

Back to Basics: What Every Investor Should Know About Mutual Funds

Although mutual funds may seem relatively straightforward, many investors may not be fully aware of some of the fundamentals—such as how they're structured, how they operate, and variations and distinctions between different types of funds. For that reason, we thought we would revisit some mutual fund basics—"Mutual Funds 101," if you will. While much of this might sound elementary, we believe it's important that investors have a solid understanding of the basics as well as some of the intricacies of mutual funds.

Key points:

- In this article we cover the basics of mutual funds: what they are, the different types, and the differences and distinctions among them.
- Many funds offer multiple share classes, which affect an investor's costs—both immediately and over time.
- Schwab offers a wide range of resources relating to investing in mutual funds; we highlight some of them here.

Mutual Funds Defined

So what exactly is a mutual fund? A mutual fund (technically, an "investment company") is a collection of assets—generally stocks, bonds, cash, or some combination thereof held by multiple shareholders for the purpose of investing. A mutual fund pools money from investors and buys and manages a portfolio of securities. The underlying logic of mutual funds is that they provide diverse investment without requiring investors to make separate purchases and trades, which can be inefficient.

The majority of mutual funds are structured as open-end, which means that an unlimited number of shares can be offered. To meet demand as more shares are sold, a fund buys additional securities. Investors purchase mutual fund shares from the fund's distributor, or through a broker who relays the sale to the fund; shares are redeemable through the same channels. All investors in a mutual fund have a stake in all of the investments held by that fund.

The investment portfolios of <u>mutual funds</u> are typically managed by separate legal entities known as investment advisors that are registered with the Securities and Exchange Commission (SEC). In addition, mutual funds themselves are registered with the SEC and are subject to SEC regulation.

Types of Funds

Some types of mutual funds are straightforward: equity or stock funds invest in individual stocks; bond funds invest in bonds and can be tax-free or taxable. Funds can also be a hybrid of the two, such as balanced funds, growth and income funds, and others. Some funds are considered "alternative strategies," such as those that employ a "long/short" strategy or invest in commodities.

Mutual funds can be actively managed or passive. With actively managed funds, professional money managers make investment decisions, buying and selling securities according to the funds' investment objectives, in most cases seeking to outperform a specific benchmark. Passive, or index, funds attempt to mimic an index, so they have no need for active management.

Within various asset classes are a world of possible investable securities. Broad-based mutual funds, such as those that focus on large-cap U.S. stocks or the entire bond market, can choose from a wide range of securities. More-specialized funds focus on narrower slices of the market, such as a specific sector, geographic region, or company size, each with a significantly smaller investment universe. The existence of such a wide range of funds allows investors the option of building a well-diversified portfolio with just a few broad-based funds or customizing with a larger number of more-narrowly defined funds.

Fund Pricing, Share Classes, and Expenses

The price of a share of an open-end fund is determined by its Net Asset Value, or NAV-the total value of the securities owned divided by the number of shares outstanding, less expenses. Although the value of a fund's underlying investments changes constantly, mutual fund NAVs are determined only once per trading day.

The NAV is the price at which a fund share can be purchased or redeemed, providing that no sales charge, or "load," is involved. But just because a fund can be bought without a load doesn't mean there are no costs involved. All mutual funds incur management fees and/or operating expenses. A fund's ongoing expenses are represented by its expense ratio, expressed as a percentage of the NAV, which comprises the management fee (the cost of compensating the fund's investment advisor), administrative costs (such as recordkeeping and customer service), and/or sometimes what are known as 12b-1 fees, which go toward sales, advertising and shareholder services.

Many funds offer multiple types of shares, known as "classes." Although all classes of a fund invest in the same pool of securities and have common investment objectives and policies, fund availability can vary across share classes, as can the associated fees and expenses, and investment returns will likely differ. Here are some of the more common types of share classes:

- Investor shares, sometimes also known as "Retail" shares, are typically <u>no-load mutual funds</u> and impose a moderate expense ratio.
- Class A shares typically charge a front-end sales load, which means that the full price an investor pays upfront is not entirely invested in fund shares, but goes to a financial professional. Class A shares may have similar or slightly higher ongoing expenses than Investor shares.
- Class B shares generally forgo a front-end sales charge but impose either a back-end sales charge or a contingent deferred sales charge, which is paid as redemption decreases over time. Expenses are typically quite high, and the use of Class B shares has declined dramatically in recent years.
- Class C shares also impose no front-end sales charges but charge higher ongoing asset-based fees. With Class C shares, a fund's sales costs are an ongoing expense as opposed to being paid on a one-time basis.

 Institutional Shares: Some funds also offer share classes available only to institutional investors or individuals who meet a high minimum-purchase threshold. Generally, these share classes have the lowest ongoing expenses but are rarely available to individual investors.

Other share classes may be offered by some funds. The appropriate share class for any particular investor will primarily depend upon how long the shares will be held, which will determine overall costs over time.

Advantages of Mutual Funds vs. Other Investments

Most investors are well aware of the advantages of investing through mutual funds as opposed to other alternatives. They include:

- Ease and convenience: Mutual funds provide an easy way to own securities. They are readily available through a number of channels. Minimum investment limits are often quite low, and most funds offer automatic purchase plans for regular, ongoing purchases.
- **Diversification:** By their nature, mutual funds are diversified, and hold hundreds or even thousands of individual securities to spread risk broadly. Replicating this level of diversification with individual securities can be quite inefficient.
- **Professional management:** For actively managed funds, professional money managers bring their expertise to the investment process, providing research, analysis, security selection, and portfolio construction and monitoring.
- Affordability: Buying sufficient individual securities to provide a reasonable level of diversification can be costly, and minimum purchases sometimes apply. Mutual funds provide a cost-effective way to achieve diversification, and due to economies of scale, transaction costs are lower than what an individual investor would otherwise pay. Many mutual funds are available with no loads, no acquisition costs, and generally low investment minimums.
- Liquidity: Investors can typically redeem mutual fund shares at any time (although some charge a redemption fee if shares are sold within a specified time frame to discourage short-term trading).

Mutual Fund Resources at Schwab

In addition to offering one of the largest selections of mutual funds in the country, Schwab provides a host of resources to help investors understand, evaluate, compare, and monitor funds. Among them:

• Mutual Fund OneSource Select List[®] is a list of rigorously prescreened funds, regularly updated by Charles Schwab Investment Advisory, Inc. (CSIA), which conducts extensive research on the full range of actively managed funds available through Schwab's Mutual Fund OneSource[®] service.

- Tools and screeners: Online tools allow investors to evaluate and screen thousands of funds by category, fees, ratings, and other criteria; investors can compare up to five funds side by side.
- In-depth fund information includes detailed quotes, portfolio holdings, Morningstar Ratings advanced charting, fee and expense information, and risk and tax metrics.
- Mutual Fund Portfolio Builder[™] is an online tool that provides investors access to a preset list of Select List funds allocated to a specific risk profile; it offers an easy way for investors to build a diversified portfolio of Select List funds.
- Schwab's Automatic Investment Plan allows investors to automatically invest a fixed dollar amount on a regular basis into one or more mutual funds.
- Expert help is available via phone or in any of more than 300 Schwab branch offices.

At Schwab, we believe that knowledge is power, and we strive to provide the information, tools, and resources for investors to be fully educated on all facets of investing. In coming issues of this publication, we will address additional topics relating to mutual fund investing. In the meantime, if you have any questions about mutual funds or mutual fund investing, Schwab is just a click or a phone call away.

The information provided is not intended to be investment or tax advice.

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