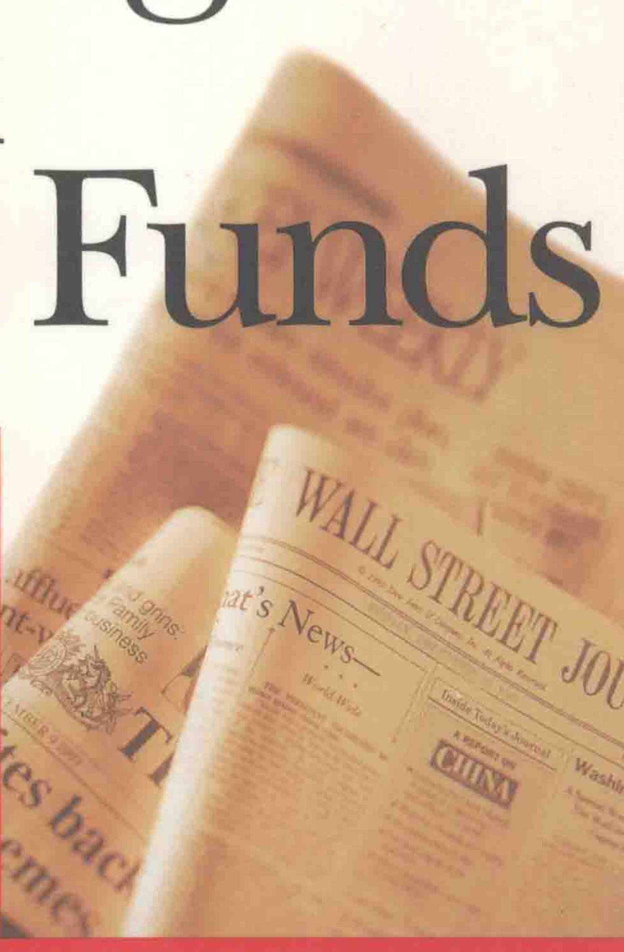
The Sensible Sourcebook!

Smart Guide™ to Profiting from Mutual Funds

Quick & Easy Strategies for Getting the Most Out of Your Investments



Smart Definitions of blended funds, balanced funds, and closed-end funds

Smart Strategies for college savings, tax-free funds, and retirement plans

Smart Tips on how to find reliable fund families and managers, and how to ride a volatile market

Susan Karp

Smart Guide™ to Profiting from Mutual Funds

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Introduction

By the time you read this, there probably will be more than nine thousand mutual funds available to the American investor. So you're not alone if you feel overwhelmed by the sheer volume of possible investment choices.

That's where this book comes in. The goal of the *Smart Guide to Profiting from Mutual Funds* is to help you make sense of the rapidly expanding mutual fund universe. You'll learn how to evaluate both potential investments—and, more important—your own individual financial needs.

The book begins with the basics of mutual fund investing. We all know that funds have grown in popularity; here we find out why. Plus, we'll compare mutual funds with securities and learn just how they stack up to stocks, bonds, and bank investments.

Then we'll take an inside look at the types of funds available. For example, you'll learn the real difference between growth and aggressive growth funds (it's surprisingly less than you might think); the story behind sector funds; the not-so-junky truth about high-yield bond funds; and we'll get to the bottom of the index fund phenomenon.

Most investors are surprised to learn that despite the many funds out there, only a handful are really right for them. That's why this book continually urges you to look at your own life and honestly assess your financial goals, time horizon, and, especially, your personal tolerance for risk.

Throughout the guide, you'll also find profitable advice from investment experts. Newsletter editors, professional money managers, financial planners, and even the lay investor just like yourself share their hard-earned wisdom about making the most of today's markets. They point out what you should look for in a mutual fund and explain smart ways to evaluate fund performance and investment styles. And whether you are looking to invest for retirement, college expenses, a new home, or current income needs, you'll find model asset-allocation plans that can help you to build your own portfolio, one easy step at a time.

Because investing is never a one-time decision, we'll also cover the best ways to manage and monitor your investments. The book includes tips to reading jargon-heavy prospectuses, newspaper fund tables, and often-confusing account statements. We also take a hard look at fund expenses and provide proven strategies to reduce the costs of investing.

There's a good reason the book is titled the *Smart Guide*: It is meant to be used as a resource and designed so that the precise information you need is always easy to find. That's why essential definitions appear right where you need them—not hidden in some back-of-the-book glossary. In addition, "Smart Sources" are included in most chapters, to help you find inexpensive funds, tax help, and places to go for more specific information. And since so many investors have turned to the Internet, you'll also find an up-to-date listing of the best online financial sites.

Investing, particularly in mutual funds, does not have to be either complicated or time consuming. But that does not make it any less important; today more than ever, Americans have to take increasing responsibility for our own financial futures. Fortunately, *you've* already taken the first step to investment success.

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CHAPTER 1

Mutual Fund Basics

THE KEYS

- Professionally managed mutual funds have become America's most popular investment.
- Mutual funds allow you to invest in hundreds of securities for remarkably little money.
- You can invest to meet specific financial goals—whether you want growth, income, or simply to preserve your capital.
- Mutual funds offer one-step diversification—and a host of other advantages.
- Mutual funds can offer better returns than bank CDs with less risk than either stocks or bonds.

America is becoming a nation of investors—and mutual funds are proving to be their investment of choice.

Over the past two decades, money has poured into the mutual fund industry to the tune of $4 *trillion*—a sum larger than most countries' economies. And the industry has responded, growing to include more than eight thousand different fund investments.

Chances are, even if you don't own a mutual fund yourself, you know someone who does—a neighbor, co-worker, or relative. In fact, as of 1997, one out of every four American households owned a mutual fund. Or, to put this in a more human context, more Americans have mutual funds than have home computers, car phones, or college educations.

A Brief History

Given their astounding popularity in the United States, it's ironic that mutual funds are actually a nineteenth-century European innovation. Back in the 1870s, Scottish merchants looking for more attractive returns pooled their assets into investment trusts, the forerunner of today's mutual funds. Some of this money eventually found its way to the United States, helping to finance the country's growth after the Civil War.

Of course, nothing succeeds like success, and by the 1920s, the U.S. versions of investment trusts were flourishing. By 1929, investors had a choice of more than seven hundred different investments. Hard hit by the Great Depression (which led to numerous federal reforms that ultimately strengthened the fund business), mutual funds rebounded after World War II—and began to grow into the industry we know today.

Until the early '70s, however, mutual funds remained largely the province of wealthy investors or institutional ones. Middle-income and novice investors relied much more heavily on bank accounts or specific stock investments. But when raging inflation outpaced bank interest rates, Americans went looking for higher-yielding prospects—and fund companies happily provided them. Innovations like money market funds and tax-free funds opened up new opportunities to small investors—and neither they nor the industry has looked back since.

SMART MONEY

Why have mutual funds struck such a chord with today's investors? "Mutual funds are one of the few options available to the typical investor who wants to pay for retirement or college," says Russ Kinnel, equity fund editor for Morningstar Mutual Funds. "So I think even if we weren't having such great market returns, funds would still have grown in popularity.

"Fund companies have also learned how to cater to investors. Lots of services and extremely easy investing have made funds very appealing. And investors are comfortable knowing they can get out of an investment any time they want—which is not quite the same feeling you have with a few individual stocks."

What Is a Mutual Fund?

A mutual fund is an investment company that pools money from many individual investors who share a common or "mutual" investing goal. The fund employs a professional money manager to invest those resources in securities like stocks, bonds, or money market instruments.

Like most corporations, mutual funds issue shares. When you invest in a fund, you own a proportion of the fund's portfolio based on the number of fund shares you own. As a shareholder, you can potentially make money in three ways:

1. You can earn dividends. Dividends are paid from the income that is generated by the fund's investments.

STREET SMARTS

Jimmy Carter was in the White House when Charlie O'Bert bought his first mutual fund. He purchased shares of a Dreyfus money market fund. He then followed that purchase with stock funds from Fidelity and Vanguard.

"I started investing in mutual funds because I understood how difficult it was to select stocks. I knew that I wasn't going to do better than someone who spends his career researching the markets." Charlie may have started off small, but he has watched those beginning investments pay off handsomely.

"I've done really well; some of my investments have easily tripled." Charlie credits his success to his patient, long-term approach. "I'm not a market timer. I don't buy and then quickly sell funds. Instead, I've just kept adding to my investments and the market's taken care of the rest."

2. You can realize capital gains, when the fund manager sells part of the fund's portfolio for a profit.

3. You can benefit from positive changes in market value. If the value of your fund's portfolio increases or appreciates, so does the value of each share you own. Of course, like most investments, fund share prices can also decrease or depreciate in value as well.

Open and Closed

There are two basic types of mutual funds: *open-end funds* and *closed-end funds.* Open-end funds are by far the more common; they're what most of us mean when we talk about mutual fund investments. Open-end funds continually issue (and buy back) shares to meet investor demand. The share price of an open-end fund is determined by the market value of the securities held by the fund's portfolio.

Closed-end funds, on the other hand, issue a fixed number of shares, which generally trade on an exchange, much like a corporate stock. That's why the price of closed-end funds depends not just on the fluctuating value of the fund's portfolio, but also on the market demand for fund shares.

While there are some good reasons to invest in closed-end funds (for example, they're often traded at a discounted price), they're much more complicated to buy, sell, and research than open-end investments, and aren't necessarily suitable for most investors. This book will focus solely on

Fidelity: The First Name in Stock Funds

Boston-based Fidelity may well be America's best-known mutual fund company; it's certainly the largest. Fueled by the stunning success of its Magellan Fund, Fidelity now has more than $600 billion under management and offers more than two hundred mutual funds.

Founded in 1946 by stockpicker Ned Johnson, Fidelity has always emphasized extensive research and a "bottom-up" investing approach that concentrates on specific companies rather than overall industries. This strategy paid off with tremendous returns throughout the 1980s and early 1990s; however, the family has stumbled in recent years. Critics charge that Fidelity's mammoth size has made it difficult for the company to implement the bold moves it was once famous for. Highly publicized fund manager defections have also hurt. However, a recent flurry of proactive management moves—like closing the now $60-billion-plus Magellan to new investors—have won kudos from the industry.

Investors interested in Fidelity funds may want to check out one of the many independent newsletters that analyze the company's offerings. Fidelity Insight, created by ex-staffer Eric Kobren, is available by calling (617) 369-2500; the equally comprehensive Fidelity Monitor is at (800) 397-3094.

Fidelity Investments
800-544-8888
www.fidelity.com

open-end funds; however, more information about closed-end funds is available from the Investment Company Institute, a Washington, D.C.-based industry association. The ICI can be reached at (202) 326-5800 or via their web site (www.ici.org).

SMART DEFINITION

Prospectus

A prospectus is a legal document that contains important information about the fund's objectives, investment strategy, and fees. The Securities and Exchange Commission (SEC) has mandated that fund companies must provide a prospectus to all potential fund investors.

Choose Your Goal: Investing for Growth, Income, or Safety

Every mutual fund, whether open- or closed-end, invests to meet a specific financial objective, which is described in the fund's prospectus. You'll find that a fund's goals are usually very broad; most fall into one of three categories:

• **Growth.** The fund manager seeks to increase the value of fund assets

• **Income.** The manager aims to generate a regular flow of current income

• **Safety.** The manager aims simply to protect your money from loss

A fund's objective should provide you with a general guide to how the fund will invest (although you'll be surprised to learn how loosely some fund managers can interpret these simple definitions). Funds seeking growth will invest mainly in stocks, which have historically outperformed all other investments, delivering the best returns over time. Stock funds come in many varieties: aggressive growth funds; growth-and-income funds; small-company funds; international funds; specialized or sector funds; index funds; and many (some might say too many) more. You'll find more information about stock funds in chapter 2.

Income funds, not surprisingly, focus primarily on bonds and other dividend-paying securities (including stocks) in order to generate a steady income stream. Quite a number of bond funds also offer tax advantages: by investing in instruments issued by the United States or by municipal governments, they can provide returns exempt from local, state, and even federal taxes.

Investors looking for stability tend to prefer money market funds, also known as money funds. These funds typically invest in high-quality, short-term securities, such as U.S. Treasury Bills and bank certificates of deposit; many provide tax-free income as well. Managed to maintain a constant $1 share price, money funds provide a remarkably high degree of safety (although it's important to note that they are neither guaranteed nor insured by the federal government). We'll discuss both bond and money funds in more depth in chapter 3.

SMART DEFINITION

Stocks

Stocks represent an ownership stake in a corporation. By purchasing shares of stock, you buy a fraction of that company; consequently, you stand to profit if and when the company makes money.

The Advantages of Fund Investing

For some, the attractive returns delivered by so many mutual funds over the past few years are justification enough to invest. But mutual funds also offer a host of special advantages, particularly for the individual investor:

• **Professional money management.** Have you ever wanted to hire a full-time financial adviser to look after your assets? That's essentially what you're doing when you invest in a mutual fund—only for a lot less money.

For a surprisingly small sum (usually for as little as a $1,000 investment), an experienced fund