some investors may relish the challenge of researching individual stocks and assembling a portfolio of diversified holdings, many do not. With mutual funds, investors can choose passively managed index funds or actively managed funds that seek to outperform indexes.

The Risks of Not Investing

The ease of investing in mutual funds has another, less obvious benefit: getting and keeping investors in the market. Following the global financial crisis of 2007–2008, for example, many previously stalwart investors sold their investments following a long and disheartening decline in stock prices. Many of those who did missed out on significant subsequent gains since the market's low in March 2009. For them and for others awaiting some signal that would urge them back into the market, it's been a lost opportunity. Given that markets are unpredictable, getting and staying invested is critical for investors who are looking for long-term investment success.

And There's More

Other reasons to invest in mutual funds include:

- The option of automatic reinvestment of dividends and capital gains to take advantage of compounding
- The transparency of publicly posted fund holdings that allows investors to know what underlying securities funds are purchasing
- Audited track records to ensure that a fund follows its stated investment strategy
- Governance by a board of directors acting in the interest of shareholders to provide oversight

In addition, for investors who are interested in growing not only their net worth but also their knowledge, most mutual fund companies offer a wealth of information for their investors. Fund companies report at least twice a year to shareholders on their performance and how their strategy has held up through current market cycles—and many, more often than that. Mutual fund websites are often replete with insights, and engaged investors can learn a lot about markets, cycles, investment strategies and more by reading reports issued by their fund managers.

Schwab recognized early on the value of mutual funds to individual investors. For decades, we have focused not only on making mutual funds accessible, but also on making purchasing and owning them easy, convenient, and cost-effective. And with tools like the Mutual Fund OneSource Select List and a host of educational resources available at Schwab.com, investors can easily determine whether mutual funds are the right investment vehicle for them.

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