What is a Mutual Fund?

A mutual fund company pools the money of many investors and invests it for them in a collection of securities by purchasing stocks, bonds, money markets and/or other securities. These securities are often referred to as **holdings** and all of the fund's holdings combined make up the **portfolio**. The assets in a mutual fund's portfolio are managed by a professional money manager(s) who decides which securities to buy and sell based on the fund's investment objective, detailed in the fund's prospectus.

When you invest in a mutual fund, you are actually buying **shares in the fund**, which means you own a small percentage of the fund's entire portfolio. These shares are a fractional representation of the entire mutual fund's diversified holdings. **The price of a share at any time is called the fund's net asset value, or NAV**. If you invest $1,000 in a mutual fund with an NAV of $24.75, you will receive 40.40 shares of that fund. (Unlike stocks, you can own fractional shares in a mutual fund). When the value of the portfolio increases, the value of your investment also increases. If, however, the value of the fund decreases, your investment value will decrease as well.

The primary asset categories found in mutual funds are money markets, bonds, and/or stocks. Mutual funds may invest in a single asset class or a combination of all. Maintaining the weight of each category and the decision on when to buy or sell is the function of the mutual fund's manager(s). Typically, the fund category indicates the primary investments (holdings) of the fund. For example, a fund that holds 85% stocks, 10% bonds and 5% cash equivalents is typically categorized as a stock fund

How Mutual Funds Work

Every mutual fund has a goal - either growing its assets (capital gains) and/or generating income (dividends) for its investors. Distributions in the form of capital gains (short-term and long-term) and dividends may be passed on (paid) to shareholders as income or reinvested to purchase more shares. For tax purposes, keep track of your distributions and cost basis of purchased/reinvested shares.

Like any business, mutual funds have risks and costs associated with returns. As a shareholder, the risks of a fund and the expenses associated with fund's operation directly impact your return.

Returns

As an investor, you want to know the fund's return-its track record over a specified period of time. So what exactly is "return?"

A mutual fund's **return** is the rate of increase or decrease in its value over a specific period of time usually expressed in the following increments: one, three, five, and ten year, year to date, and since the inception of the fund. Since return is a common measure of performance, you can use it to evaluate and compare mutual funds within the same fund category. Generally expressed as an annualized percentage rate, return is calculated assuming that all distributions from the fund are reinvested.

Since average returns can sometimes "hide" short-term highs and lows, you should evaluate returns for a time period of several years-not just one year or less. A fund that has a high return in one year may have experienced losses in other years-these fluctuations may not be apparent in its average return. **While a fund's return shows its track record, keep in mind that past performance is no guarantee of future results.**

When using returns to compare funds, always use net returns. Net returns are the true returns of both load and no-load funds after deducting all costs and expenses

Risk

Every type of investment, including mutual funds, involves risk. Risk refers to the possibility that you will lose money (both principal and any earnings) or fail to make money on an investment. A fund's investment objective and its holdings are influential factors in determining how risky a fund is. Reading the prospectus will help you to understand the risk associated with that particular fund.

Generally speaking, risk and potential return are related. This is the risk/return trade-off. Higher risks are usually taken with the expectation of higher returns at the cost of increased volatility. While a fund with higher risk has the potential for higher return, it also has the greater potential for losses or negative returns. The school of thought when investing in mutual funds suggests that the longer your investment time horizon is the less affected you should be by short-term volatility.   Therefore, the shorter your investment time horizon, the more concerned you should be with short-term volatility and higher risk.

How do the professionals manage risk? click here

Advantages

What are the key advantages of mutual fund investing?

Diversification

Using mutual funds can help an investor diversify their portfolio with a minimum investment. When investing in a single fund, an investor is actually investing in numerous securities. Spreading your investment across a range of securities can help to reduce risk. A stock mutual fund, for example, invests in many stocks - hundreds or even thousands. This minimizes the risk attributed to a concentrated position. If a few securities in the mutual fund lose value or become worthless, the loss maybe offset by other securities that appreciate in value. Further diversification can be achieved by investing in multiple funds which invest in different sectors or categories. This helps to reduce the risk associated with a specific industry or category. Diversification may help to reduce risk but will never completely eliminate it. It is possible to lose all or part of your investment.

Professional Management:

Mutual funds are managed and supervised by investment professionals. As per the stated objectives set forth in the prospectus, along with prevailing market conditions and other factors, the mutual fund manager will decide when to buy or sell securities. This eliminates the investor of the difficult task of trying to time the market. Furthermore, mutual funds can eliminate the cost an investor would incur when proper due diligence is given to researching securities. This cost of managing numerous securities is dispersed among all the investors according to the amount of shares they own with a fraction of each dollar invested used to cover the expenses of the fund. What does this mean? Fund managers have more money to research more securities more in depth than the average investor.

Convenience:

With most mutual funds, buying and selling shares, changing distribution options, and obtaining information can be accomplished conveniently by telephone, by mail, or online.

Although a fund's shareholder is relieved of the day-to-day tasks involved in researching, buying, and selling securities, an investor will still need to evaluate a mutual fund based on investment goals and risk tolerance before making a purchase decision. Investors should always read the prospectus carefully before investing in any mutual fund.

Liquidity:

Mutual fund shares are liquid and orders to buy or sell are placed during market hours. However, orders are not executed until the close of business when the NAV (Net Average Value) of the fund can be determined. Fees or commissions may or may not be applicable. Fees and commissions are determined by the specific fund and the institution that executes the order.

Minimum Initial Investment:

Most funds have a minimum initial purchase of $2,500 but some are as low as $1,000. If you purchase a mutual fund in an IRA, the minimum initial purchase requirement tends to be lower. You can buy some funds for as little as $50 per month if you agree to dollar-cost average, or invest a certain dollar amount each month or quarter.

Disadvantages

Risks and Costs:

Changing market conditions can create fluctuations in the value of a mutual fund investment.

There are fees and expenses associated with investing in mutual funds that do not usually occur when purchasing individual securities directly.

As with any type of investment, there are drawbacks associated with mutual funds.

- **No Guarantees.** The value of your mutual fund investment, unlike a bank deposit, could fall and be worth less than the principle initially invested. And, while a money market fund seeks a stable share price, its yield fluctuates, unlike a certificate of deposit. In addition, mutual funds are not insured or guaranteed by an agency of the U.S. government. Bond funds, unlike purchasing a bond directly, will not re-pay the principle at a set point in time.
- **The Diversification "Penalty."** Diversification can help to reduce your risk of loss from holding a single security, but it limits your potential for a "home run" if a single security increases dramatically in value. Remember, too, that diversification does not protect you from an overall decline in the market.
- **Costs.** In some cases, the efficiencies of fund ownership are offset by a combination of sales commissions, 12b-1 fees, redemption fees, and operating expenses. If the fund is purchased in a taxable account, taxes may have to be paid on capital gains. Keep track of the cost basis of your initial purchase and new shares that are acquired by reinvesting distributions. It's important to compare the costs of funds you are considering. **Always look at "net" returns when comparing fund performances. Net return is the bottom line; an investment's true return after all costs are deducted.**

Prospectuses will not contain all the costs that affect the net return on your investment. This is why it is important to compare net returns whether or not the fund in a no-load or load fund.

Expenses

Because mutual funds are professionally managed investments, there are management fees and operating expenses associated with investing in a fund. These fees and expenses charged by the fund are passed onto shareholders and deducted from the fund's return.

These expenses are typically expressed as the expense ratio - the percent of fund assets spent (annually) on day-to-day operations. Expense ratios can vary widely among funds.

Expense ratios for mutual funds commonly range from 0.2% to 2.0%, depending on the fund. Consult the fund's prospectus to determine the expense ratio for a specific fund.

Make yourself aware of all fees and expenses that impact the fund's return by reducing gains and increasing losses.

Defining Mutual Fund costs

All mutual funds have costs, but some funds are more expensive to own than others. Be conscious of the effect of seemingly minor cost differences which can significantly affect the growth of your investment assets, especially over longer periods of time.

Mutual fund costs fall into two main categories: One-time fees and ongoing annual expenses. Not all funds charge one-time fees, but all funds charge ongoing annual fees of some sort.

One-Time Fees

Loads

Loads come in three forms:

- **Front-End Load**
  - Charged when you purchase fund shares-usually class A shares, effectively reducing your purchase amount.
  - May be charged on reinvested distributions.
  - Can be as high as 8.5%.
- **Back-End Load**
  - Charged when you sell fund shares.
  - Usually assessed based on the length of time you have held your shares, and declines over time.
  - **Maximum allowed is 8.5%**, but this is rarely seen. According to Lipper Inc., back-end loads can be as high as 6% if you sell shares within one year.
- **Level Load**
  - Deducted annually from fund assets as marketing and distribution costs.
  - Used to pay commissions to brokers and the fund's financial adviser, and is generally reported as part of a fund's operating expenses.
  - Can be as high as 0.75% per year, according to Lipper Inc.

Funds that have no sales charges are known as **"no-load,"** while funds that charge loads of 1% to 3% are called "low-load." Keep in mind; funds that have lower loads or no-loads tend to have higher operating expenses. **Again, read each fund's prospectus and compare "net" returns.**

Ongoing Annual Expenses

- Management Fees
- Distribution and Service Fees
- Other Expenses
- Underlying Fund Expenses

Other fees

In addition to sales loads, fund companies and brokerages may charge other fees when you buy or sell fund shares.

Taxes and Fund Ownership

Since your goal as an investor is to keep as much as possible of what you earn from your mutual fund investments, you can't overlook the inescapable reality that taxes take a big bite out of bottom-line returns. One way to shelter yourself from taxes is to purchase your funds in a retirement account.

As a fund shareholder, you can be taxed on:

- Distributions (dividends & capital gains) maid by the fund while you own its shares.
- Profits you make when you sell fund shares.

Taxes on Fund Distributions

A fund passes on to shareholders all the income or profits it earns from its investments. Shareholders, in turn, are liable for any taxes due. The distributions made by a fund to shareholders take two forms:

- Income Dividends. The interest and dividends generated by a fund's investments.
- Capital Gains. The profit a fund makes when it sells securities at a higher price than it paid for them. The fund subtracts its capital losses from its capital gains to determine its net capital gains, which it distributes to shareholders. (Net capital losses are not passed through to shareholders; the fund retains those to offset future capital gains.)

Generally, all income dividend and capital gains distributions are subject to federal income tax (and state and local taxes if applicable). Exceptions are:

- Distributions received in tax-deferred accounts, such as 401(k) and 403(b)(7) plans, individual retirement accounts, or variable annuities. Only withdrawals from such accounts are subject to tax. (Withdrawals from a Roth IRA are exempt from taxes under certain conditions.)
- Income dividend distributions from municipal money market funds and municipal bond funds. These distributions are exempt from federal and, in some cases, state taxes. (Capital gains distributions from municipal bond funds are taxable, however.)

Apart from the exceptions noted above, you must pay taxes on distributions whether you receive them in cash or reinvest them in additional shares.

Please remember that IRS tax rules can change. You should consult a tax adviser for guidance on your specific tax situation.

Taxes on Profits From Shares You Sell

When you sell fund shares, the tax rate on any capital gains is determined by how long you held the shares. Short-term gains are taxed as ordinary income at your marginal tax rate, while long-term gains are taxed at a maximum rate of 20% (10% for taxpayers in the lowest tax bracket).

Keep in mind that:

- All capital gains from the sale of fund shares are taxable, even those from the sale of shares of a tax-exempt fund.
- Exchanging shares between funds is considered a sale, which may lead to capital gains. (An exchange involves selling shares of one fund to buy shares in another.)
- Writing a check against an investment in a fund with a fluctuating share price (generally all funds except money market funds) also triggers a sale of shares and may expose you to tax on any resulting capital gains.

The impact of expenses on return over time is why you should consider expenses when you invest in mutual funds. Even though published return data is always reported net of expenses, higher expenses will reduce your investment return.

Mutual fund categories

Mutual funds fall into the following categories: money market funds, bonds funds, stocks funds, balanced funds, and asset allocation funds.

Stock funds

As the name implies, stock mutual funds invest mainly in common stocks. These stocks may be sold on the New York Stock Exchange, the NASDAQ or other exchanges.

The objective of a stock fund is long-term capital appreciation versus generating income (dividends) more common with bond funds. However, stock funds may generate modest dividends from the stocks in the portfolio and from short-term cash investments. These stock tend to be larger capitalized stocks versus smaller growth stocks.

Bond funds

Bond funds[1] invest in various types of bonds - issued by corporations, municipalities, and the U.S. government. Bond mutual funds are designed mostly to provide investors with a steady stream of income[2] versus capital gains.

Bond Fund Types:

- **Government:** Primarily invest in bonds issued by the U.S. Department of Treasury as well as various federal agencies. Government bonds are generally taxable.
- **Municipal:** Primarily invest in municipal bonds issued by state and local governments and their agencies to fund projects such as schools, streets, highways, hospitals, bridges, and airports. Municipal bonds can be insured or non-insured securities. Income generated from municipal bonds may be tax free at both the federal and state level (consult the funds prospectus).
- **Corporate:** Primarily invest in bonds issued by corporations to help fund business activities. Income from corporate bonds is taxable.

[1] Bond fund shares are not guaranteed and will fluctuate with market conditions and interest rates and include a greater risk to principal than Certificates of Deposit. Shares, when redeemed, may be worth more or less than their original cost.

[2] Income may be subject to the Alternative Minimum Tax (AMT) and capital appreciation from discounted bonds may be subject to state and local taxes.

Money market funds

Money market funds invest in short-term securities such as Treasury bills. Most money market funds offer a higher rate of interest than bank savings accounts, and some are free of federal or state taxes. But unlike bank savings accounts, money market funds are not FDIC insured.

Money market mutual funds are designed to be more stable than stock or bond funds. Money market funds are designed to provide steady dividend income on the investment amount, although the yield may fluctuate daily.

Taxable: Invest in short-term obligations from corporations.

Tax-free: Invest in short-term obligations from government entities.

Balanced Funds:

- Invest in stocks, bonds, and cash investments, in varying proportions.
- Produce dividend and capital gain distributions and share price appreciation in proportion to their allocation among the three major asset classes.

Asset Allocation Funds:

In an asset allocation fund, the manager will diversify the assets among each category: cash, bonds, and stocks and weight them according to the portfolio strategy. The manager will redistribute the weightings according to market conditions. Portfolio strategies generally differ according to risk tolerance:

- Aggressive Growth Strategy Portfolio
- Growth Strategy Portfolio
- Growth and Income Strategy Portfolio
- Income Strategy Portfolio

Asset allocation funds are usually made up of a combination of other mutual funds within the same fund family. As market conditions change, the manager has the discretion to reduce exposure in one fund and increase it in another. Just about all mutual fund families allow you to switch between funds in the same family and class (A, B, or C shares) without incurring any costs.

You make money from your mutual fund investment when:

- The fund earns income on its investments, and distributes it to you in the form of dividends.
- The fund produces capital gains by selling securities at a profit, and distributes those gains to you.
- You sell your shares of the fund at a higher price than you paid for them.

TASK: Mutual fund EXAMPLES: Mutual funds fall into the following categories: money market funds, bonds funds, stocks funds, balanced funds, and asset allocation funds. Use this website and research types of mutual funds, risk level, average performance (5 years or more).
https://www.rbcgam.com/en/ca/products/mutual-funds/?tab=overview&series=f

TYPE OF FUND	DESCRIPTION OF FUND	RISK LEVEL	AVERAGE PERFORMANCE (5 YEARS OR MORE)
Stock (equity only) funds			
Government Bonds			
Corporate Bonds			
Money market funds			
Balanced Funds			
Aggressive Growth Fund			
Income Strategy Fund			