CAPITAL ACCUMULATION

MUTUAL FUNDS

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HISTORY

Mutual funds have been around for a long time. The idea of pooling resources and hiring one professional manager can be traced to France and England over a hundred years ago. However, the mutual fund concept as we know it today was only recognized as a viable investment alternative in this country after World War II.

All mutual funds used to invest in common stock. Common stock did nothing but rise during the heady days of the 1950s and 1960s and so did mutual funds. They were selling at up to twenty times earnings in some instances. The recession of 1974 took the sails out of the investment market in general, but did even more damage to the mutual funds. Many mutual funds began investing in more risky and dramatic holdings and abandoned their former conservative approach. They were discredited for a few years until their popularity revived in the 1980s.

Stock prices in the 1980s bore some relationship to book value, dividends and earnings once again. The industry initiated offerings of income and corporate and municipal bond funds to go with the original equity funds. However, the biggest sellers in the early 1980s were the money market funds. These are short term holdings which at one point paid over fifteen percent.

The concept of the no-load fund (no commission or fee) was developed, and cost conscious clients rushed for the bait. The bait was an unbeatable combination of convenience and lower cost. Offerings were made directly by mail to the consumer. Shares could be bought and sold (redeemed) by mail. If an investor was able to make up his mind, choosing from all the literature available to him, he could by-pass the salesman (broker) completely. Statistics showed mutual funds held their own and actually out-performed many other investments. Between 1978-1980, the pension funds (more cost conscious than ever due to high inflation rates) jumped into the Mutual Fund Market with both feet, doubling their investment form 1.4 billion to 2.9 billion.

WHY ARE MUTUAL FUNDS SO POPULAR?

It is not surprising that the small individual investor gets poorer information and fewer breaks than the institutions or wealthy investors. It takes the same effort to sell 50 shares as it does to sell 50,000 shares. Mutual Funds put a change to that. Small investors, by pooling their resources, are able to attract the best investment advisors and fund managers in the industry; something not one of them would probably be able to afford on his own. It is the job of the Mutual Fund's advisor to evaluate the past by giving just the right amount of credence to the rate of return that has been earned by the fund compared to similar funds and the overall investment market. The fee for this advice is usually the largest expense a mutual fund faces. The ratio between the fund's assets and this fee, plus any office overhead, is referred to as the fund's expense ratio. Of course the lower the expense ratio the better. In a load fund there is an additional interest fee so the return had better be superior to that of the no-loads.

Convenience is another reason mutual funds are popular. Withdrawals and purchases can be set up on a monthly worry-free basis. The fund redeems shares at the current NA (net asset value) with no hassle or discounts. Bookkeeping for tax purposes is done by the fund and sent to the individual investors. One certificate is evidence of shares in several different companies; much more convenient than shuffling the stock certificates of twenty or thirty companies.

However, diversification is probably the number one reason investors find mutual funds so inviting. You might be invested in several institutions, all diverse with a total of fifty to one hundred stocks spread among them. Remember the more kinds of stock you own the lower your risk.

KINDS OF MUTUAL FUNDS

OPEN AND CLOSED-END FUNDS

The closed-end funds have a fixed number of outstanding shares that are traded on the open market. Usually the issuing company will not buy back their own shares. The price, as with everything on the stock market, fluctuates according to supply and demand. The price of a closed-end share bears no direct relationship to its *net asset value* (NAV) which is the fund's assets minus liabilities divided by all shareholders, the price is pushed up when the demand is high and drops when the demand eases.

Open-end funds are more numerous than closed. The number of shares is not *fixed* but is *open*. The corporation can issue more shares as the demand arises. An investor buys from and sells directly to the company. Shares are not traded on the open market. The price is determined by the NAV, discussed above. Most of the Mutual Funds we are discussing are open-end. Open-end funds are currently the most popular.

STOCK FUNDS

These funds invest in both growth and income stocks. A typical diversified stock fund portfolio might consist of growth stocks, where the income received is incidental, riskier more aggressive growth stocks and income stocks offering the highest yields where growth is secondary.

BOND FUNDS

Mutual funds invest in all or only one or two of the following types of bonds: U.S. government bonds that are risk free but offer lower yields because of the increased security; top rated corporate bonds offering a high yield but with limited risk; and finally the lower quality corporate bonds with a higher yield and more risk.

BALANCED FUNDS

These funds try to achieve a balance in their portfolios between stocks and bonds. The traditional balance has been two-thirds stocks and one-third bonds. The income-oriented balance funds attempt to accumulate more bonds when interest rates are higher than dividend returns and vice versa.

MUNICIPAL BOND FUNDS

These funds are popular because their income is tax exempt. Investments here are classified according to the length of time the funds are committed. They can be bought as tax-free money markets (very short term), intermediate or longer term and in the category of high yield, lower grade but long term bonds.

TAX-MANAGED FUNDS

Tax-managed funds emphasize utilities. The objective is to minimize taxes by reinvesting income instead of paying taxable dividends. That way the investors qualify for long-term capital gains treatment.

SPECIALIZED FUNDS

An investor can purchase mutual funds that specialize in one particular market such as gold and everything to do with it. Other funds specialize in chemical or energy companies exclusively or

the stocks of other nations traded on foreign exchanges. High technology stocks have become a popular specialty. If you feel strongly about a certain industry and if you search, chances are you'll find a mutual fund specializing in it. It would be prudent to remember that diversity is the name of the investment game and the more specialized mutual funds ignore that rule.

DUAL-PURPOSE FUNDS

These funds offer two kinds of shares; income and capital. The income shareholder has no need for, or interest in, capital appreciation and so the capital shareholder gets a double benefit. Similarly the capital shareholder is not interested in current income and is happy to see it go to the income shareholder. These are actually closed-end investment companies. The fund is organized for a definite period of time after which the income shares are retired at a fixed price. All the capital growth would go to the capital shareholder only at that time, the income shareholder having received all the income exclusively over the years. It is a win-win for both types of investor.

LETTER STOCK AND HEDGE FUNDS

Letter stock funds consist of stock holdings of companies that are so new or small that they are not registered with the SEC (Securities and Exchange Commission). Buyers of these stocks must sign a document (*letter*) which states that they will keep the stock for a specified time before reselling.

Hedge funds involve wheeling and dealing and are grouped with Letter Stock Funds because neither are prudent investment for the novice. They are both highly speculative mutual funds and are brought to your attention as a cautionary measure.

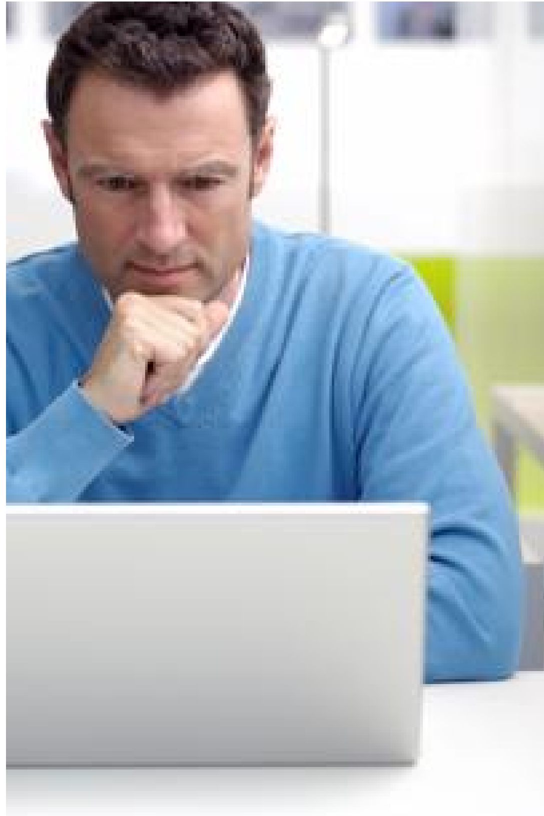
VENTURE CAPITAL FUNDS

Venture Capital Funds could also be grouped with the two funds mentioned above. The small non-professional investor should be warned about these funds also. They are not registered with the SEC in some instances, and those that are often provide the start-up capital to other companies too new to have been tested. The estimation of the new company's ability to stand in the marketplace is left wholly to the discretionary judgment of the Venture Capital Fund's manager. To risk your investment dollars solely on a manager’s judgment is not prudent for a beginning investor.

FAMILY OF FUNDS

Investment companies that can offer a variety of funds with different objectives have gained in popularity. A *Family of Funds* may refer to separate corporations, a trust or maybe a single corporation with a series of separate and distinct portfolios, called, not surprisingly a *series fund*. This makes switching from one fund to another within the family very convenient. For instance you may invest in the Family's stock fund during your early years and wish to switch to an income fund upon retirement. This exchange privilege would allow a person to switch form a growth fund to a money market in order to protect his funds if he anticipates a market decline or vice versa.

YOUR GOALS COMPARED TO THE OBJECTIVES OF THE MUTUAL FUND



In analyzing your own situation you should decide the amount of risk you are willing and able to take and see if there is a mutual fund with compatible objectives and policies. The worksheet at the end of the chapter is designed to help you do just that. I would caution you in examining a fund's past performance, to do so with the realization that there is no guarantee that the past will be repeated. There are, however, some guidelines to help you understand a fund's goals. Money market funds strive for current income without risk to principal. Bond funds emphasized stable income, whereas growth equity funds are best for obtaining capital appreciation. A retired person may prefer a combination: a stock fund for as a hedge against inflation; a bond fund for durable income and a money market for capital preservation.

WHEN SHOULD YOU INVEST?

In general it is never a good idea to invest a very large lump sum all at one time. It might be advisable to put all the money in a money market fund at the beginning and exchange within the same family of funds over a period of several months. Dollar cost averaging, discussed in another workbook, reduces risk. We referred to it as time diversification.

People have tried to jump into stocks when the market is low and reverse at the high point. It sounds so easy to invest in aggressive funds during runaway markets and switch back to conservative holdings in a trading market. Unfortunately statistics have shown that market-timing just doesn't work overall. The same illusive skill (luck) is required to pick the *hot* table and *cold* blackjack dealer in Las Vegas.

SAFEGUARDS

Mutual Funds are regulated by the SEC. Federal law mandates that only five percent of a mutual

fund's assets may be invested in securities of any single entity. A fund may own no more than ten percent of any class of securities issued by an individual company. Mutual funds are restricted to the amount they may borrow and must distribute ninety percent of their net income to shareholders annually.

SUMMARY

Mutual funds are a proven and popular investment vehicle. Many people with similar objectives are able to participate in a variety of investments by pooling their resources. Diversification, as you know by now, always reduces risk. The investors can also afford better quality (higher priced) management and advice than they could hope to obtain individually. Mutual funds outperform other types of traditional investments due to their well developed objectives and the size of their pooled assets which allows them to attract top managers. Mutual funds provide convenience and diversification. Not only that, the investor receives professional management and custodial administrative and bookkeeping services, all at an unbelievable low cost. They are often the ideal investment for a person who doesn't want to take time from his profession or business to handle investments.

Worksheet

CHOOSING A MUTUAL FUND

1. What do you want this fund to accomplish?

forced savings? ____

college tuition for the kids? ____

retirement fund? ____

current income? ____

other? ____

2. What size is this fund?

____

(remember large size might be good for stability but a smaller fund will achieve large capital gains)

3. How diversified are its holdings? ____

(Often diversification = less risk but less diversification can more easily result in spectacular performance up and down!)

4. What are the objectives and investment policies of this mutual fund?

5. Analyze this Mutual Fund's Assets

a) Number of different companies
b) Size of companies
c) Primary fields of investment
d) Emphasis on investments in each of these fields
e) Balance between seasoned and unseasoned holdings
f) Proportion of bonds, preferred stock and cash
6. Are you prepared to invest regularly and long term? Mutual Funds are not the proper vehicle for short term speculation.
7. What do you know about the management of this Mutual Fund?
8. If you compare Fund A with Fund B do you know the period of time these investment records cover? What was the market environment? Was one Fund able to benefit because of spectacular growth-issues in a run-away bull market?
9. Have you checked the long term record before investing in this particular Mutual Fund? Long term is 10 years minimum.
10. Can this Mutual Fund hold its own in a bear (down) market?
11. Is this the best place for your investment dollars?

RECOMMENDED READING

Dow-Jones Irwin Guide to Mutual Funds, by Rugg & Hale
Gaining on the Market, by Charles J. Rolo
Money, by Michael Hayes
The Money Game, by Adam Smith
Competing for Stock Market Profits, by Paul F. Jessup
The Internet makes obtaining investment information about a particular company quick and easy. The increased speed via the expansion of broad band and wireless plus powerful search engines like Yahoo and Google make investing easier and safer than ever and give you no excuse not to do your research before investing.