Mutual Funds

A Tutorial for the Independent Investor

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Rule of Thumb: Good funds are run by good fund managers. That's why some investors prefer to"buy the manager, not the fund."

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How this Tutorial can Help You

The mutual fund has become a popular way to invest, partly because it is the primary investment vehicle of the 401(k) plan. The typical 401(k) plan offers its participants investment choices in several stock mutual funds. Millions of Americans participate in 401(k) plans, indicating the widespread determination to save for retirement. It has been my experience that these participants must solve by themselves for the most part the mystery of choosing the fund or funds that make the most sense for their retirement plan.

If you are investing outside a 401(k) plan, you can find thousands of mutual funds from which to choose. The number of possibilities is enough to intimidate beginners and can be overwhelming for anyone who doesn't know where to begin. This tutorial will show you how to begin, and will help you narrow your search to a manageable number of funds.

Mutual funds do not have to remain a mystery. They can be broken down into ingredients that can be explained and evaluated. In this tutorial rules of thumb are identified and applied to those ingredients. You will be introduced to various kinds of investing strategies, expert opinions about fund managers, and illuminating statistics regarding a variety of mutual funds. You will also learn the evaluating criteria and guidelines to use in choosing mutual funds. The glossary provides definitions for terms you need to know. In addition, you will be directed to other free professional resources that publish similar "Investing 101" tutorials for the independent investor.

First Steps in Choosing a Mutual Fund

There are several components of choosing an appropriate fund for your portfolio, even before you are ready to evaluate fund candidates. The following sections have exercises that are the first steps toward finding a fund that is suitable for you and your objectives.

Identify your investor profile

You will need to determine your time horizon, i.e. how long you will be investing. Establish a realistic amount of money you will be able to invest. And try to judge how aggressive your investment style should be. Ask yourself these questions:

- Will I need this money for a specific reason at some future date? If so, when? The answer to this question will determine if you are a long-term or short-term investor, or if it is even sensible for you to take the risk of investing. After one year, which is considered short-term, the amount available may have diminished because of fluctuation in the value of your investment. For this reason it may not be advisable to invest money in a mutual fund, if you know you need the money for something else in less than one or two years.
- How much money can I afford to comfortably dedicate to investments? The amount of money you have to invest may limit your investment choices, as

mutual funds usually have a minimum initial investment dollar amount. If the amount you have is enough, you may want to choose more than one mutual fund to create a more diversified portfolio.

- Would I be satisfied with at least moderate growth over a number of years? Or would I be impatient or dissatisfied if I do not experience substantial growth in just a few months? Or is my most important criterion that I do not lose any money? Chances are the answers to these questions will be the hardest to get right, because each question implies an investment style of more or less risk, and because you may need some experience as an investor before you can recognize your comfort zone for risk.

Often young people feel that they should be very aggressive, because they want the most growth from their investments. They think they can handle the risk and volatility of an aggressive investment, because their investing time horizon is long enough to go through down times and return to profitability. This theory was supported by 30 years (1970–2000) of upward trend in the equity market. But since the spring of 2000, when the stock market started its long decline—the S&P currently down about 45% from its high, and the Nasdaq Composite Index, composed primarily of technology stocks, down about 74%--many formerly aggressive investors have become very conservative in reaction to the pain of so much loss. I describe this extreme as a backdrop of how difficult it is to truly know your risk tolerance, and how unpredictable the market can be.

Rule of Thumb*: An investment style that seeks substantial growth in a short amount of time, which is called an aggressive growth strategy, generally involves more risk and volatility than more moderate or conservative styles. Strategies are discussed in "Take the Mystery out of Mutual Funds".*

Table 1. Complete the two worksheets. This exercise, although quite simple, should point you in the right direction.

Worksheet A will help you identify your profile, which will then guide you to the kinds of investments that are appropriate for you. ***Circle the answers*** on the right that best describe your investor profile.

Worksheet A: Determining Your Investor Profile

How involved do you want to be with investment decisions?		**Answer**
	I prefer to do my own research and manage them myself	Self
	I prefer to have them professionally managed	Prof.
What is your investment time horizon?		
	Less than one year – Short-term	Short
	One to three years – Medium-term	Med.
	Over three years – Long-term	Long
How much risk are you willing to take?		

	I am willing to take risks and invest aggressively for more growth	Agg. Gr.
	I am willing to take some risk for moderate growth	Mod. Gr.
	I want to preserve my capital by being conservative	Cons.
How much money do you have to invest?		
	Under $2,000	2K
	Between $2,000 and $10,000	2-10K
	Over $10,000	+10K

Find the four answers you circled above and ***circle them wherever they appear in Worksheet B***. The row(s) with the most circles across it will indicate the kind(s) of investments most suitable to your investor profile: stocks, mutual funds, cash/money market fund, or bonds.

Worksheet B: Investments most Suitable for your Profile

Stocks	Self	Long	Agg. Growth Mod. Growth	$10,000+
Mutual Funds	Self Prof.	Medium Long	Agg. Growth Mod. Growth Conservative	$2,000 or less $2–10,000 $10,000+
Cash/MoneyMkt	Prof.	Short Medium Long	Conservative	$2,000 or less $2–10,000 $10,000+
Bonds	Prof.	Medium Long	Conservative	$10,000+

For example, if you circled “Self”, “Medium”, “Mod. Growth”, and “$2,000” in Worksheet A, and then everywhere those words appear in Worksheet B, you will see that the row for “Mutual Funds” has four circles across, indicating mutual funds are probably the most appropriate investment for you.

Stocks are appropriate for investors who want to do their own research, decide for themselves when to buy and sell, and assemble their portfolios themselves. Stock prices are often volatile, making stocks risky for short-term investors, but often offering more growth potential. More money is needed so that a diversified portfolio of stocks can be bought.

Mutual Funds are professionally managed, but the investor must do some research to choose the fund(s). If they are comprised of stocks, i.e. not a bond fund, their value can be volatile. Volatility may be mitigated by the fact that there are many stocks in a fund. When some stocks are going up, others are going down. Still, buying a fund for the short-term can be risky. Funds have styles ranging from conservative to aggressive. Purchase minimums range from around $250 to much higher amounts.

Cash/Money Market Funds are the most conservative, as their goal is to never go below the initial investment value, the “profit” being the interest rate they are able to pay. They are professionally managed and very liquid, often with no minimum investment amount.

Bonds are also conservative and professionally managed. The initial investment amount is usually $10,000. See the glossary for a fuller explanation of bonds.

Make a plan with your investing goals and timetable

What kind of returns do you expect from your investments and by when? Will you need any of your invested money in the near future? Once you've determined your investor profile, make some goals, such as "I will invest $5000 in a mutual fund (or two or three) now, and I hope it will be worth $6000 in one year, a 20% annual return. I will review this goal and reevaluate the fund(s) I have chosen in three months." You may want to revisit your investment plan more frequently, perhaps even monthly, when you start investing, until you feel comfortable with your game plan and confident in your growing knowledge about investing.

For some investors the plan will be to accumulate enough money to invest. Many mutual funds have Automatic Investment Purchase (AIP) plans that make that wait unnecessary. With these plans shares of the fund can be bought with a smaller amount of money, sometimes as low as $50 or $75, as long as an automated purchase is made on a monthly or bi-monthly basis directly to the mutual fund company.

Consider all of your investments

Do you have an IRA, a 401k, stock options, or any other investments? How are they invested? All of these investments should be considered as parts of your total portfolio. Any mutual fund you purchase should complement, rather than duplicate, other investments you have. See the section on "Asset and sector allocation" in "Take the Mystery out of Mutual Funds" for an in-depth discussion of breaking down and allocating your investments.

Learn the basic definitions of mutual fund investing

Learn the meaning of mutual fund, stock, growth and value investing, blend fund, asset allocation, and other terms defined in this tutorial. If you understand the meaning of each term in the glossary at the end of this tutorial, you should feel comfortable reading analyses of funds and making decisions on their appropriateness for you.

Identify mutual funds that are suitable for your profile

The above steps should have guided you to an idea of what kind of fund(s) you would like to include in your portfolio. For example, are you only interested in conservative funds because your main objective is to not lose money? Or perhaps you realize that you would like a combination of styles, such as a conservative fund for one-fourth of your investing money, something moderate for half of it, and an aggressive fund for the other quarter.

When you know the general style and strategy you are looking for, you can prepare a list of funds that meet these objectives and begin your research to select the best from among them.

Table 2 provides a list of funds that can be used as a guide for narrowing your search for a mutual fund or funds that suit your investment style and objectives. It begins with **growth funds**, followed by **blend funds**, **value funds**, and **balanced funds**, generally *in order from most risk to least risk*. The list finishes with a fund based on the S&P 500 Index. These mutual funds meet the following criteria:

- Highly-rated by Morningstar.com, a global investment research firm.
- Outperformed the S&P 500 Index over the last five years, or three years if less than five years old. (The exception to this is the Vanguard 500 Index fund, which *is* an S&P 500 index fund.)
- Expense ratio is less than 2%.
- Have no loads.

You should establish your criteria for screening funds. Reading about various strategies such as this list provides can help you discover what criteria make sense to you.

Table 2. Mutual Funds of varying Styles

The five-year performance of the S&P 500 Index as of 12/31/02 was **-.59%**.

Fund and Strategy	**$ Minimums** **Non-IRA—IRA—AIP**	**5-yr Performance** **as of 12/31/02**
Marsico Focus (MFOCX) – small portfolio (about 25 holdings) is comprised mostly of **large steady-growth** stocks, held long-term. Fund manager, Tom Marsico, excels at stock picking and macroeconomic analysis.	$2,500 $1,000 $1,000	4.93%
T. Rowe Price Mid-Cap Growth (RPMGX) – looks for fundamental quality and attractive valuation in **out-of-favor growth sectors**. Manager is willing to own volatile stocks, but keeps indivividual positions small.	$2,500 $1,000 $50	4.82%
Janus Core Equity (JAEIX) – this **blend of large growth and large value** focuses on sustainable earnings growth, rising returns on capital, and strong free cash flow; maintains a broad sector diversification.	$2,500 $500 $500	5.35%

Meridian Value (MVALX) – uses a **contrarian approach**, buying small and mid-cap companies that have had earnings disappointments, but are market leaders with sound financials, so should have plenty of upside potential.	$1,000 $1,000 $1,000	16.90%
Gabelli Westwood Balanced Fund (WEBAX) – is a **hybrid** of government bonds (about 30%) and stocks (about 60%) that have posted earnings surprises but are still undervalued, particularly large dividend-paying stocks.	$1,000 $250 NA	3.81%
Dodge & Cox Balanced (DODBX) – a **hybrid** of stocks and bonds (60%/35%) that sticks to a strict value discipline in its strong stock selection, and buys only government and mid-quality corporate bonds.	$2,500 $1,000 $2,500	8.02%
Pax World Balanced (PAXWX**)** this **socially conscious hybrid** prefers large growth stocks, which must pass environmental and other screens, and conservative bonds (25% of portfolio).	$250 $250 $250	5.05%
Vanguard 500 Index (FVINX) – index fund that buys and holds the stocks in the S&P 500 index.	$3,000 $1,000	-.61%

Go to www.morningstar.com and type in the five-letter symbol to view Morningstar's complete analysis of the fund. You can also click on their Funds tab and use their Fund Selector to create a list of funds that meet your criteria.

Take the Mystery Out of Mutual Funds

Much of the analysis of a fund is mathematical, and rules of thumb can be used to eliminate the dependence on guessing or dart board selection. The following sections discuss the criteria you should use to evaluate a fund, with some guidelines for interpreting and judging the information you find out about each.

Analysis of the fund manager

This step is sometimes the least conclusive, because the information you find is not so much statistical as subjective. You may have to rely largely on opinion from mutual fund experts, but there are certain objective data to consider also. Find out how long the manager has been with this fund. What has been the performance of the fund under this manager? What other experience does this manager have?

Online sources are usually the best sources for data and opinions on fund managers, but business newspapers and magazines often write excellent, in-depth commentaries on them also.

Smartmoney.com's Investing 101 lists "Know Your Manager" as one of the "7 Steps to Picking A Good Fund". They also make a good point about team-managed funds: "The great intangible in all fund investing is the fund manager. . . . With a team-managed fund, you may never know exactly who is making the key decisions regarding the portfolio. However, it can be reassuring to know that several people know the ropes at the fund, and continuity is practically guaranteed if a manager departs."

In Morningstar.com's Investing Classroom, they compare fund managers to football coaches: "Like college football teams, mutual funds are only as good as the people behind them: the fund managers. Managers are the people who decide what to buy and what to sell, and when. Because the fund manager is the person who is most responsible for a fund's performance, knowing who's calling the shots and for how long is a key to smart mutual fund picking. . . . So if you're looking for new investments and find two equally good funds, choose the one with the more-experienced manager."

Rule of Thumb*: A fund manager must usually run a mutual fund for three years or more before a judgment can be made on his/her success with that fund. If it is a new fund, the performance for one or two years could be the result of luck or the overall economy, rather than the manager's skill. If the manager takes the fund over from another manager, the new manager may make very few changes to the fund for some time, so the fund continues to perform based on the previous manager's stock-picking skills.*

Strategy/objective/style of the fund

Mutual funds are categorized by their objectives: aggressive growth, growth, growth and income, value, preservation of capital, index, international, global, bond, tax-exempt, blend, balanced, and hybrid are some examples. See the glossary for definitions of these most common objectives.

You should choose a fund with the same objective as your investment objective. If your objective is growth, you must then decide how much risk suits you, in order to choose from various kinds of growth funds. If your objective is to include international exposure, you may want to consider a combination of mutual funds.

The strategy of the fund manager should seem reasonable, based on your growing knowledge of investing principles. The fund manager's job is to create a portfolio that achieves the maximum return for a given level of risk. Morningstar describes fund manager Tom Marsico's strategy for his Marsico Focus (a **growth fund**): "Marsico's methods include macroeconomic plays as well as company-specific fundamental analysis. . . . (He) combines top-down analysis with bottom-up stock-picking. He fills the bulk of the portfolio with steady-growth stocks that he intends to hold for the long haul, but he has owned more-explosive growth names in the tech and telecom areas. He also reserves a portion of the portfolio for relatively inexpensive firms that stand to benefit from a catalyst. Marsico limits the portfolio to a small number of stocks, typically around 25." This kind of focused portfolio (only 20+ holdings) is typically higher risk, because poor performance of just a few holdings can have a huge negative impact on the fund's performance.

Here are some other examples of strategies, as described by Morningstar.com:

- **Aggressive Growth** – Red Oak Technology Select (ROGSX) Jim Oelschlager and Doug MacKay focus on companies with sustainable competitive advantages in what they think are the fastest-growing segments of the technology market. Their stock-selection process is mostly qualitative, but the managers also consider a stock's valuation relative to its growth prospects. Management keeps the fund concentrated among about 25 names, and turnover is low. Red Oak is about as risky as they come.

- **Large Growth** – Janus (JANSX) The fund mixes pricey, high-growth stocks with more-stable growth names. Like most Janus managers, Blaine Rollins prizes companies that have significant free cash-flow yields and can deliver strong returns on invested capital. Rollins also likes firms that are able to steal market share from their competitors. For a fund of its size, it parks a lot of assets in its top holdings, and not all of its stocks are the biggest blue chips.

- **Value** - AIM Basic Value A (GTVLX) Managers Bret Stanley, Matt Seinsheimer, and Michael Simon do a discounted cash-flow analysis to determine which companies have a 50% appreciation potential between their price and their intrinsic value. They particularly like companies that have been oversold but are still meeting earnings estimates or are only marginally falling short. They take a multi-cap approach, and the fund's median market cap is much lower than the group norm thanks to their affinity for mid-cap stocks

- **Small Value** – Ariel Fund (ARGFX) Manager John Rogers seeks out smaller-cap stocks that are selling at a discount of 40% or more to their intrinsic values. He favors firms with strong brands or franchises that operate in consistent and stable industries, have sound balance sheets, generate lots of cash, and have strongly motivated management teams. The upshot of this approach is that the fund tends to have scant exposure to volatile sectors like technology and biotech, and big stakes in consumer goods, services, and industrial materials. The portfolio is typically concentrated in about 40 or fewer stocks.

- **Mid-Cap Blend** – Meridian Value (MVALX) Unlike most fund managers, Kevin O'Boyle screens for companies that have had two to three disappointing quarters in a row, arguing such firms are often punished too harshly for their troubles. He then invests in those firms that are market leaders and that have good returns on capital and sound financials. O'Boyle employs a multi-cap approach, although he favors small- and mid-cap issues. Because of the fund's size, though, he usually limits initial purchases in micro- and small-cap names to just 1% of assets.

- **Domestic Hybrid** – Gabelli Westwood Balanced (WEBAX) Equity manager Susan Byrne scours the domestic-equity universe for companies that have posted positive earnings surprises but have yet to see positive estimate revisions from analysts. If the fundamentals check out, she's interested. The fund generally stakes about 60% of assets in stocks. Its bond stake is a conservative, intermediate-term portfolio.

- **Index Fund** - Vanguard 500 Index (VFINX) The core of the fund's strategy is simple: Manager Gus Sauter buys and holds the stocks that compose the S&P 500 Index. Sauter attempts to add value on the margins by opportunistically buying futures contracts, among other techniques, and he actively tries to reduce trading costs.

As a guide to what kind of performance you might expect from the above strategies, their returns for the last ten years, along with the returns of other styles of funds are in the Performance section of this tutorial.

Risk

Risk refers to the possibilities for a fund to lose value. Identifying the risk associated with a particular mutual fund is not necessarily simple, because it involves analyses of the fund manager, the strategy, and each security the fund holds. Losing value is almost always a possibility, but you can quickly identify some red flags that increase the odds of losing value, such as a small number of holdings, a tendency to overweight one sector, international exposure. You can then weigh them against the attractive features of the fund.

Rule of Thumb: *An aggressive strategy of buying stocks after their prices have already substantially moved up increases risk of losing value. Many investors are likely to sell stocks to take profits after big run-ups, which will cause prices to go down.*

Counter Rule of Thumb: *Don't fight the tape. This is a saying, like "the trend is your friend", that means you should not sell where there is momentum. If a stock has been going up, stay with it, because its momentum could take it higher.*

Rule of Thumb: *Small cap funds have an inherent risk, since the small companies the fund buys are more likely to go out of business than their larger, more established competitors.*

Counter Rule of Thumb: *Small cap stocks have more room to grow.*

Costs/expenses of the fund

These facts are readily available from the fund or a rating service, and they are easy to compare. The expense ratio reflects the fund's efficiency of operation. This cost is "invisible" to the shareholder, as it is calculated into the Net Asset Value (N.A.V.) each day and never actually charged to the buyer of the fund.

A load is a percentage fee that is paid to the fund and/or to the broker, either by reducing the dollar amount purchased or the proceeds of a sale. A **front-end load fee**, typically about 5%, is charged at the time of purchase. If you pay $5,000 to buy a fund with a 5% load, the $250 fee reduces the purchase amount to $4,750 worth of the fund. A **"back-end" or deferred fee** is charged when the fund is sold. If your proceeds from the sale are $10,000, and the fee is 5%, $500 will be kept by the fund, and you will receive $9,500 for the sale. A **redemption fee** is usually a smaller percentage and is charged if you sell a fund before the fund's required holding period has expired.

Rule of Thumb*: A well-run fund should have an expense ratio under 2%.*

Rule of Thumb*: You don't have to buy a fund with a fee. There are good funds that do not charge fees.*

The number of no-load funds is diminishing. According to Christine Benz, Morningstar analyst, more and more funds have added loads as an encouragement to brokers to sell those funds, because of the overall decline in investor enthusiasm.

According to NAIC's (National Association of Investors Corporation's) Mutual Fund Resource Center, "While an investor in a load fund pays for a broker or financial planner's expertise via the sales charge, there is no guarantee that the load-fund will out-perform a similar no-load fund. In fact, a loaded fund would have to perform several percentage points better than the no-load fund to make up for the fact that the load-fund investor initially gets fewer fund shares. There is no proven correlation between high fees and high returns."

Performance

Performance can be stated in a number of ways: year-to-date (YTD), one-year, three-years, five-years, etc. Most ratings also show the peer group average performance for comparison. See Table 3 for the breakdown of performances for the last five years for various fund styles. The S&P 500 (Large Cap) returned -2.39% for this period.

Table 3. Five-Year Total Returns for Various Fund Styles (through 2/6/03)

Small Value Funds	1.84%	Mid Growth Funds	-2.38%
Mid-Cap Value Fds	1.69%	Small Growth Funds	-2.50%
Large Value Funds	-2.02%	Large Growth Funds	-4.38%
Index Fund (VFINX)	-2.39%	Tech Funds	-5.52%

Source: Morningstar

Rule of Thumb*: Look at long-term performance records for consistency. A spectacular one-year performance could be a fluke.*

The Motley Fool (www.fool.com) says in “A Fool’s Guide to Mutual Funds”, “. . . . for your long-term success in investing in mutual funds: Buy an index fund.” Their reason is historical performance: “Though you would think that mutual funds provide benefits to shareholders by hiring "expert" stock pickers, the sad truth of the matter is that over time, the vast majority –- approximately 80% -- of mutual funds underperform the average return of the stock market. . . . Why the underperformance? . . . . Quite simply, the majority of mutual funds fall short because of the fees they charge you to be a shareholder.”

Asset and sector allocation

Overall asset allocation refers to the ratio of equities to fixed income securities (debt) and cash.

***Rule of Thumb**: During a healthy economy, strategists typically recommend an asset allocation of 65%-70% equities and 30%-35% bonds and cash. When the economy is weak, the equity weighting is reduced usually by 5%-10%.*

Within the equity portion of a portfolio the allocation among industry sectors should be monitored and adjusted to be in sync with your objective. The technology, healthcare, and financial sectors have historically provided more growth than the other sectors, which is why they have had larger allocations in growth funds. Since the outlook for most of technology has been negative the last couple years, and it is expected to continue to be negative, growth funds should have made appropriate adjustments in their portfolio allocation.

To determine the industry allocation of a mutual fund, identify the stocks held by the mutual fund, the industries they represent, and the proportions in each industry sector. You can compare this asset allocation to your ideal allocation. The industry sector allocation of the **S&P 500 Index (as of 12/31/02)**, as shown in Table 4, can be used as a model for equities in your portfolio. Table 5 proposes allocations for an aggressive growth portfolio and a less aggressive growth portfolio.

Table 4. S&P Industry Allocation

Table 5. Allocation for Growth

	Range of Aggressiveness	
INDUSTRY	**More**	**Less**
Technology	25%	20%
Healthcare	20%	20%
Financials	20%	20%
Industrials	15%	15%
Retail/consumer	10%	15%
Energy	10%	10%

Sources for data on funds

There are a number of free online mutual fund rating services that also give analyses of funds. Morningstar.com provides "Snapshots" for free, which provide details on fund performance history, fees, and asset and sector allocation. This site and others will usually show the top holdings in the fund and give a brief opinion about the fund managers and their strategies. In-depth analyses are available to paying subscribers on Morningstar. They feature commentary on profitability, valuation, growth and financial health of individual companies, as well as valuable insight into strategies of mutual fund managers.

Other free online sources are maxfunds.com, smartmoney.com, money.com, and fool.com. Each of these has Investing 101 departments that feature mutual funds. Most of these sites have a version of a fund-finder, an interactive program that responds to parameters you choose with a list of funds that meet your criteria. For example, you might choose a) growth fund, b) same manager for at least three years, c) has out-performed the S&P 500 Index for at least three years, and d) expense ratio under 2%. The fund-finder will pull up a list of funds meeting these requirements for you to research further. Money.com's Find-a-Fund is the simplest to use.

Timing the Market

Awareness of the health of the economy can be helpful in timing when to buy and sell investments. Generally, a healthy economy and a healthy stock market coincide, but their turning points may not, and not all sectors move in tandem with each other. Learning to recognize patterns and signals of imminent turning points in sectors, in the market, and in the economy is the best chance at successfully timing the market.

***Rule of Thumb**: It is difficult to consistently time the market successfully. An alternative to trying to time the market is doing research to find the best quality investments that are appropriate for your investor profile. Then buy and hold these quality securities for the long-term, if their quality and your objectives do not change.*

There is another timing consideration with regard to mutual funds. Each December mutual funds distribute their capital gains and dividends for the year. All shareholders receive these distributions, which can be in cash or in more shares of the fund, as long as they own the fund by the date of the distribution. Some people prefer to wait until after this date to purchase funds, because they do not want to pay taxes on these capital gains and dividends.

Taxes and Mutual Funds

Taxes on mutual funds are a little tricky. Detailed tax information can be found online. The best and most thorough guide I know is fairmark.com, a plain language tax guide for investors.

Shareholders are taxed on the distributions paid by the fund in December. The *dividend distributions* are straightforward in that they are simply taxed as ordinary income for the year in which they are received, whether the dividends are received in cash or are automatically reinvested into more shares of the fund. One of the tricky parts is that a fund's short-term capital gains are also passed onto the shareholder as ordinary dividends and must be treated as dividends. They cannot be used to offset capital losses.

The *capital gains* the fund passes on to its shareholders are taxed as long-term gains, meaning they are the result of the fund owning the securities more than one year when they sold them. Shareholders are taxed on a long-term capital gain, even if they just bought the mutual fund a month earlier.

The mutual fund company sends a Form 1099 to each shareholder; the 1099 identifies how much of the distributions paid to the shareholder were for dividends or long-term capital gains. Short-term gains and ordinary dividends are taxed as ordinary income, i.e. at whatever your income tax bracket is. Long-term gains are taxed at 20% for most shareholders under current tax laws.

Shareholders will also realize a capital gain or loss when they sell the mutual fund, and this gain will also be taxed as long-term or short-term, depending on how long the fund was owned by the shareholder. Here's another tricky part. How do you calculate your gain or loss if you have been reinvesting dividends over a period of time? Your cost basis increases by the value of each reinvested dividend, so you'll want to keep thorough and accurate records of the dividends.

Keep in mind that income and capital gains received from mutual funds in retirement accounts, such as IRAs and 401(k)s, are not taxed until distributions are made from the account.

Putting It All Together to Make Choices

You can now begin your research to find the best mutual funds for your portfolio. But first, here are a couple examples of typical investors on the same quest and the results of their efforts.

Example investor A

Potential investor A determines her investor profile by completing Worksheet A. She wants to be involved in investment decisions for her portfolio and circles "Self". Her time horizon is at least 15 years, so she feels she can be slightly aggressive; she circles "Long" and both "Agg. Growth" and "Mod. Gr." Since she already has $3,500 to invest, she circles "2-10K". In Worksheet B she circles "Self", "Long", "Agg. Growth", "Mod. Gr.", and "2-10K" wherever they appeared. Circles all across the top two rows indicate that both stocks and mutual funds would be suitable for her.

Next she researches the first three funds in the list beginning on page 7, since they are growth funds. Using an online fund-finder and the screening criteria that seemed most important to her, she compiled a list of five more funds that seemed attractive to her, based on their objectives and the fund managers' styles. She examined the industry allocation for each of the eight funds and found that some of them owned more than 30% technology stocks, and none of them really had adequate allocations in all of the other sectors.

Since she also has an IRA with a few thousand dollars and a 401(k) that offers a variety of mutual funds, she decides to:

- Buy $2,500 (minimum amount) of the Marsico Focus Fund in her non-retirement account, because 70% of its allocation consists of the top three growth sectors.
- Buy $1,000 of Pax World Balanced (PAXWX), also in her non-retirement account. The minimum for this fund is only $250, and its socially conscious strategy seemed perfect for her investing nature. Also the 25% of the portfolio in bonds acknowledged her "moderate" growth propensity.
- Buy several individual stocks in her IRA account, since she wants to do her own research to choose them. Also the mutual funds are a bit overweight in technology, and she could balance this out by choosing good quality health care, energy, and industrial companies.
- Split her 401(k) monies between an S&P 500 Index Fund and a more aggressive fund that the plan offers. The above funds are growth funds. These two will give her the full range from moderate growth to aggressive growth.

Example investor B

B's worksheet results pointed to mutual funds as appropriate for his $3,000 and conservative, long-term profile. He followed the same steps as Investor A, but he focused on the more conservative value funds on the list and from online sites. Since he has no other investments and prefers a professionally managed portfolio, he will rely on the mutual funds he chooses for sector allocation. He decides to:

- Buy $3,000 (minimum amount) of the Vanguard 500 Index, because of its consistent performance.
- Buy $50 of T. Rowe Price Mid-Cap Growth (RPMGX), because he likes the manager's attention to valuation, because the sector allocation is well-diversified, and they have a $50 AIP plan.

You

When you go through the same steps as our example investors, you should be able to identify your investor profile, goals, and investing strategy. With that in mind, and some research of suitable funds, you will be on your way to choosing mutual funds that make sense for you.

Glossary

401(k) Plan - a retirement plan offered by an employer, to which both the employee and the employer may contribute. In this kind of plan the employee usually designates from a list of specific mutual funds how they want their retirement monies invested.

Aggressive - refers to a style or an investing strategy that aims for growth, also assuming risk. It can refer to buying stocks that are already highly priced because the investor feels the stock price will continue higher. Sometimes it refers to the strategy of buying emerging companies because they have innovative products.

AIP – automated investment purchase. See page 6.

Allocation - refers to the breakdown of assets in a portfolio, i.e. what is the ratio of stocks to bonds and cash. It can also refer to the breakdown of equities by industry sector, i.e. what percent of stocks are in technology, healthcare, finance, energy, etc.

Balanced – or “hybrid”, refers to a fund that includes both stocks and bonds.

Blend - refers to a fund that includes both growth stocks and value stocks.

Bond - is a debt instrument. This means the investor is lending money to the issuer of the bond, and in return the investor will receive a specified amount of interest, paid bi-annually—this is called the coupon—as well as receiving par value of the bond at maturity. The coupon is indicated as a percentage; par is $1000 per bond; maturity refers to the end of the time period the investor must hold the bond in order to receive the full benefit. Corporate bonds are issued by corporations to raise money. The interest an investor receives from a corporate bond is taxable income. A municipal bond is issued by a community, such as a state or a county, and the interest paid by a municipal bond is tax-free, as long as the investor lives in the state that has issued the bond. An example is 10,000 California General Obligation 4.00% 7/1/2004, purchased at $97.50. In this case the investor pays $9,750, receives $200 in interest twice a year (on January 1 and July 1 in this case, for a total of $400 or 4% per year), and receives $10,000 (par value) on July 1, 2004, as long as the investor still owns the bond at maturity.

Capital gain – refers to profit realized from the sale of an investment. When a loss is realized, it is called a capital loss.

Cap (Capitalization) – refers to the size of a company. To calculate, multiply the number of shares outstanding times the stock price.

Defensive – a kind of investment or style that avoids volatility.

Dividends – are income a company pays to its shareholders on a quarterly basis. Mutual funds usually pay dividends once a year in December.

Equity - refers to investments that are not debt, usually stocks and mutual funds.

Expense Ratio – is the cost of operation of a mutual fund. It is stated as a percent and is viewed as a measurement of efficiency.

Fund Family – refers to the mutual fund company, which may have many individual mutual funds in its family. Popular fund families are Janus, Fidelity, and Oppenheimer.

Global Fund – is a mutual fund that invests in both U.S. stocks and non-U.S. stocks. “International” funds do not invest in U.S. stocks.

Growth - refers to an investment that expands faster than the economy, such as a growth stock or a growth fund. Companies accomplish this by reinvesting their profits into the company, instead of paying them out to investors as dividends; funds accomplish this by investing in growth stocks.

Hybrid - is a mutual fund invested in a combination of stocks and bonds.

IRA - Individual Retirement Account. Contribution amounts are limited and monitored by the IRS and are sometimes tax-deductible. Investment options are determined by where the account is held. If it has been opened with a mutual fund company, then mutual funds are the only investment options.

Large Cap – refers to the size of the companies in a fund, i.e. large capitalization (see **Cap**). A “mid-cap growth” fund only buys medium-sized growth companies.

Liquid – refers to assets that can be sold easily, and converted to cash.

Load - refers to a fee charged by a mutual fund company. A front-end load is a percentage paid to the fund company and/or the broker at the time of purchase of the mutual fund. If the front-end load is 5%, and the investor is buying $5000 worth of a fund, $250 will be kept by the fund, and $4,750 worth of the fund will be purchased for the investor. Funds with front-end loads are generally called “A shares”. A deferred fee, or “back-end” load deducts the percentage from the proceeds at the time of sale of the fund. Funds with deferred fees are generally called “B shares”. Not all funds charge fees.

Mutual Fund - a basket of securities purchased by a fund manager according to an objective for the fund. A mutual fund may be a bond fund, in which case the securities in it are bonds; or it may be a combination of bonds and stocks. An equity mutual fund will usually hold between 30 and 80 stocks, but sometimes more than that. An investor buys shares of a mutual fund, therefore owning the securities in that fund.

N.A.V. - net asset value. At the close of each trading day, a mutual fund company will tally the value of each holding in a fund and divide the sum total by the number of shares distributed to shareholders to derive a value per share for the fund. This value per share is called the net asset value. It is also the price per share for purchasing that fund on that day. Investors always buy mutual funds at their value per share after the close of trading.

S&P 500 Index –the 500 largest publicly-owned companies. Companies are removed from the list when companies merge or are bought by foreign companies; the next largest company, previously not on the list, is then added.

Stock - shares of a publicly-owned company. A stockholder is a partial owner of the company.

Stock Options - are grants issued by publicly-owned companies to their employees, allowing them the opportunity to purchase shares of the company at the specified grant price, which is usually the stock price at the time of the grant. If the company's stock price goes up after the grant is issued, the employee may "buy" the shares at the cheaper price and simultaneously sell the shares at the current higher price, keeping the profit.

Value - may refer to a stock, a mutual fund or a style of investing. Value investing uses a discipline to determine if a stock is fundamentally more valuable than its price suggests. A common criterion for a value investor is the price-to-earnings (P/E) ratio. If the share price is not more than his predetermined standard multiple of the earnings per share, then the stock is undervalued. Other criteria may be used to determine if a stock is undervalued. A value fund buys value stocks.

Volatility - refers to the fluctuation in stock price or N.A.V.