



Mutual Funds

A Guide for Investors



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Mutual Funds

Over the past decade, American investors increasingly have turned to mutual funds to save for retirement and other financial goals. Mutual funds can offer the advantages of diversification and professional management. But, as with other investment choices, investing in mutual funds involves risk. And fees and taxes will diminish a fund's returns. It pays to understand both the upsides and downsides of mutual fund investing and how to choose products that match your goals and tolerance for risk.

This brochure explains the basics of mutual fund investing, how mutual funds work, what factors to consider before investing, and how to avoid common pitfalls.

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Key Points to Remember

- ☑ Mutual funds are *not* guaranteed or insured by the FDIC or any other government agency—even if you buy through a bank and the fund carries the bank’s name. You can lose money investing in mutual funds.
- ☑ Past performance is not a reliable indicator of future performance so don’t be dazzled by last year’s high returns. But past performance can help you assess a fund’s volatility over time.
- ☑ All mutual funds have costs that lower your investment returns. Shop around and compare fees.

How Mutual Funds Work

WHAT THEY ARE

A mutual fund is a company that pools money from many investors and invests the money in stocks, bonds, short-term money-market instruments, other securities or assets, or some combination of these investments. The combined holdings the mutual fund owns are known as its portfolio. Each share represents an investor's proportionate ownership of the fund's holdings and the income those holdings generate.

OTHER TYPES OF INVESTMENT COMPANIES

Legally known as an "open-end company," a mutual fund is one of three basic types of investment companies. While this brochure discusses only mutual funds, you should be aware that other pooled investment vehicles exist and may offer features that you desire. The two other basic types of investment companies are:

- **Closed-end funds**—which, unlike mutual funds, sell a fixed number of shares at one time (in an initial public offering) that later trade on a secondary market; and
- **Unit Investment Trusts (UITs)**—which make a one-time public offering of only a specific, fixed number of redeemable securities called "units" and which will terminate and dissolve on a date specified at the creation of the UIT.

"Exchange-traded funds" (ETFs) are a type of investment company that aims to achieve the same return as a particular market index. They can be either open-end companies or UITs. But ETFs are not considered to be, and are not permitted to call themselves, mutual funds.

A WORD ABOUT HEDGE FUNDS AND “FUNDS OF HEDGE FUNDS”

“Hedge fund” is a general, non-legal term used to describe private, unregistered investment pools that traditionally have been limited to sophisticated, wealthy investors. Hedge funds are not mutual funds and, as such, are not subject to the numerous regulations that apply to mutual funds for the protection of investors—including regulations requiring a certain degree of liquidity, regulations requiring that mutual fund shares be redeemable at any time, regulations protecting against conflicts of interest, regulations to assure fairness in the pricing of fund shares, disclosure regulations, regulations limiting the use of leverage, and more.

“Funds of hedge funds,” a relatively new type of investment product, are investment companies that invest in hedge funds. Some, but not all, register with the SEC and file semi-annual reports. They often have lower minimum investment thresholds than traditional, unregistered hedge funds and can sell their shares to a larger number of investors. Like hedge funds, funds of hedge funds are not mutual funds. Unlike open-end mutual funds, funds of hedge funds offer very limited rights of redemption. And, unlike ETFs, their shares are not typically listed on an exchange.

For more information about hedge funds, please read our publication entitled *Hedging Your Bets: A Heads Up on Hedge Funds and Funds of Hedge Funds* at www.sec.gov/answers/hedge.htm.

For more information about funds of hedge funds, please read the Financial Industry Regulatory Authority’s (FINRA) Investor Alert entitled *Funds of Hedge Funds—Higher Costs and Risks for Higher Potential Returns* at www.finra.org.

CHARACTERISTICS OF FUNDS

Some of the traditional, distinguishing characteristics of mutual funds include the following:

- Investors purchase mutual fund shares from the fund itself (or through a broker for the fund) instead of from other investors on a secondary market, such as the New York Stock Exchange or Nasdaq Stock Market.
- The price that investors pay for mutual fund shares is the fund’s per share net asset value (NAV) plus any shareholder fees that the fund imposes at the time of purchase (such as sales loads).

- Mutual fund shares are “redeemable,” meaning investors can sell their shares back to the fund (or to a broker acting for the fund).
- Mutual funds generally create and sell new shares to accommodate new investors. In other words, it sells its shares on a continuous basis, although some funds stop selling when, for example, they become too large.
- The investment portfolios of mutual funds typically are managed by separate entities known as “investment advisers” that are registered with the SEC.

ADVANTAGES AND DISADVANTAGES

Every investment has advantages and disadvantages. But it’s important to remember that features that matter to one investor may not be important to you. Whether any particular feature is an advantage for you will depend on your unique circumstances. For some investors, mutual funds provide an attractive investment choice because they generally offer the following features:

- **Professional Management**—Professional money managers research, select, and monitor the performance of the securities the fund purchases.
- **Diversification**—Diversification is an investing strategy that can be neatly summed up as “Don’t put all your eggs in one basket.” Spreading your investments across a wide range of companies and industry sectors can help lower your risk if a company or sector fails. Some investors find it easier to achieve diversification through ownership of mutual funds rather than through ownership of individual stocks or bonds.
- **Affordability**—Some mutual funds accommodate investors who don’t have a lot of money to invest by setting relatively low dollar amounts for initial purchases, subsequent monthly purchases, or both.
- **Liquidity**—Mutual fund investors can readily redeem their shares at the current NAV—plus any fees and charges assessed on redemption—at any time.

But mutual funds also have features that some investors might view as disadvantages, such as:

- **Costs Despite Negative Returns**—Investors must pay sales charges, annual fees, and other expenses (which we discuss in detail on page 13) regardless of how the fund performs. And, depending on the timing of their investment, investors may also have to pay taxes on any capital gains distribution they receive—even if the fund went on to perform poorly after they bought shares.
- **Lack of Control**—Investors typically cannot ascertain the exact make-up of a fund’s portfolio at any given time, nor can they directly influence which securities the fund manager buys and sells or the timing of those trades.
- **Price Uncertainty**—With an individual stock, you can obtain real-time (or close to real-time) pricing information with relative ease by checking financial websites or by calling your broker. You can also monitor how a stock’s price changes from hour to hour—or even second to second. By contrast, with a mutual fund, the price at which you purchase or redeem shares will typically depend on the fund’s NAV, which the fund might not calculate until many hours after you’ve placed your order. In general, mutual funds must calculate their NAV at least once every business day, typically after the major U.S. exchanges close.

DIFFERENT TYPES OF FUNDS

When it comes to investing in mutual funds, investors have literally thousands of choices. Before you invest in any given fund, decide whether the investment strategy and risks of the fund are a good fit for you. The first step to successful investing is figuring out your financial goals and risk tolerance—either on your own or with the help of a financial professional. Once you know what you’re saving for, when you’ll need the money, and how much risk you can tolerate, you can more easily narrow your choices.

Most mutual funds fall into one of three main categories—money market funds, bond funds (also called “fixed income” funds), and stock funds (also called “equity” funds). Each type has different features and different risks and rewards. Generally, the higher the potential return, the higher the risk of loss.

Money Market Funds

Money market funds have relatively low risks, compared to other mutual funds (and most other investments). By law, they can invest in only certain high-quality, short-term investments issued by the U.S. Government, U.S. corporations, and state and local governments. Money market funds try to keep their net asset value (NAV)—which represents the value of one share in a fund—at a stable \$1.00 per share. But the NAV may fall below \$1.00 if the fund’s investments perform poorly. Investor losses have been rare, but they are possible.

Money market funds pay dividends that generally reflect short-term interest rates, and historically the returns for money market funds have been lower than for either bond or stock funds. That’s why “inflation risk”—the risk that inflation will outpace and erode investment returns over time—can be a potential concern for investors in money market funds.

Bond Funds

Bond funds generally have higher risks than money market funds, largely because they typically pursue strategies aimed at producing higher yields. Unlike money market funds, the SEC’s rules do not restrict bond funds to high-quality or short-term investments. Because there are many different types of bonds, bond funds can vary dramatically in their risks and rewards. Some of the risks associated with bond funds include:

Credit Risk—the possibility that companies or other issuers whose bonds are owned by the fund may fail to pay their debts (including the debt owed to holders of their bonds). Credit risk is less of a factor for bond funds that invest in insured bonds or U.S. Treasury Bonds. By contrast, those that invest in the bonds of companies with poor credit ratings generally will be subject to higher risk.

Interest Rate Risk—the risk that the market value of the bonds will go down when interest rates go up. Because of this, you can lose money in any bond fund, including those that invest only in insured bonds or U.S. Treasury Bonds. Funds that invest in longer-term bonds tend to have higher interest rate risk.

Prepayment Risk—the chance that a bond will be paid off early. For example, if interest rates fall, a bond issuer may decide to pay off (or “retire”) its debt and issue new bonds that pay a lower rate. When this happens, the fund may not be able to reinvest the proceeds in an investment with as high a return or yield.

Stock Funds

Although a stock fund’s value can rise and fall quickly (and dramatically) over the short term, historically stocks have performed better over the long term than other types of investments—including corporate bonds, government bonds, and treasury securities.

Overall “market risk” poses the greatest potential danger for investors in stocks funds. Stock prices can fluctuate for a broad range of reasons—such as the overall strength of the economy or demand for particular products or services.

Not all stock funds are the same. For example:

- *Growth* funds focus on stocks that may not pay a regular dividend but have the potential for large capital gains.
- *Income* funds invest in stocks that pay regular dividends.
- *Index* funds aim to achieve the same return as a particular market index, such as the S&P 500 Composite Stock Price Index, by investing in all—or perhaps a representative sample—of the companies included in an index.
- *Sector* funds may specialize in a particular industry segment, such as technology or consumer products stocks.

HOW TO BUY AND SELL SHARES

You can purchase shares in some mutual funds by contacting the fund directly. Other mutual fund shares are sold mainly through brokers, banks, financial planners, or insurance agents. All mutual funds will redeem (buy back) your shares on any business day and must send you the payment within seven days.

EXCHANGING SHARES

A “family of funds” is a group of mutual funds that share administrative and distribution systems. Each fund in a family may have different investment objectives and follow different strategies.

Some funds offer exchange privileges within a family of funds, allowing shareholders to transfer their holdings from one fund to another as their investment goals or tolerance for risk change. While some funds impose fees for exchanges, most funds typically do not. To learn more about a fund's exchange policies, call the fund's toll-free number, visit its website, or read the “shareholder information” section of the prospectus.

Bear in mind that exchanges have tax consequences. Even if the fund doesn't charge you for the transfer, you'll be liable for any capital gain on the sale of your old shares or, depending on the circumstances, eligible to take a capital loss. We'll discuss taxes in further detail below.

The easiest way to determine the value of your shares is to call the fund's toll-free number or visit its website. The financial pages of major newspapers sometimes print the NAVs for various mutual funds. When you buy shares, you pay the current NAV per share plus any fee the fund assesses at the time of purchase, such as a purchase sales load or other type of purchase fee. When you sell your shares, the fund will pay you the NAV minus any fee the fund assesses at the time of redemption, such as a deferred (or back-end) sales load or redemption fee. A fund's NAV goes up or down daily as its holdings change in value.

HOW FUNDS CAN EARN MONEY FOR YOU

You can earn money from your investment in three ways:

- 1. Dividend Payments**—A fund may earn income in the form of dividends and interest on the securities in its portfolio. The fund then pays its shareholders nearly all of the income (minus disclosed expenses) it has earned in the form of dividends.

2. **Capital Gains Distributions**—The price of the securities a fund owns may increase. When a fund sells a security that has increased in price, the fund has a capital gain. At the end of the year, most funds distribute these capital gains (minus any capital losses) to investors.
3. **Increased NAV**—If the market value of a fund’s portfolio increases, after deduction of expenses and liabilities, then the value (NAV) of the fund and its shares increases. The higher NAV reflects the higher value of your investment.

With respect to dividend payments and capital gains distributions, funds usually will give you a choice: the fund can send you a check or other form of payment, or you can have your dividends or distributions *reinvested* in the fund to buy more shares (often without paying an additional sales load).

Factors to Consider

Thinking about your long-term investment strategies and tolerance for risk can help you decide what type of fund is best suited for you. But you should also consider the effect that fees and taxes will have on your returns over time.

DEGREES OF RISK

All funds carry some level of risk. You may lose some or all of the money you invest—your principal—because the securities held by a fund go up and down in value. Dividend or interest payments may also fluctuate as market conditions change.

Before you invest, be sure to read a fund’s prospectus and shareholder reports to learn about its investment strategy and the potential risks. Funds with higher rates of return may take risks that are beyond your comfort level and are inconsistent with your financial goals.

A WORD ABOUT DERIVATIVES

Derivatives are financial instruments whose performance is derived, at least in part, from the performance of an underlying asset, security, or index. Even small market movements can dramatically affect their value, sometimes in unpredictable ways.

There are many types of derivatives with many different uses. A fund’s prospectus will disclose whether and how it may use derivatives. You may also want to call a fund and ask how it uses these instruments.

FEEES AND EXPENSES

As with any business, running a mutual fund involves costs—including shareholder transaction costs, investment advisory fees, and marketing and distribution expenses. Funds pass along these costs to investors by imposing fees and expenses. It is important that you understand these charges because they lower your returns.

Some funds impose “shareholder fees” directly on investors whenever they buy or sell shares. In addition, every fund has regular, recurring, fund-wide “operating expenses.” Funds typically pay their operating expenses out of fund assets—which means that investors indirectly pay these costs.

SEC rules require funds to disclose both shareholder fees and operating expenses in a “fee table” near the front of a fund’s prospectus. The lists below will help you decode the fee table and understand the various fees a fund may impose:

Shareholder Fees

- **Sales Charge (Load) on Purchases**—the amount you pay when you buy shares in a mutual fund. Also known as a “front-end load,” this fee typically goes to the brokers that sell the fund’s shares. Front-end loads reduce the amount of your investment. For example, let’s say you have \$1,000 and want to invest it in a mutual fund with a 5% front-end load. The \$50 sales load you must pay comes off the top, and the remaining \$950 will be invested in the fund. According to the rules of FINRA, a front-end load cannot be higher than 8.5% of your investment.
- **Purchase Fee**—another type of fee that some funds charge their shareholders when they buy shares. Unlike a front-end sales load, an after purchase fee is paid to the fund (not to a broker) and is typically imposed to defray some of the fund’s costs associated with the purchase.
- **Deferred Sales Charge (Load)**—a fee you pay when you sell your shares. Also known as a “back-end load,” this fee typically goes to the brokers that sell the fund’s shares. The most common type of back-end sales load is the “contingent deferred sales load” (also known as a “CDSC” or “CDSL”). The amount of this type of load will depend on how long the investor holds his or her shares and typically decreases to zero if the investor holds his or her shares long enough.
- **Redemption Fee**—another type of fee that some funds charge their shareholders when they sell or redeem shares. Unlike a deferred sales load, a redemption fee is paid to the fund (not to a broker) and is typically used to defray fund costs associated with a shareholder’s redemption.

- **Exchange Fee**—a fee that some funds impose on shareholders if they exchange (transfer) to another fund within the same fund group or “family of funds.”
- **Account Fee**—a fee that some funds separately impose on investors in connection with the maintenance of their accounts. For example, some funds impose an account maintenance fee on accounts whose value is less than a certain dollar amount.

Annual Fund Operating Expenses

- **Management Fees**—fees that are paid out of fund assets to the fund’s investment adviser for investment portfolio management, any other management fees payable to the fund’s investment adviser or its affiliates, and administrative fees payable to the investment adviser that are not included in the “Other Expenses” category (discussed below).
- **Distribution [and/or Service] Fees (“12b-1” Fees)**—fees paid by the fund out of fund assets to cover the costs of marketing and selling fund shares and sometimes to cover the costs of providing shareholder services. “Distribution fees” include fees to compensate brokers and others who sell fund shares and to pay for advertising, the printing and mailing of prospectuses to new investors, and the printing and mailing of sales literature. “Shareholder Service Fees” are fees paid to persons to respond to investor inquiries and provide investors with information about their investments.
- **Other Expenses**—expenses not included under “Management Fees” or “Distribution or Service (12b-1) Fees,” such as any shareholder service expenses that are not already included in the 12b-1 fees, custodial expenses, legal and accounting expenses, transfer agent expenses, and other administrative expenses.
- **Total Annual Fund Operating Expenses (“Expense Ratio”)**—the line of the fee table that represents the total of all of a fund’s annual fund operating expenses, expressed as a percentage of the fund’s average net assets. Looking at the expense ratio can help you make comparisons among funds.

Be sure to review carefully the fee tables of any funds you're considering, including no-load funds. Even small differences in fees can translate into large differences in returns over time. For example, if you invested \$10,000 in a fund that produced a 10% annual return before expenses and had annual operating expenses of 1.5%, then after 20 years you would have roughly \$49,725. But if the fund had expenses of only 0.5%, then you would end up with \$60,858—an 18% difference.

A WORD ABOUT "NO-LOAD" FUNDS

Some funds call themselves "no-load." As the name implies, this means that the fund does not charge any type of sales load. But, as discussed above, not every type of shareholder fee is a "sales load." A no-load fund may charge fees that are not sales loads, such as purchase fees, redemption fees, exchange fees, and account fees. No-load funds will also have operating expenses.

Some mutual funds that charge front-end sales loads will charge lower sales loads for larger investments. The investment levels required to obtain a reduced sales load are commonly referred to as "breakpoints."

The SEC does not require a fund to offer breakpoints in the fund's sales load. But, if breakpoints exist, the fund must disclose them. In addition, a brokerage firm that is a member of FINRA (formerly known as the National Association of Securities Dealers) should not sell you shares of a fund in an amount that is "just below" the fund's sales load breakpoint simply to earn a higher commission.

Each fund company establishes its own formula for how it will calculate whether an investor is entitled to receive a breakpoint. For that reason, it is important to seek out breakpoint information from your financial advisor or the fund itself. You'll need to ask how a particular fund establishes eligibility for breakpoint discounts, as well as what the fund's breakpoint amounts are.

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