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Personal Financial Literacy

Lesson 17

Investing in Mutual Funds

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ABU DHABI COUNCIL FOR ECONOMIC DEVELOPMENT

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Investing in Mutual Funds

A mutual fund pools money together from thousands of small investors and then its manager buys stocks, bonds or other securities with it.

When you contribute money to a fund, you get a stake in all its investments.

Mutual funds are extremely useful since they allow you to begin investing with as little as a couple thousand Dirhams, you can attain a diversified portfolio for much less than you could by buying individual stocks and bonds. Plus, you don't have to worry about keeping track of dozens of holdings – that's the fund manager's job.

The price for a share of an open-end fund is determined by the net asset value, or NAV, which is the total value of the securities the fund owns, divided by the number of shares outstanding.
If a mutual fund has a portfolio of stocks and bonds worth $10 million and there are a million shares, the NAV would be $10. A fund's NAV changes every day, depending on the price fluctuations of the fund's holdings.

The NAV is the price at which you can buy and sell shares, as long as you don't have to pay a sales commission, or "load." You have to pay loads when you buy from a broker, financial planner, insurance agent or other adviser.

There are different types of mutual funds. We will discuss both stock and bond funds in this section.

Stock Funds

When searching for stock mutual funds, you're going to run into all sorts of names and categories. They are usually pretty broad and sometimes misleading, but at least they give you an idea of what you are getting yourself into.

Here are some of the most common stock fund categories and sub-categories.

Value Funds

Value fund managers look for stocks that they think are cheap on the basis of earnings power (which means they often have low price/earnings ratios) or the value of their underlying assets (which means they often have relatively low price/book ratios).

Large-cap value managers typically look for big corporations whose shares are selling at discounted prices. Often these managers have to hang on for a long time before their picks pan out.

Small-cap value managers typically look for small companies (usually ones with market value of less than $1 billion) that have been ignored by other investors.

Growth Funds

There are many different breeds of growth funds. Some growth fund managers are content to buy shares in companies with mildly above-average revenue and earnings growth, while others, shooting for larger returns, try to catch the fastest growers before their prices drop.
Aggressive growth fund managers take on sizeable risk. These types of funds often lead the pack

over long periods of time – as well as over short periods when the stock market is booming – but when markets decline they may have issues.

Growth funds also invest in shares of rapidly growing companies, but lean more toward large established names.
As a result, growth funds won't increase as high in bull markets as their aggressive cousins, but they hold up a bit better when the market starts to go down.

Consider them if you're seeking high long-term returns and can tolerate the normal ups and downs of the stock market. For most long-term investors, a growth fund should be the core holding around which the rest of their portfolio is built.

Growth-and-Income, Equity-Income, and Balanced Funds

These three types of funds have a common goal: Providing steady long-term growth while simultaneously throwing off reliable income. They all hold some combination of dividend-paying stocks and income-producing securities, such as bonds or convertible securities (bonds or special types of stocks that pay interest but can also be converted into the company›s regular shares).

Growth-and-income funds concentrate more than the other two on growth, so they generally have the lowest yields. Balanced funds strive to keep anywhere from 50 to 60 percent of their holdings in stocks and the rest in interest-paying securities such as bonds and convertibles, giving them the highest yields. In the middle is the equity-income class.

All three types tend to hold up better than growth funds when the market turns sour, but lag in a raging bull market.

All of these are for risk-averse investors and anyone seeking current income without forgoing the potential for capital growth.

Specialty and Other Types of Funds

Rather than diversifying their holdings, sector and specialty funds concentrate their assets in a particular sector, such as technology or health care. There's nothing wrong with that approach, as long as you remember that one year's top sector could crash the following year.

They are most appropriate for investors who are interested in a particular theme – say, biotech – but want to defray some of the risk of choosing individual stocks within the sector.

Bond Funds

Mutual Funds also include funds that invest specifically in bonds. These funds invest primarily in bonds issued by the U.S. Treasury or federal government agencies, which means you don't have to worry about credit risk. But because of their higher level of safety, their yields and total returns tend to be slightly lower than those of other bond funds.

That's not to say government bonds funds don't fluctuate – they do, right along with interest rates. If you can't tolerate swings of more than a few percentage points, stick to short-term government bond funds.

If fluctuations of 5 percent or so don't cause you to panic, then you can pick up a bit more yield with intermediate government bond funds. If you plan on holding on for several years and can handle 10 percent swings, long-term government bond funds will provide even more yield.

Corporate Bond Funds

Funds in this category buy the bonds issued by corporations that may range from well-known household names to obscure widget makers most of us have never heard of.

When researching corporate bonds funds, consider the credit quality of the individual bonds they hold (most hold highly rated bonds, AAA to A minus or A3, but some take more risk by adding small doses of high-yielding junk bonds.) Also consider the average maturity of the bonds – the longer the average maturity, the greater the volatility.

High-Yield Bond Funds

Putting the euphemism aside, these are junk bond funds. They invest in debt of fledgling or small firms whose staying power is untested as well as in the bonds of large, well-known companies in weakened financial condition.

The potential for these companies to default on their interest payments is much greater than on higher quality bonds, but since these funds usually hold more than 100 issues, a default here and there won't capsize the fund.

There is more risk, however, and for that, you get higher yields – usually 3 to 10 percentage points more than safer bond funds. These funds tend to shine when the economy is on a roll, and suffer when the economy is fading (increasing the chance of default).

Who should buy them: Investors who want to boost their income and total returns and can tolerate losses of 10 percent or so during periods of economic turbulence.

Municipal Bond Funds

Tax-exempt bond funds – also known as muni bond funds – invest in the bonds issued by cities, states, and other local government entities in the United States. As a result, they generate dividends that are free from federal income taxes.

The income from muni bond funds that invest only in the issues of a single state is also exempt from state and local taxes for resident shareholders. Once you factor in the tax benefits, muni funds often offer better yields than government and corporate funds.

Guidelines for Choosing Stock Funds

In-depth mutual fund information is widely available, either from the funds themselves or third-party ratings companies like Morningstar (see http://www.morningstar.com/). Here are some things to look out for:

1. Opt for funds With Low Expenses

Fund expenses directly reduce your returns, so you'll increase your odds of success by avoiding funds with bloated expense ratios; that's the annual cost, divided by your investment.

2. Look for Consistency of Style

For a fund to fit into a diversified portfolio, it's important that the manager stick to a particular investing style. If you bought a fund because you want your portfolio to include, say, small value stocks, then you don't want a fund manager jumping into large growth issues.

3. Consider Risk

Returns may vary, but funds that are risky tend to stay risky. So be sure to check out the route the fund took to rack up past gains and decide whether you would be comfortable with such a ride. Here are some risk measures to consider.

Beta measures how much a fund's value jumps around in relation to changes in the value of the S&P 500 index, which by definition has a beta of 1.0. A stock fund with a beta of 1.20 is 20 percent more volatile than the S&P – that is, for every move in the S&P, the fund will move 20 percent more in either direction, up or down.

Standard deviation tells you how much a fund fluctuates from its own average returns. A standard deviation of 10 means the fund's monthly returns usually fall within 10 percentage points of their average. The higher the standard deviation, the more volatile the fund can be.

Worst quarter is a very straightforward measure of risk: It merely shows the fund's worst quarterly return on record, giving you a feel of what to brace yourself for.

4. Check Out Past Performance Relative to Peers

When examining a fund's performance, you should look at its long-term record (at least three years and preferably five years) versus that of its peers, as well as how it has fared over shorter stretches.

Compare those results to category averages – you can't really fault a small-cap fund manager for a lousy year if all small-cap funds did poorly. But it's a lot harder to be forgiving if a fund does much worse than all its peers, especially if it does so over a sustained period.

5. Seek Low Taxes

You can't forget about taxes just because you don't have any intention of selling your fund shares, or because the UAE does not have income taxes. As a fund owner, you also own all the stocks in the fund's portfolio. If the fund manager sells a stock for a huge capital gain, you'll have to report that gain on your tax return.

6. Steer Clear of Unusual Asset Weighting

This is more of an issue with small-cap funds than with large-cap funds. The latter funds buy big stocks with a lot of shares outstanding, so the manager shouldn't have too much of a problem buying more GE and IBM when investors pour money into the fund.
But since small-cap funds are buying stocks with very few shares outstanding, an extra billion or two in total assets can tie the manager's hands.
To put the additional money to work, the small-cap fund manager may have to drop his standards or accumulate overly large positions in individual stocks, which might limit the manager's liquidity when trading.

Guidelines for Choosing Bond Funds

The single most important thing you can do to earn competitive returns in a bond fund is to opt for those with low expenses. As a general rule, bond index funds will have lower expense ratios than managed funds that invest in, say, municipal bonds, and junk bonds. With the latter, at least stick with below-average expenses.

1. Stick With Short to Intermediate Maturities

Over the past 20 years or so, long-term bond funds have provided the highest returns, partly because interest rates have steadily declined over that period. That may not always be the case.

What's more, long-term bond funds can be surprisingly volatile. If interest rates rise just 1 percentage point, a long-term bond fund can drop 10 percent or more, wiping out more than a year's interest.

If you're investing for shorter periods – 10 years or less – or if you're using bond funds to add some ballast to a predominantly stock portfolio, then you may be better off with bond funds with short to intermediate-term maturities – say, five to 10 years.

You can typically get 75 to 80 percent of the return of long-term funds, while incurring roughly 40 percent less volatility.

2. Beware Tempting Yields

Fund companies know that investors focus on yields. So some do everything they can short of putting the fund on steroids to pump up yields. They may throw some low-grade bonds into a government portfolio, or even invest in international bonds from countries where rates are especially high.

These ploys to boost interest may or may not pay off, but they all involve risks that are difficult to evaluate. A bond fund that's touting much higher yields than funds with similar maturities raises red flags – it's a sign that the fund is doing something much different, and probably much riskier, than its peers.

If a much higher-yielding offering can't explain its outsized yields by having ultra-low expenses, move on (or accept the fact that you're investing in a riskier-than-average fund).

Index Funds

With the best business schools in the world graduating a steady supply of expensively educated MBAs who go to work for fund companies, you'd think funds would have no trouble posting above-average returns.

After all, fund shareholders (that's you) are paying fund managers high fees to find the best stocks in the market.

The fact is, however, a majority of funds don't beat the market in most years. That is, you're better off buying all the stocks in the Standard & Poor's 500 index or in the Wilshire 5000 index (which includes just about every stock on the New York, American, and Nasdaq stock exchanges) than paying someone to select what he thinks are the best ones.

There are several reasons so many funds fall short.

First, consider the investing costs that fund companies incur – the cost of research, administration, managers' salaries, and so on.

That cost is borne by the shareholders and gets deducted from returns. A fund manager needs to pick a lot of great stocks to make up for those costs.

Index funds, meanwhile, are much lower maintenance and tend to have much lower costs.
There are some caveats. Indexing seems to work better in some areas than others. The case is most solid for large U.S. stocks and bonds, largely because there is so much information on these

big securities that it is tough for a fund manager to gain an edge.
For additional information about index funds see the US Securities and Exchange Commission website: http://www.sec.gov/answers/indexf.htm.

When to Sell a Fund

There are signals that suggest it is time for you to sell a fund:

1. Your Fund is a Persistent Loser

The mere fact that a fund has low returns or even losses isn't a good reason to sell. If the overall market is down, or the specific sector your fund invests in is out of favor, you can't expect your fund manager to be a miracle worker. But if you own a fund that trails similar funds for two years by a substantial margin – say, 2 percentage points or more – think about moving on.

2. The Fund's Investment Strategy Has Changed

If you've attempted to create a diversified portfolio, then you're probably counting on the managers of all your funds to invest a certain way. The small-cap fund manager should be sticking to small-cap stocks, and the large-cap value fund manager should be buying large-cap value stocks. If they stray, it puts your entire plan in jeopardy.

3. There's Been a Manager Change

Any time your fund gets a new skipper, you should closely monitor the situation to assure two things: first, that the new manager is following the same investing style and strategy as his predecessor; second, that performance hasn't suffered. Give a new manager one year (and no more than two) to prove them.

4. You Could Use the Tax Loss

There are times when you might be able to lower your tax bill by dumping a losing fund yet still pretty much maintain your asset mix. For example, say you own shares in a large-cap growth fund that are worth less than you paid for them.

If you sell, you can use the loss to offset gains in other securities. Then, you can turn right around and buy another large-cap growth fund. Or, you can buy back the very same fund after 31 days.