Chapter 2

Mutual Funds: Advantages and Disadvantages

In This Chapter

- Seeing how mutual funds work
- Discovering reasons to choose mutual funds
- Considering the drawbacks

I'm not sure where the "mutual" in mutual funds comes from; perhaps it's so named because these funds allow many people of differing economic means to mutually invest their money for

- Easy diversification
- Access to professional money managers
- Low investment management costs

Some of the big-time investors who haven't invested in mutual funds probably wish that they had — instead of putting their money into now-vacant office buildings, barren oil fields, lame racehorses, and other "promising" investments.

Getting a Grip on Mutual Funds

A mutual fund is a collection of investment money pooled from lots of people to be invested for a specific objective. When you invest in a mutual fund, you buy shares and become a *shareholder* of the fund. A fund manager and his or her team of assistants determine which specific securities (for example, stocks, bonds, or money market funds) they should invest the shareholders' money in, in order to accomplish the objectives of the fund and keep shareholders happy.

Because good mutual funds take most of the hassle and cost out of figuring out which securities to invest in, they're among the best investment vehicles ever created:

- Mutual funds allow you to *diversify* your investments — that is, invest in many different industries and companies instead of in just one or two. By spreading the risk over a number of different securities representing many different industries and companies, mutual funds lessen your portfolio's volatility and the chances of a large loss.
- Mutual funds enable you to give your money to the best money managers in the country — some of the same folks who manage money for the already rich and famous.
- Mutual funds are the ultimate couch potato investment! However, unlike staying home and watching television or playing video games, investing in mutual funds can pay you big rewards.

What's really cool about mutual funds is that when you understand them, you realize that they can help you meet many different financial goals. Maybe you're building up an emergency savings stash of three to six months' living expenses (a prudent idea, by the way). Perhaps you're starting to think about saving for a home purchase, retirement, or future educational costs. You may know what you need the money for, but you may not know how to protect the money you have and make it grow.

Don't feel bad if you haven't figured out a long-term financial plan or don't have a goal in mind for the money you're saving. Many people don't have their finances organized, which is why I write books like this one! I talk more specifically in Chapter 4 about the kinds of goals mutual funds can help you accomplish.

In addition to understanding such terms as fund prospectuses and performance numbers (which I discuss in Chapters 5 and 13, respectively), you need to know some important fund terminology from the get-go to avoid confusion.

Understanding families and individual funds

Throughout this book, I discuss mutual fund companies, as well as individual funds. To better illustrate the difference between the two, let me draw an analogy to a family with parents and children.

Mutual fund companies, such as T. Rowe Price and Vanguard, can be thought of as parent organizations that act as the distributors for a group of funds. The parent organization doesn't actually take your money. Instead, it's responsible for distributing (selling, marketing, and so on.) and managing the individual mutual funds — the kids, if you will, in the family. (Don't worry: Children don't actually manage the funds, although some portfolio managers are on the young side — in their 30s!)

You actually invest your money in an individual mutual fund — one wayfaring child of the whole family — such as Vanguard's Wellesley Income Fund or the T. Rowe Price Balanced Fund. Vanguard and T. Rowe Price are the parent organizations.

As with real families, good parent organizations tend to produce better offspring. That's why you should understand the reputation of the parent organization that's responsible for overseeing the fund before you ever invest in it. What is the parent's track record with similar funds? How long has the parent been managing the types of funds you're interested in? Has the parent had any disasters with similar funds? The specific funds I recommend later in the book satisfy these concerns.

Financial intermediaries

A mutual fund is a type of financial intermediary. (Now that's a mouthful!) Why should you care? Because if you understand what a financial intermediary is and how mutual funds stack up to other financial intermediaries, you'll better understand when funds are appropriate for your investments and when they probably aren't. A *financial intermediary* is nothing more than an organization that takes money from people who want to invest and then gives the money to those who need investment *capital* (another term for money).

Suppose that you want to borrow money to invest in your own business. You go to your friendly neighborhood banker, who examines your financial records and agrees to loan you $20,000 at 8 percent interest for five years. The money that the banker is lending you has to come from somewhere, right? Well, the banker got that money from a bunch of people who deposited money with the banker at, say, 2 percent interest. Thus, the banker acts as a financial intermediary, or middleman — one who receives money from depositors and lends it to borrowers who can use it productively.

Insurance companies do similar things with money. They sell investments, such as annuities (see Chapter 1), and then turn around and lend the money — by investing in bonds, for example — to businesses that need to borrow. (Remember, a bond is nothing more than a company's promise to repay borrowed money over a specified period of time at a specified interest rate.)

The best mutual funds are the best financial intermediaries for you to invest through. The reasons: They skim off less (that is, they charge lower management fees) to manage your money and allow you more choice and control over what your money actually gets invested into.

The sky's (or the ceiling's) the limit: Open-end versus closed-end funds

Open end and closed end are general terms that refer to whether a mutual fund company issues an unlimited or a set amount of shares in a particular fund.

- **Open end:** The vast majority of funds in the marketplace are open-end funds, and they're also the funds that I focus on in this book because the better open-end funds are superior to their closed-end counterparts (more on this point in a moment). *Open end* simply means that the fund issues as many (or as few) shares as investors demand. Open-end funds theoretically have no limit to the number of investors or the amount of money that they hold.
- **Closed end:** *Closed-end* funds are those where the mutual fund companies decide up front, before they take on any investors, exactly how many shares they'll issue. After they issue these shares, the only way you can purchase shares (or more shares) is to buy them from an existing investor through a broker. This is the same process that happens with buying and selling stock.

Open-end funds are usually preferable to closed-end funds for the following reasons:

- **Management talent:** The better open-end funds attract more investors over time. Thus, they can afford to pay the necessary money to hire leading managers. I'm not saying that closed-end funds don't have good managers, too, but as a general rule, open-end funds attract better talent.
- **Expenses:** Because they can attract more investors, and therefore more money to manage, the better open-end funds charge lower annual operating expenses. Closed-end funds tend to be much smaller and, therefore, more costly to operate. Remember, operating expenses are always deducted out of shareholder returns before a fund pays its investors their returns. Thus, relatively higher annual expenses depress the returns for closed-end funds.

  Brokers who receive a hefty commission generally handle the initial sale of a closed-end fund. Brokers' commissions usually siphon anywhere from 5 to 10 percent out of your investment dollars, which they generally don't disclose to you. (Even if you wait until after the initial offering to buy closed-end fund shares on the stock exchange, you still pay a brokerage commission.) You can avoid these high commissions by purchasing a *no-load* (commission-free), open-end mutual fund.

- **Fee-free selling:** With an open-end fund, the value of a share (known as the *net asset value*) always equals 100 percent of what the fund's investments are currently worth. And you don't have the cost and trouble of selling your shares to another investor as you do with a closed-end fund. Because closed-end funds trade like securities on the stock exchange, and because you must sell your shares to someone who wants to buy, closed-end funds sometimes sell at a discount. Even though the securities in a closed-end fund may be worth, say, $20 per share, the fund may sell at only $19 per share if sellers outnumber buyers.

  Sometimes, a closed-end fund that sells at a discount has a good side. You could buy shares in a closed-end fund at a discount and hold onto them in hopes that the discount disappears or — even better — turns into a *premium* (which means that the share price of the fund exceeds the value of the investments it holds). You should never pay a premium to buy a closed-end fund, and you shouldn't generally buy one without getting at least a 5 percent discount.

REMEMBER

Unless I specify otherwise, the funds I discuss and recommend in this book are open-end funds.

Sorry to complicate things, but I need to make one clarification. Open-end funds can, and sometimes do, decide at a later date to "close" their fund to new investors. This doesn't make it a closed-end fund, however, because investors with existing shares can generally buy more shares from the fund company. Rather, it becomes an open-end fund that's closed to new investors!

Why Should I? Opting for Mutual Funds

To understand why funds are so sensible is to understand how and why funds can work for you. Read on to discover their many benefits. Because mutual funds also have their drawbacks, I cover those later in this chapter. In Chapter 3, I compare mutual funds to other investing alternatives so that you may clearly understand when funds are and aren't your best choice.

Fund managers are well trained

Mutual funds are investment companies that pool your money with the money of hundreds, thousands, or even millions of other investors. The company hires a portfolio manager and a team of researchers whose full-time job is to analyze and purchase investments that best meet the fund's stated objectives.

Typically, fund managers are CFAs and/or graduates of the top business and finance schools in the country, where they learn the principles of portfolio management and securities valuation and selection. (Despite the handicap of their formal education, most of them still do a good job of investing money!) In addition to their educational training, the best fund managers typically have a decade or more of experience in analyzing and selecting investments.

A mutual fund management team does more research and due diligence than you could ever have the energy or expertise to do in what little free time you have. Investing in mutual funds will help your friendships, and maybe even your love life, because you'll have more free time! Consider the following activities that an investor should do before investing in stocks and bonds:

- **Analyze company financial statements.** Companies whose securities trade in the financial markets are required to issue reports every three months detailing their revenue, expenses, profits and losses, and assets and liabilities. Unless you're a numbers geek, own a financial calculator, and enjoy dissecting tedious corporate financial statements, this first task alone is reason enough to invest through a mutual fund and leave the driving to them.
- **Talk with the muckety-mucks.** Most fund managers log thousands of frequent-flier miles and hundreds of hours talking to the folks running the companies they're invested in or are thinking about investing in. Because of the huge amount of money they manage, large fund companies even get visits from company executives, who fly in to grovel at the fund managers' feet. Now, do you have the correct type of china and all the place settings that etiquette demands of people who host such high-level folks?!
- **Analyze company and competitor strategies.** Corporate managers have an irritating tendency to talk up what a great job they're doing. It's not that they fib; they just want rich investors to feel warm and fuzzy about forking over their loot. Some companies may look as if they're making the right moves, but what if their products are soon to lag behind the competition's? Fund managers and their researchers take a skeptical view of what a company's execs say — they read the fine print and check under the rugs. They also keep on top of what competitors are doing. Sometimes they discover better investment ideas this way.
- **Talk with company customers, suppliers, competitors, and industry consultants.** Another way the mutual fund managers find out if a company's public relations story is full of holes rather than reality is by speaking with the company's customers, suppliers, competitors, and other industry experts. These people often have more balanced viewpoints and can be a great deal more open about the negatives. These folks are harder to find but can provide valuable information.

- **Attend trade shows and review industry literature.** It's truly amazing how specialized the world is becoming. Do you really want to subscribe to business magazines that track the latest happenings with ball bearing or catalytic converter technology? They'll put you to sleep in a couple of pages. Unlike popular mass-market magazines, they'll also charge you an arm and a leg to subscribe.

Are you, as the investor, going to do all these tasks and do them well? Nothing personal, but I doubt that you will. Even in the unlikely event that you could perform investment research as well as the best fund managers, don't you value your time? A good mutual fund management team will happily perform all the required research for you, do it well, and do it for a fraction of what it would cost you to do it haphazardly on your own.

Funds save you money and time

Chances are, the last thing you want to do with your free time is research where to invest your savings. If you're like many busy people, you've kept your money in a bank just to avoid the hassles. Or maybe you turned your money over to some smooth-talking broker who sold you a high-commission investment you still don't understand but are convinced will make you rich.

Mutual funds — which you can purchase by writing a check or calling a toll-free number — can pay you a much better rate of return over the long haul than a dreary, boring bank account or an insurance company account. And you don't have to pay high commissions.

What does it cost to hire such high-powered talent to do all the dreadful research and analysis? A mere pittance, if you pick the right funds. In fact, when you invest your money in an efficiently managed mutual fund, it should cost you less than it would to trade individual securities on your own.

Mutual funds are a cheaper, more communal way to get the investing job done. A mutual fund spreads out the cost of extensive — and expensive — research over thousands of investors.

TECHNICAL STUFF

Mutual funds are also able to manage money more efficiently through effective use of technology. Innovations in information management tools enable funds to monitor and manage billions of dollars from millions of investors at a very low cost. In general, moving around $5 billion in securities doesn't cost them much more than moving $500 million. Larger investments just mean a few more zeros in the computer data banks.

A (brief) history of mutual funds

Mutual funds date back to the 1800s, when English and Scottish investment trusts sold shares to investors. Funds arrived in the U.S. in 1924. They were chugging along and growing in assets until the late 1920s, when the Great Depression derailed the financial markets and the economy. Stock prices plunged, and so did mutual funds that held stocks.

As was common in the stock market at that time, mutual funds were *leveraging* their investments — which is a fancy way of saying that they put up only, for example, 25 cents on the dollar for investments they actually owned. The other 75 cents was borrowed. That's why, when the stock market plunged in value in 1929, some investors and fund shareholders got clobbered. They were losing money on their investments *and* on all the borrowed money. But, like the rest of the country, mutual funds, although bruised, pulled through this economic calamity.

In 1940, the Investment Company Act established ground rules and oversight of the fund industry by the Securities and Exchange Commission (SEC). Among other benefits, this landmark federal legislation required funds to gain approval from the SEC *before* issuing or selling any fund shares to the public. Over time, this legislation has been strengthened by requiring funds to disclose cost, risk, and other information in a uniform format through a legal document called a *prospectus* (see Chapter 5).

During the 1940s, 1950s, and 1960s, funds grew at a fairly high and constant rate. From less than $1 billion in assets in 1940, fund assets grew to more than $50 billion by the late 1960s — more than a fiftyfold increase. Before the early 1970s, funds focused largely on investing in stocks. Since then, however, money market mutual funds and bond mutual funds have mushroomed. They now account for nearly half of all mutual fund assets.

Today, thousands of mutual funds manage about $8 trillion.

The most efficiently managed mutual funds cost less than 1 percent per year in expenses. (Bond funds and money market funds cost much less — good ones charge just 0.5 percent per year or less.) Some of the larger and more established funds charge annual expenses of less than 0.2 percent per year. (I explain the role of fees in your investment decisions in Chapter 5.)

And today, many funds don't charge a commission (load) to purchase or redeem shares. Commission-free funds are called *no-load funds.* Such opportunities used to be rare. Fidelity and Vanguard, the two largest distributors of no-load funds today, exacted sales charges as high as 8.5 percent during the early 1970s. Even today, some mutual funds known as *load funds* charge you a commission for buying or selling shares in their funds. (Turn to Chapter 5 for the complete story on loads — and why you should avoid them.)

If you decide that you want to withdraw money from a fund, most funds — particularly no-loads — don't charge you a redemption fee. (Think about that — some investments require that you pay to get your own money back!)

Fund diversification minimizes your risk

Diversification is a big attraction for many investors who choose mutual funds. Here's an example of why, which should also explain what diversification is all about: Suppose you heard that Phenomenal Pharmaceuticals has developed a drug that stops cancer cells in their tracks. You run to the phone, call your broker, and invest all your savings in shares of Phenomenal stock. Five years later, the Food and Drug Administration denies the company approval for the drug and the company goes belly up, taking your entire nest egg with it.

Your money would've been much safer in a mutual fund. A mutual fund might buy some shares of a promising, but risky company like Phenomenal without exposing investors like you to financial ruin. A fund owns stocks or bonds from dozens of companies, diversifying against the risk of bad news from any single company or sector. So when Phenomenal goes belly up, the fund may barely feel a ripple.

Diversifying like that on your own would be difficult — and expensive — unless you have a few hundred thousand dollars and a great deal of time to invest. You'd need to invest money in at least eight to twelve different companies in various industries to ensure that your portfolio could withstand a downturn in one or more of the investments.

Mutual funds typically invest in 25 to 100 securities, or more. Proper diversification increases the probability that the fund receives the highest possible return at the lowest possible risk, given the objectives of the fund.

I'm not suggesting that mutual funds escape without share-price declines during major market downturns. For example, mutual funds that invested in U.S. stocks certainly declined during the October 1987 U.S. stock market crash. However, the unhappiest investors that month were the individuals who had all their money riding on only one or a handful of stocks. Some individual stock share prices plunged by as much as 80 to 90 percent. During the early 2000s bear market, many mutual funds declined in value. But again, the investors who were most harmed were those who held individual stocks that, in the worst cases, ended up plummeting to $0 as companies went bankrupt, or those investors who loaded up on technology and Internet stocks that dropped 80 to 90 percent or more.

WARNING!

Although most mutual funds are diversified, some aren't. For example, some stock funds, known as *sector funds,* invest exclusively in stocks of a single industry (for instance, healthcare). Others focus on a single country (such as India). I've never been a fan of such funds because of the lack of diversification and because such funds typically charge higher operating fees. It's also worth noting that investors who bought sector funds investing exclusively in Internet stocks got hammered in the technology stock crash of the early

2000s. Many of those funds dropped 80 percent or more, whereas broadly diversified funds fared far better. I talk more about narrowly focused stock funds in Chapter 10.

Funds undergo regulatory scrutiny

Before a fund can take in money from investors, the fund must go through a tedious review process by the Securities and Exchange Commission (SEC). After it offers shares, a mutual fund is required to publish in its prospectus (see Chapter 5) historical data on the fund's earnings, its operating expenses and other fees, and its rate of trading (turnover) in the fund's investments.

It should go without saying that government regulators aren't perfect. Conceivably, a fund operator could try to slip through some bogus numbers. But I wouldn't lose sleep worrying about this, especially if you invest through the larger, reputable fund companies recommended in this book.

You choose your risk level

Choosing from a huge variety of mutual funds, you can select the funds that meet your financial goals and take on the kinds of risks that you're comfortable with. Funds to choose from include

- **Stock funds:** If you want your money to grow over a long period of time (and you can put up with some bad years thrown in with the good), select funds that invest more heavily in stocks. (Check out Chapter 10 for the complete story on stock funds.)
- **Bond funds:** If you need current income and don't want investments that fluctuate as widely in value as stocks do, consider bond funds (see Chapter 9).
- **Money market funds:** If you want to be sure that your invested principal does not drop in value because you may need to use your money in the short term, you can choose a money market fund (see Chapter 8).

Most investors choose a combination of these three types of funds to diversify and help meet different financial goals. I get into all that information in the chapters to come.

Fund risk of bankruptcy is nil

Mutual funds don't work like banks and insurance companies, hundreds of which have failed in recent decades. Banks and insurers can fail because their *liabilities* (the money customers have given them to invest) can exceed

Are mutual funds too risky?

One of the major misconceptions about mutual funds is that they all invest entirely in stocks and, therefore, are too risky. They don't, and they're not. Using mutual funds, you can invest in a whole array of securities, ranging from money market funds, bonds, stocks, and even real estate.

You may be surprised to discover that only about half of all the money invested in mutual funds is invested in stocks. The other portion of mutual fund assets is invested in money market securities and bonds.

When you hear folks talking about the riskiness of mutual funds, even in the media, you know that they're overlooking this fact: All mutual funds are not created equal.

- Some funds, such as money market funds, carry virtually zero risk that your investment will decline in value.
- Bond funds that invest in shorter-term bonds don't generally budge by more than several percentage points per year.

And you may be surprised to find out in Chapter 10 that some conservative stock funds aren't all that risky if you can plan on holding them for a decade or more.

their *assets* (the money they've invested or lent). When a big chunk of a bank's loans go sour at the same time that its depositors want their money back, the bank fails. That happens because banks have less than 20 cents on deposit for every dollar that you and I place with them. Likewise, if an insurance company makes several poor investments or underestimates the number of claims that insurance policyholders will make, it too can fail.

Such failures can't happen with a mutual fund. The situation in which the investors' demand for the return of their investment (the fund's liabilities) exceeds the value of a fund's investments (the fund's assets) simply can't occur. The reason: For every dollar that a fund holds for its customers, that mutual fund has a dollar's worth of redeemable securities.

REMEMBER

That's not to say that you can't lose money in a mutual fund. The share price of a mutual fund is tied to the value of its underlying securities: If the underlying securities, such as stocks, decrease in value, so, too, does the net asset value (share price) of the fund. If you sell your shares when their price is less than what you paid for them, you get back less cash than you originally put into the fund. But that's the worst that can happen; you can't lose all your investment in a mutual fund unless every single security owned by that fund simultaneously becomes worthless — an extraordinarily unlikely event.

In fact, since the Investment Company Act of 1940 was passed to regulate the mutual fund industry, no fund has gone under. (A money market fund run by and invested in by banks did disband after losing a small portion of principal — see Chapter 8.)

You may be interested to know that the specific stocks and/or bonds that a mutual fund buys are held by a *custodian* — a separate organization or affiliate of the mutual fund company. The employment of a custodian ensures that the fund management company can't embezzle your funds and use assets from a better-performing fund to subsidize a poor performer.

Funds save you from sales sharks

Stock brokers (also known as financial consultants) and commission-based financial planners make more money by encouraging trading activity and by selling you investments that provide them with high commissions — limited partnerships and mutual funds with high load fees, for example. Brokers and planners also get an occasional message from the top brass asking them to sell some newfangled investment product. All this creates inherent conflicts of interest that can prevent brokers from providing objective investment and financial advice and recommendations.

The better no-load (commission-free) fund companies discussed in this book generally don't push specific products. Their toll-free telephone lines are staffed with knowledgeable people who earn salaries, not commissions. Sure, they want you to invest with their company, but the size of their next paycheck doesn't depend on how much they persuade you to buy or trade.

You have convenient access to your money

What I find really terrific about dealing with mutual funds is that they're set up for people who don't like to waste time going to a local branch office and waiting in line. I don't know about you, but I enjoy waiting in lines, especially in places like a bank, about as much as I enjoy having my dentist fill a cavity.

With mutual funds, you can make your initial investment from the comfort of your living room by filling out and mailing a simple form and writing a check. (Computer lovers can open and fund accounts online as I discuss in Chapter 12.) Later, you can add to your investment by mailing in a check or by authorizing money transfers by phone or online from one mutual fund account to another.

Selling shares of your mutual fund for cash is just as easy. Generally, all you need to do is call the fund company's toll-free number or click your computer mouse at your investment firm's Web site. Some companies have representatives available by phone 24 hours a day, 365 days a year. (Web sites, of course, are always supposed to be open.)

Don't fret about the crooks

Don't worry about others having easy access to the money you've invested in mutual funds. Even if someone were able to convince a fund company through the toll-free phone line that he were you (say, by knowing your account number and Social Security number), the impostor, at worst, could only request a transaction to occur between accounts registered in your name. You'd find out about the shenanigans when the confirmation arrived in the mail, at which time you could call the mutual fund company and undo the whole mess. (Just by listening to a tape of the phone call, which the fund company records, the company could confirm that you didn't place the trade.)

No one can actually take money out of your account, either. Suppose that someone does know your personal and account information and calls a fund company to ask that a check be sent from a redemption on the account. Even in such a scenario, the check would be sent to the address on the account and be made payable to you.

The only way that someone can actually take money out of your account is with your authorization. And there's only one way to do that: by completing a full trading authorization or power-of-attorney form. I generally recommend that you not grant this authority to anyone. If you do, make sure the investment firm makes checks payable only to you, not to the person disbursing the money from the account.

Many mutual fund companies also allow you to wire money back and forth from your local bank account, allowing you to access your money almost as quickly through a money market fund as through your local bank. (As I discuss in Chapter 8, you probably need to keep a local bank checking account to write smaller checks and for immediate ATM access to cash.)

When dealing with a money market fund, in particular, the ease of access is even greater. Most money market funds also offer check-writing privileges. These accounts often carry a restriction, however, that your bank checking account doesn't have: Money market checks must be greater than a specified minimum amount — typically $250.

If you like to conduct some transactions in person, some of the larger fund companies, such as Fidelity, and certain discount brokers, such as Charles Schwab and TD Waterhouse, have branch offices in convenient locations.

Addressing the Drawbacks

Although I'm a fan of good mutual funds, I'm also well aware of their drawbacks, and you need to know them, too. After all, no investment vehicle is perfect, and you need to understand the risks unique to mutual funds before you take the plunge.

Still, the mutual fund drawbacks that I'm concerned about are different from the ones that some critics like to harp on. Here's my take on which mutual fund drawbacks you shouldn't worry about — and which ones you should stop and think about a little more.

Don't worry about these . . .

The following concerns shouldn't trouble you:

- **Fund company scandals:** In recent years, a number of funds (none that were recommended in the past edition of this book) earned negative publicity due to their involvement in problematic trading practices. In the worst cases, some fund managers placed their own selfish agendas ahead of their shareholders' best interests. Rightfully, these fund companies have been hammered for such behavior and forced to reimburse shareholders (more on these scandals in the sidebar "In scandal's wake, are funds still a good investment?"). However, the amount of such damage and reimbursement has been less than one percent of the affected fund's assets, which pales in comparison to the ongoing drag of high expenses discussed in the next section.
- **The investment Goliath:** One of the concerns I still hear about is the one that, because the fund industry is growing, if stock fund investors head for the exits at the same time, they may get stuck or trampled at the door. Mutual funds hold just 22 percent of outstanding U.S. stocks. They're growing in importance simply because they're a superior alternative for a whole lot of people.
- **Doing business outside of a building:** Some people, particularly older folks who grew up doing all their saving through a local bank, feel uncomfortable doing business with an organization that they can reach only via a toll-free number, the mail, or a Web site. But please recognize the enormous benefits of mutual funds' *not* having branch offices all over the country. Branch offices cost a lot of money to operate, which is one of the reasons why bank account interest rates are so scrawny.

  If you feel better dropping your money off in person to an organization that has local branch offices, invest in mutual funds through one of the firms that I recommend later that maintain branch offices, such as Charles Schwab, TD Waterhouse, or Fidelity. Or do business with a fund company that's headquartered near your abode. (See the Appendix for the main addresses of the fund companies recommended in this book.)

Worry about these (but not too much) . . .

No doubt you hear critics in the investment world state their case for why you should shun funds. Not surprisingly, the most vocal critics are those who compete with fund companies and stand to lose money as increasing numbers of investors discover the virtues of fund investing.

In scandal's wake, are funds still a good investment?

When news of the mutual fund scandals broke during 2003, I got a lot of questions from people, and most questions took one of two forms: Whether I still believed that mutual funds were a swell investment, and if I thought the revelations were an industry-wide problem or limited to the handful of funds. Simply put, I do still enthusiastically recommend mutual funds as an investment vehicle. And I don't see this as a widespread problem.

Specific funds at Alger, Alliance, Bank of America (Nations Funds), Bank One, Federated, Janus, Putnam, and Strong have been accused of one or two problematic trading practices:

- **Late trading:** Employees at Bank of America's Nations Funds and at Federated have so far been accused of this illegal activity. *Late trading* occurs when a fund allows an investor to place an order to buy or sell fund shares after the close of business (4:00 p.m. EST). For example, suppose that some U.S. companies announce at 4:30 p.m. EST that their profits were above analysts' estimates. This news is expected to cause U.S. stocks to trade higher the next day. At 4:35 p.m. EST, a fund allows a large shareholder to place a buy order at that day's closing net asset value (share price), despite the fact that the order wasn't put in before the 4:00 p.m. deadline. Thus, the fund has given preferential treatment to the investor by allowing that person to trade based upon information unavailable to other shareholders in the fund at the time they had to place their trades.
- **Short-term trading:** This problematic, although not illegal, trading practice occurs when investors actively purchase and redeem fund shares over short time periods, often a few days or less. This kind of short-term trading increases the fund's operational costs that all fund shareholders end up shouldering. Many fund companies discourage short-term trading because of its adverse impact on most shareholders. Some mutual funds enabled certain investors to engage in short-term trading despite the fund company's claiming in their prospectuses that they discouraged short-term market timing. Interestingly, the fund companies involved in this scandal, with the possible exception of Janus, aren't among the premier players in the industry. With the collapsing of the high-flying growth stocks after the late 1990s, the bloom has been off of Janus's rose.

As I have always stressed, the parent company responsible for an individual fund should be an important consideration when deciding which funds to entrust with your money. I would avoid fund companies that do not place their shareholders' interests first.

You can easily overcome the common criticisms raised about fund investing if you do your homework and buy the better available mutual funds, which I show you how to do in this book. Make sure that you consider and accommodate these factors before you invest in any mutual fund:

- **Volatility of your investment balance:** When you invest in mutual funds that hold stocks and/or bonds, the value of your funds fluctuates with the general fluctuations in those securities markets. These fluctuations don't happen if you invest in a bank certificate of deposit (CD) or a fixed insurance annuity that pays a set rate of interest yearly. With CDs or annuities, you get a statement every so often that shows steady — but slow — growth in your account value. You never get any great news, but you never get any bad news either (unless your insurer or bank fails, which could happen).

Over the long haul, if you invest in solid mutual funds — ones that are efficiently and competently managed — you should earn a better rate of return than you would with bank and insurance accounts. And if you invest in stock funds, you'll be more likely to keep well ahead of the double bite of inflation and taxes.

WARNING!

If you panic and rush to sell when the market value of your mutual fund shares drops (instead of holding on and possibly taking advantage of the buying opportunity), then maybe you're not cut out for funds. Take the time to read and internalize the investment lessons in this book, and you'll soon be an honors graduate from my Mutual Fund University!

- **Mystery (risky) investments:** Some mutual funds (not those that I recommend) have betrayed their investors' trust by taking unnecessary and, in some cases, undisclosed risks by investing in volatile financial instruments such as futures and options (also known as *derivatives*). Because these instruments are basically short-term bets on the direction of specific security prices (see Chapter 1), they're very risky when not properly used by a mutual fund. If a fund discloses in its prospectus that it uses derivative, look to see if the derivatives are used only for hedging purposes to reduce risk rather than as speculation on stock and bond price movements, which would increase risk.
- **Investments that cost an arm and a leg:** Not all mutual funds are created equal. Some charge extremely high annual operating expenses that put a real drag on returns (again, you won't find such funds on my recommended lists in this book). I talk more about expense ratios and how to find great funds with low expenses in Chapter 5.
- **Taxable distributions:** The taxable distributions that funds produce can also be a negative. When fund managers sell a security at a profit, the fund must distribute that profit to shareholders in the fund. For funds held outside tax-sheltered retirement accounts, these distributions are taxable. I fill you in on taxes and mutual funds in Chapter 7.

BEWARE

Some people — especially brokers and self-anointed gurus who advocate investing in individual securities — argue that taxes on mutual fund distributions are a problem big enough to justify the avoidance of mutual funds altogether, especially for higher tax-bracket investors. They don't have to be. If you're concerned about the money you're investing outside of tax-sheltered retirement accounts, don't worry — I have a solution: See my recommended tax-friendly funds in Chapters 8 through 10.