Understanding Mutual Funds

In devising an investment strategy, would you put all of your money into one or two stocks and hope for the best? If you're like most people, the answer is "probably not." It would be more prudent to "diversify" your assets over a variety of stocks, so that your financial situation didn't depend on the performance of any one investment. Of course, diversification does not offer protection against overall market trends that generally affect stocks or bonds. However, it does protect against poor performance of a single stock or bond. Mutual funds are a good way to diversify your assets.

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What is a Mutual Fund?

A mutual fund is a collection of stocks, bonds or other securities owned by a group of investors and managed by one or more professional portfolio managers. Investing in mutual funds is one of the best ways to tap into the growth potential of the stock and bond markets. But with thousands of mutual funds to choose from, finding the funds that best suit your needs can be a tricky business. But, it doesn't have to be impossible. In fact, understanding mutual funds is easier than you might imagine. In general, mutual funds fall into three main categories: equity, bond and money market.

Equity Funds

Equity funds invest primarily in equities, or stocks. However, their portfolios differ depending on each fund's investment objective. Some funds, for example, invest in well-established "blue chip" companies. Others invest in a particular industry or sector of the economy, such as health care or finance. The primary benefit of investing in equity funds is the potential for capital appreciation over the long term. In return for this potential, investors must be willing to accept the risk of greater interim fluctuations in value.

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Equity funds can be further subdivided based on the market capitalization, or total market value, of the stocks they hold. Companies above a certain market-cap threshold are considered "large cap," companies below a market-cap threshold are "small cap," and everything else in the middle is "mid cap." These "market caps" are flexible and can change according to market conditions.

Bond Funds

Bond funds invest in government, municipal or corporate debt securities, and are similar to bonds in that they provide regular income. The advantage of bond funds is that you can invest a much smaller amount of money than you would need to buy an individual bond on your own. And like all mutual funds, bond funds offer diversification and professional management. Bond funds come in two varieties – taxable and tax-exempt. Dividends earned on corporate and U.S. government bond funds are subject to federal taxes, while municipal bond fund earnings are exempt from federal and state income taxes—and often local income taxes—for investors living in the state issuing the underlying bonds.

There are two basic types of risk associated with bond funds–credit risk and interest rate risk. Credit risk refers to the possibility that a bond's issuer may not be able to pay interest payments or principal when due. Interest rate risk is the fact that as interest rates rise, the value of bonds decline.

Money Market Funds

Money market funds provide low risk and high stability. They invest in short-term debt securities of U.S. government agencies, banks and corporations. While money market funds do not seek capital appreciation, they do attempt to maintain a constant share price – only the yield fluctuates. Also, most money market funds let investors write checks against their accounts. Like bond funds, money market funds fall into the taxable and tax-exempt categories. Taxable funds buy the best yielding short-term corporate or government issues available, while tax-exempt funds are limited to buying primarily municipal debt.

compliments of:

Money market funds are among the most conservative investment vehicles available, offering relative stability of principal, liquidity and a return that is generally higher than that available on most bank savings and checking accounts. It is important to remember that an investment in a money market fund is not insured or guaranteed by the Federal Deposit Insurance Corporation (FDIC) or any other government agency. And, although these funds seek to preserve the value of your investment at $1.00 per share, there is no guarantee that they will do so.

Mutual Fund Objectives

Once you know how a fund invests, you should consider its investment objective. Obviously, you'll want to choose mutual funds geared toward your own needs and goals. Funds may have a number of different objectives, but they generally fall into one of the following categories:

Growth Funds — These funds typically invest in stocks for share price appreciation rather than current income.

Growth and Income Funds —These funds seek long-term growth of capital, as well as current income. They invest in securities that may pay interest or dividends.

Balanced Funds — The objective of these funds is to preserve initial principal and provide current income in addition to long-term growth of principal and income. They pursue this by buying a mix of bonds, preferred stocks and common stocks.

Value Funds — Primarily, value funds invest in dividend-paying stocks of companies thought to be undervalued by the market. The funds generally seek to achieve total return through a combination of stock appreciation and dividend payments.

Some categories of funds zero in on specific geographic or economic areas of interest. They include:

Focused Funds — These funds seek high capital appreciation by concentrating their investments in the common stocks of a few select companies. The benefit of a focused fund is that the portfolio consists only of the portfolio manager's best stock picks. If successful, the non-diversified approach can produce returns that exceed those of a diversified fund. But, while a focused fund's concentrated approach has the potential to bring substantial returns, these funds generally entail more risk than a fund that is more broadly diversified.

Sector Funds — These funds concentrate their investments in securities of a specific industry or sector of the economy, such as health care, finance or utilities.

Global & International Funds —Global funds seek growth by investing in securities of companies from around the world, including those in the United States. International funds invest primarily in non-U.S. securities. These funds provide investors with another opportunity to diversify their mutual fund portfolios, since foreign markets don't always move in the same direction as the U.S. markets.

Professional Management

The world of investing moves quickly. Few investors have the time to track these changes, to study the trends that significantly affect the financial markets. Mutual fund investors have the time-tested benefit of professional management. These money managers are dedicated to helping the funds meet their objectives.

Risk/Return Considerations

No investment is risk-free, and mutual funds are no exception. Risks vary from fund to fund, and include market and interest rate risk. In addition, the narrower a fund's focus, the higher the level of risk involved. Focused funds, for example, are by design higher risk, since they "focus" their portfolios on a handful of investments. Similarly, sector funds present greater risk because their performance may depend on the success of a single industry. Global and international funds may expose investors to currency exchange and other risks not associated with investments in U.S. stocks.

Finding Funds that Suit Your Goals

Sound investing entails more than merely tracking the market for "hot" stocks; it requires a serious examination of your financial goals. Whatever the specifics of your situation, prior to committing any money, it's a good idea to develop an investment strategy. For any investment strategy to be successful, discipline and a long-term approach are essential. Once you identify your own needs, choosing the right portfolio of mutual funds becomes much easier.

Step-by-Step Guidance

Before you invest in a mutual fund, talk to a First Investors Financial Services Representative about which funds may be right for you. Your financial services representative can custom-tailor a portfolio based on your current financial situation and level of risk tolerance and will continue to work with you as your needs and goals change.

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