Financial Wellness
& Education

Understanding mutual funds

In devising an investment strategy, would you put all of your money into one or two stocks and hope for the best? If you're like most people, the answer is "probably not." It would be more prudent to "diversify" your assets over a variety of stocks, so that your financial situation didn't depend on the performance of any one investment. Of course, diversification does not offer protection against overall market trends that generally affect stocks or bonds. However, it does protect against poor performance of a single stock or bond. Mutual funds are a good way to diversify your assets.

Investing in mutual funds is one of the best ways to tap into the growth potential of the stock and bond markets.

What is a mutual fund?

A mutual fund is a collection of stocks, bonds or other securities owned by a group of investors and managed by one or more professional portfolio managers. Investing in mutual funds is one of the best ways to tap into the growth potential of the stock and bond markets. But with thousands of mutual funds to choose from, finding the funds that best suit your needs can be a tricky business. But, it doesn't have to be impossible. In fact, understanding mutual funds is easier than you might imagine. In general, mutual funds fall into three main categories: equity, bond and money market.

Equity funds

Equity funds invest primarily in stocks. However, their portfolios differ depending on each fund's investment objective. Some funds, for example, invest in well-established companies. Others invest in a particular industry or sector of the economy, such as health care or finance. The primary benefit of investing in equity funds is the potential for capital appreciation over the long term. In return for this potential, investors must be willing to accept the risk of greater interim fluctuations in value.

Equity funds can be further subdivided based on market capitalization, or total market value, of the stocks they hold. Companies above a certain market-cap threshold are considered "large cap," companies below a market-cap threshold are "small cap," and everything else in the middle is "mid cap." These "market caps" are flexible and can change according to market conditions.

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Bond funds

Bond funds invest in government, municipal or corporate debt securities, and are similar to bonds in that they provide regular income. The advantage of bond funds is that you can invest a much smaller amount of money than you would need to buy an individual bond on your own. And like all mutual funds, bond funds offer diversification and professional management. Bond funds come in two varieties— taxable and tax-exempt. Dividends earned on corporate and U.S. government bond funds are subject to federal taxes, while municipal bond fund earnings are exempt from federal income taxes—and often state and local income taxes for investors living in the state issuing the underlying bonds.

There are two basic types of risk associated with bond funds–credit risk and interest rate risk. Credit risk refers to the possibility that a bond's issuer may not be able to pay interest payments or principal when due. Interest rate risk is the fact that as interest rates rise, the value of bonds decline. Finally, unlike an investment directly in a bond which, if held to maturity, will return the full amount of its principal in the absence of a default, an investment in a bond fund upon redemption may return more or less than the original investment depending upon interest rate fluctuations and defaults, if any, and their effects on the bond fund portfolio.

Money market funds

Money market funds provide low risk and high stability. They invest in short-term debt securities of U.S. government agencies, banks and corporations. While money market funds do not seek capital appreciation, they do attempt to maintain a constant share price—only the yield fluctuates. Also, most money market funds let investors write checks against their accounts. Like bond funds, money market funds fall into the taxable and tax-exempt categories. Taxable funds buy the best yielding short-term corporate or government issues available, while tax-exempt funds are limited to buying primarily municipal debt.

Money market funds are among the most conservative investment vehicles available, offering relative stability of principal, liquidity and a return that is generally higher than that available on most bank savings and checking accounts. It is important to remember that an investment in a money market fund is not insured or guaranteed by the Federal Deposit Insurance Corporation (FDIC) or any other government agency. And, although these funds seek to preserve the value of your investment at $1.00 per share, there is no guarantee that they will do so.

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- Create retirement income strategies
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- Plan your legacy

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