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Investment Fund Management (Module 208) and Jordan Investment Simulation Game

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Investment Fund Management (Module 208)

Introduction

Managing a mutual fund is a lot like gathering a group of friends willing to share their dinner orders; you can sample a little of everything on the menu.

A mutual fund brings together people, too--people who want to invest. The fund pools together the group's money and invests it for them in a collection of securities, such as stocks or bonds or a combination of the two.

Setting Investment Fund Objectives

When you buy a mutual fund, you're actually buying shares of the fund. The price of a share at any time is called the fund's net asset value, or NAV. Invest $1,000 in a fund with an NAV of $118.74, and you will get 8.42 shares. (Unlike stocks, you can own fractions of a fund share.)

For example, Vanguard 500 Index's VFINX four largest holdings are Microsoft MSFT (4.16% of its portfolio as of February 1999), General Electric GE (3.28%), Intel INTC (2.24%), and Wal-Mart Stores WMT (1.85%). Your $1,000 investment in the fund means you own $41.60 worth of Microsoft, $32.80 of General Electric, and so on. In an indirect way, you own the 500 stocks in the fund's portfolio.

The Benefits

1. They don't demand large up-front investments.

You can buy some funds for as little as $50 per month if you agree to dollar-cost average, or invest a certain dollar amount each month or quarter.

2. They're easy to buy and sell.

You can buy mutual funds three ways: through financial advisors, directly from fund families, or via no-transaction fee networks, which are also called fund supermarkets.

The exception: closed funds. Closed funds no longer accept new money, except, in some cases, from current shareholders. Investors who own closed funds can sell at any time, though. And when you sell shares of a fund, you get cash in return.

3. They're regulated.

Mutual funds can't take your money and head for some remote island somewhere.

The act of 1940 is important to investors because it makes your mutual fund a regulated investment company (regulated by the Securities & Exchange Commission), and it makes you an owner of that company. Fidelity, for example, is a company that runs dozens of mutual funds.

Mutual funds are *not* insured or guaranteed.

4. They're professionally managed.

If you plan to buy individual stocks and bonds, you need to know how to read a cash-flow statement or calculate duration. Such knowledge is not required to invest in a mutual fund.

Mutual funds are not fairy-tale investments.

What is NAV?

At first blush, mutual fund NAVs seem just like stock prices. Both represent the price of one share of an investment and appear in newspapers and on financial Web sites. But that's where the similarities end.

Calculating NAV

A mutual fund calculates its NAV by adding up the current value of all the stocks, bonds, and other securities (including cash) in its portfolio, adjusting for expenses, and then dividing that figure by the fund's total number of shares.

For example, a fund with 500,000 shares that owns $9 million in stocks and $1 million in cash has an NAV of $20.

Differences between NAVs and stock prices in in four important ways.

Difference One. Stock prices change throughout the trading day, but mutual fund NAVs are usually calculated only once each day, at the end of trading.

In contrast, stock purchases are often made in even share amounts--you buy 50 shares of Coca Cola KO or 100 shares of Microsoft MSFT. A high stock price can therefore be a barrier to investors who don't have much money to invest.

Difference Two. Stocks have a fixed number of shares outstanding.

In contrast, mutual funds generally have an unlimited number of shares.

Difference Three. You can determine whether a stock is a bargain or not by comparing its price to a "fair" price, based on such information as earnings estimates or cash flows.

With mutual funds, however, NAV is tied solely to the current value of the fund's underlying holdings. There is no "fair" price of a mutual fund the way there might be with a stock.

Difference Four. You can often use stock prices and nothing else to gauge how well a stock is performing. Mutual funds, however, distribute any income or gains they realize to shareholders as dividends, which, in turn, pulls down their NAVs. Unless you account for such distributions, you're underestimating a fund's actual performance.

To accurately gauge a fund's performance, you need to examine its total return, which takes into account both the appreciation of the fund's holdings as well as any distributions that have been paid.

Daily access to NAVs reassures you that your investment is being watched over, valued, and reported on.

How to Calculate a Fund’s Total Return

With funds, interference occurs whenever a fund makes a payment to its shareholders, otherwise known as a distribution.

Distributions Complicate Things

By law, mutual funds must distribute any income they have received and capital gains they have realized from their holdings. But whenever a fund passes along either income or capital gains to shareholders, its NAV drops. If a fund with an NAV of $10 makes a $4 distribution, its NAV slips to $6.

What is Yield

Yield represents income that a fund distributes to its shareholders. Income comes from dividend-paying stocks and bonds owned by the fund. Income excludes any capital-gains distributions, as well as any underlying gains in the portfolio that have yet to be realized.

Yield can be calculated in a variety of ways. Morningstar calculates yield on a trailing-12-month basis.

Yield tends to interest those investors who need regular income, because they can reinvest any capital gains a fund generates while pulling out the income, or yield. Also, because income is taxed at a higher rate than capital gains, high-yielding funds are usually tax headaches.

Measuring Performance with Total Return

Total return encompasses yield and capital gains: changes in NAV caused by appreciation or depreciation of the underlying portfolio, payment of any income (yield) or capital-gains distributions, and reinvestment of all distributions.

Ending position - beginning position

[redacted]

X 100 = total return

Beginning position

Example. Say you buy 10 shares of Fund A at $9 per share. After a few months, the fund's NAV rises to $12. The fund sells some of its winning stocks and makes a $2 per-share capital-gains distribution. It makes no income distributions. As a result, the fund's NAV falls to $10. Your distribution of $20 ($2 x 10 shares) is used to buy 2 more shares at the new $10 price. Finally, say the fund's NAV rises again, this time to $11 share.

So what is the yield on this investment? Zero, because it has not paid out any income. What about your overall return? Well, if you used only your NAV to calculate return, your shares would be worth the fund's final $11 NAV times your initial 10 shares, or $110. That's an NAV return of 22% on your original investment.

But that figure would be inaccurate, because you need to factor in the capital-gains distribution that you reinvested. Add that back in and you'll find your investment is actually worth that $110 plus the $22 your two new shares are worth, for a grand total of $132. Your total return is really 47%.

Mutual Funds and Taxes

Mutual funds don't require a large up-front investment. They're professionally managed. They're easy to buy and to sell. But there is one thing that mutual funds aren't: tax friendly. Here's why, and how you can minimize the tax bite.

Funds, Capital Gains, and Income

Mutual funds can cause tax headaches because investors have no control over when and how much their funds realize in gains

Mutual funds must pass along to their shareholders any realized capital gains that are not offset by realized losses by the end of their accounting year.

Fund managers also distribute any income that their securities generate.

When paying out capital gains or income, funds multiply the number of shares you own by the per-share distribution amount.

Distributions and Taxes

Unless you own your mutual fund through some other type of tax-deferred account, you owe taxes on the distribution--even if you reinvested, or used the distribution to buy more shares of the fund. That is particularly painful if you have just purchased the fund, because you are paying taxes for gains you didn't get.

Example. Suppose you invest $250 in Fund D on Monday. The fund's NAV is $25, so you are able to buy 10 shares. If the fund makes a $5-per-share distribution on Tuesday (which means you have been handed a $50 distribution), and you reinvest, your investment is still worth the same $250:

Monday	10.0 shares @ $25	=	$250
Tuesday	12.5 shares @ $20	=	$250

The trouble is, you now owe capital gains taxes on that $50 distribution. We'll assume that the distribution is made up entirely of long-term gains (which means the manager sold stocks she had held for one year or longer) and is therefore taxed at 20%. (Gains on stocks held for less than one year and income are taxed at higher rates.) That would translate into a $10 tax bill for you.

If you immediately sold the fund, the whole thing would be a wash, as the capital gains would be offset by a capital loss. The distribution lowers the NAV, so the amount of taxes you would pay would be lower than if you sold the fund years from now. Still, most investors would rather pay taxes later than sooner. And we're guessing that if you just invested in the fund, you weren't planning to turn around and sell it right away.

Funds occasionally can add insult to injury by paying out a large capital-gains distribution in a year in which the fund lost money.

Avoiding Over-Taxation

Tip One. Ask a fund company if a distribution is imminent before buying a fund, especially if you are investing late in the year. Find out, too, if the fund has tax-loss carry-forwards--that is, if they have booked capital losses in previous years that can be used to offset capital gains in future years.

Tip Two. Place tax-inefficient funds in tax-deferred accounts, such as IRAs or 401(k)s.

Tip Three. Search for extremely low turnover funds, or funds whose holdings are not bought and sold constantly throughout the year.

Tip Four. Favor funds run by managers who have their own wealth invested in their funds, like Third Avenue Value Fund's TAVFX Marty Whitman or the managers of

Tweedy, Browne. You can often find fund-manager ownership information in a fund's shareholder report, prospectus, or Statement of Additional Information.

Tip Five. If you want fixed-income exposure, consider municipal-bond funds. Income from these funds is usually tax-exempt.

Tip Six. Finally, consider tax-managed funds. These funds use a series of strategies to limit their taxable distributions. Vanguard, Fidelity, and Putnam all offer tax-managed funds.

Even using these tips, it can be difficult to find a fund that's consistently tax-efficient.

How to purchase a fund

Investing in a mutual fund may not be as easy as picking up a gallon of milk from the corner store, but it's pretty close. The trick lies in figuring out whether you want some help choosing your funds, or whether you'd rather do it on your own. Either path has its benefits and drawbacks.

Want some help

Maybe you don't have the time, interest, or wherewithal to craft your own mutual fund portfolio. Fine! All sorts of financial advisors, from planners to brokers, can help you pull together a financial plan and a basket of funds that can help you achieve your goals.

The advantages of working with an advisor are clear: You have someone helping you make financial decisions, taking care of paperwork for you, monitoring fund performance, and forcing you to stick to your investment plan for tomorrow instead of cashing in for an around-the-world jaunt today.

The drawbacks include cost, of course. Then there's the task of finding an advisor whom you can work with, whom you can trust to put your interests before his or her own, and who will turn your financial dreams into realities, not nightmares.

Go it alone: Version 1

Those with the time and interest to learn about investing and to monitor their own portfolios can invest in funds without the help of an advisor. If you choose to invest on your own, focus on what are called no-load funds, which, as their name implies, do not charge any sales commissions. Why pay a commission when you're not getting any investment advice?

Go-it-alone types can buy funds directly from no-load fund groups (also called fund families) such as Fidelity, Vanguard, and T. Rowe Price. (Be careful with Fidelity: It runs load funds, too.)

New investors who plan to buy more than one fund might choose one of the larger no-load families. Why? Because these families are diversified:

Investing with a single fund family--even a large one--can be limiting, though. For example, some families don't offer a wide array of funds.

Another way to diversify, then, is to invest with several fund families, a series of specialists who do one thing particularly well.

Go it alone: Version 2

Do-it-yourselfers who want only the best and who hate paperwork, perk up: Charles Schwab came up with the solution for you. It's called a no-transaction fee network, or a mutual fund supermarket, if you really want to sound in-the-know. Schwab pioneered this idea in 1992 when he launched Charles Schwab OneSource. If you invest through OneSource, you can choose from thousands of funds from dozens of fund families--and there's no direct cost to you. So you could buy one fund from Janus, another from Royce, yet another from PIMCO, and one from Scudder and receive all of your information about performance, taxes, etc., on one consolidated statement.

There are a number of fund supermarkets today, including versions from Jack White and Fidelity. More and more fund families are getting into the act, too: Both T. Rowe Price and Vanguard have supermarkets that include non-T. Rowe Price and non-Vanguard funds.

What could the drawbacks here possibly be? Ironically, one drawback is cost. While it is true that fund supermarkets do not charge you when you invest in a fund through their programs, they charge the fund companies to be included in their programs. That charge ranges from 0.25% to 0.35% of assets per year. However, that fee is often passed along to shareholders--that's right, to you--as part of a fund's expense ratio, the fee the fund charges you each year for managing your money. The real kicker is that shareholders are paying these fees whether they buy the funds through the fund supermarket or directly from the fund family.

Observers, including Vanguard founder John Bogle, also suggest that fund supermarkets encourage rapid trading among funds. Most supermarkets offer online trading, and with so many funds from so many families investing in so many different things to choose from, the temptation is great. But trading too much can hurt your portfolio's overall performance.

Five Questions to ask before buying a fund:

You may feel intimidated by the task of picking a mutual fund. With more than 10,000 funds to choose from, it's tempting to buy a magazine or visit a Web site that will tell you what funds you should buy. Or to just pick the fund that's topping the performance charts. Or to throw darts at a list of funds that earn 5-star ratings from Morningstar.

Obviously, that's not the best way to find the fund that will meet your goals or your investment personality. You should learn how to answer the following five questions before buying a stock fund.

1. How has it performed?

Many would say that a fund that produced returns of 22% per year for the past five years performed better than a fund that returned 20% per year over the same period. That's sometimes the case, but not always. The fund that gained 20% may have beaten competing funds that follow the same investment style by six percentage points, while the 22% gainer may have lagged its competitors by a mile.

To really know how well a fund is doing, you can't look at returns in isolation; instead, put a fund's returns into context. Compare the fund's returns to appropriate benchmarks--to indexes and to other funds that invest in the same types of securities.

2. How risky has it been

The very act of investing involves an element of risk. But some funds are more volatile than others. Generally, the greater the return of an investment, the greater the risk--and therefore the greater potential for loss. Investors who take on a lot of risk expect a greater return from their investments, but they don't always get it. Other investors are willing to give up the potential for large gains in return for a less bumpy ride. Consider a fund's volatility in conjunction with the returns it produces. Two funds with equal returns might not be equally attractive investments; one could be far more volatile than the other.

There are a number of ways to measure how volatile a fund is: standard deviation and beta are the most common. In addition, Morningstar publishes risk ratings, and bear market rankings.

3. What does it own

To set realistic expectations for what a fund can do for you, it's important to know what types of securities a fund's manager buys. You shouldn't expect a bond fund to gain 10% per year, but that's not an unrealistic expectation for a stock fund.

Don't rely on a fund's name to tell you what it owns. Fidelity Magellan FMAGX is a giant in the fund industry, but does the fund's name give you any idea of the types of securities its manager buys?

As we mentioned in our first session, fund managers can buy just stocks, just bonds, or a mix of the two. They can stick with U.S. companies or venture abroad. They can hold popular big companies, like Coca-Cola KO or Gillette G, or focus on small companies most of us have never heard of. They can like high-priced companies that are growing quickly, or they can favor value stocks with lower earnings prospects but cheap prices. Finally, managers can own 20 or 200 stocks. How a manager chooses to invest your money affects your return.

To get a feel for how a manager invests, examine a fund's portfolio. The portfolio section of our Quicktake Reports provides a plethora of portfolio information, including top holdings, sector breakdowns, and the Morningstar style box.

4. Who runs it

Mutual funds are only as good as the people behind them: the fund managers who make the investments. Because the fund manager is the person most responsible for a fund's performance, knowing who's calling the shots, as well as how long he or she has been doing it is essential to smart mutual fund picking. Make sure that the manager who built the majority of the fund's record is still the one in charge. Otherwise, you may be in for an unpleasant surprise.

5. What does it cost

Mutual funds aren't free. You should pay for professional money management, but paying enormous expenses to invest is like giving money away. That's because every penny that you give to fund management or to brokerage commissions is a penny you take away from your own return. Further, costs are one of the few constants in investing--they'll remain pretty stable year in and year out while the returns of stocks and bonds will fluctuate. You can't control the whims of the market, but you can control how much you pay for your mutual funds.

Unfortunately, fund costs are somewhat invisible, buried in shareholder reports and taken right off the top of your return. We provide a detailed breakdown of a fund's costs on our Quicktake Reports. Remember that you may sometimes make money in your mutual funds, but you'll always pay fees.

Why diversify

In reality, however, most investors have assembled a portfolio of different kinds of funds. Why? Because they are seeking diversification.

In this session, we'll cover what diversification is and what role it plays in building a mutual fund portfolio. Subsequent courses in this level will discuss how to build a portfolio of mutual funds.

Modern Portfolio Management Techniques Involve Diversification

Say you are having friends over for a barbecue. Would you only serve coffee to your guests? Probably not. You would likely offer an assortment of beverages--maybe lemonade, iced tea, soda, or beer. In short, you would want to diversify your beverage cart so that your guests, as a group, are satisfied.

Now consider investing. You want to own various types of funds so that your portfolio, as a group of investments, does well. Certain types of investments will do well at certain times while others won't. But if you have enough variety in your portfolio, it is pretty likely you'll always have something that is performing relatively well. Thus owning various types of funds can help reduce the volatility of your portfolio over the long term.

Let's say that you buy a value fund that owns a lot of cyclical stocks, or stocks that tend to do well when investors are optimistic about the economy. If that were your only fund, your returns wouldn't look very good during a recession. So you decide to diversify by finding a fund heavy in food and drug-company stocks, which tend to do relatively well during recessions. By owning the second fund, you limit your losses in an economic downturn. That is the beauty of diversification.

What diversification is not

Say you are having friends over for a barbecue. Would you only serve coffee to your guests? Probably not. You would likely offer an assortment of beverages--maybe lemonade, iced tea, soda, or beer. In short, you would want to diversify your beverage cart so that your guests, as a group, are satisfied.

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Ways to diversify

Diversification can occur at several different levels of your portfolio. Some of those levels are more important for mutual fund investors than others.

Diversifying across Investments. Say you owned stock in a single company. If the company flourished, so would your investment. But if the company went bankrupt, you could lose a large sum of money. To reduce your dependence on that single company, you buy stock in four or five other companies, as well. Even if one of your holdings sours, your overall portfolio won't suffer as much. By investing in a mutual fund, you're getting this same protection.

Diversifying by Asset Class (Asset Allocation). The three main asset classes are stocks, bonds, and cash. Some financial advisors contend that international stocks, real-estate investment trusts, emerging-markets stocks, and the like are also asset classes--but the stocks, bonds, cash division is the most widely accepted. Adding bonds and cash to a stock-heavy portfolio lowers your overall risk. Adding stocks to a bond- or cash-heavy portfolio increases your growth potential. For most investors, it is wise to own a mix of all three. How you determine that mix depends on what your goals are and how long you plan to invest.

Diversifying by Subasset Classes. Within two of the three main asset classes--stocks and bonds--investors can choose several flavors of investment.

With stocks, for example, you may distinguish between U.S. stocks, foreign developed-market stocks, and emerging-markets stocks. Furthermore, within your U.S. stock allocation, you can have large-growth, large-value, small-growth, or small-value investments. You can also make investments in particular sectors of the market, such as real estate or technology. The possibilities for classification are endless and often overwhelming, even to experienced investors.

So what is the bottom line on diversification? Diversifying across investments and by asset class is crucial, and subasset class diversification can be useful. But not everyone needs to own a bond fund, an international fund, a small-cap fund, a real-estate fund, etc. Nor must everyone have exposure to value and growth styles. You should nonetheless consider the various ways that such investments might add diversity to your portfolio--and allow you to rest a little easier.

Methods for investing in Mutual Funds

It's time for a little fantasizing. Say one of your ridiculously wealthy relatives is feeling generous, so she gives each family member $10,000. Her only stipulation is that you invest your gifts in a mutual fund. Would you: 1) wait to invest the 10 grand until the fund you're interested in cools off or heats up? 2) Invest the entire wad immediately? 3) Put a little bit to work at a time?

Which route you choose can have a profound impact on your return.

Waiting, or Market-timing

Let's start with waiting, or what's often called market-timing--holding off on investment until you sense the time is right. That can mean when the fund's performance falls, when it rises, or when the moon is full on an odd-numbered day of the week in a month beginning with *J*.

As you can probably sense, we're not keen on market-timing. It just doesn't work. Predicting the future has never been easy--just ask anyone who has had his or her fortune told. Further, studies from Morningstar and others show that making the right market call just isn't good enough.

Chalk it up to the cruelty of mathematics, as illustrated in an experiment conducted by Morningstar. We went back 20 years and assumed that in each quarter, an investor chose to own all stocks (represented by the S&P 500) or all cash (in our experiment, Treasury bills). A market-timer who picked the better performer half the time *still* ended up way behind the market after two decades. We found that not until the timer's hit rate reached 65% did he beat the S&P 500. In other words, the market-timer had to be right two out of three times to justify the effort.

Why? Because the stock market makes more money than cash does over time. Botching a market-timing decision usually means sacrificing good performance. Worse still, missing a period of strong returns means giving up the chance to make even more on those strong returns, thanks to the effects of compounding. (That is, each year you earn returns on the returns you earned in prior years, as well as on your initial investment.) So unless you know something that we don't--and you wouldn't be reading this if you did--avoid market-timing.

Lump Sum Investing, or Investing All at Once

If market-timing is a losing strategy, what about the opposite: putting all the money to work at once? Many financial advisors recommend this approach above the others, because the market goes up more often than it goes down.

Here's an example. Say you decide to invest your $10,000 gift all at once in one fund while your cousin, who also received a $10,000 windfall, invests $2,000 per month in the same fund over the next five months. The fund consistently rises in value during that time. The chart below illustrates what would happen to the two investments.

Fund Value Increases

Month	Your Investment	Your Cousin's Investment
1	5,556 shares at $1.80 per share	1,111 shares at $1.80 per share
2	N/A	1,099 shares at $1.82 per share
3	N/A	1,081 shares at $1.85 per share
4	N/A	1,070 shares at $1.87 per share
5	N/A	1,053 shares

		at $1.90 per share
Total Shares	5,556	5,414
Ending Value	$10,556	$10,287

You would end up ahead, because you own more shares at the end of the five-month period. And you own more shares because, due to the consistently rising value of the fund, your cousin couldn't afford to purchase as many shares as you had purchased originally. But what happens if the value of your fund fluctuates dramatically during those five months?

Fund Value Fluctuates		
Month	Your Investment	Your Cousin's Investment
1	5,556 shares at $1.80 per share	1,111 shares at $1.80 per share
2	N/A	1,667 shares at $1.20 per share
3	N/A	1,081 shares at $1.85 per share
4	N/A	1,481 shares at $1.35 per share
5	N/A	1,053 shares at $1.90 per share
Total Shares	5,556	6,393
Ending Value	$10,556	$12,147

In this case, your cousin ends up in the lead. By investing a fixed-dollar amount in the fund every month, your cousin bought more shares when the price was low, fewer shares when the price was high, and ended up with more shares after five months.

Such drastic fluctuations in NAV are rare, though. Because funds go up more often than they go down, most investors will receive the best long-term results by lump-sum investing.

Why Dollar-Cost Average

Investing in dribs and drabs may not be the path to greater return, but we still think dollar-cost averaging, investing a set amount every month, is a viable method of investing. In fact, you may already be investing in this way if you contribute to a 401(k) plan at work.

For starters, dollar-cost averaging can reduce your risk. If your mutual fund declines in value, the worth of your investment is less, even though you still own the same number of shares. In the same way that dollar-cost averaging will net you more shares in a declining market, it can curtail your losses as the fund goes down. The chart below illustrates this point.

Fund Value Decreases

Month	Your Investment	Your Cousin's Investment
1	5,556 shares at $1.80 per share	1,111 shares at $1.80 per share
2	N/A	1,250 shares at $1.60 per share
3	N/A	1,379 shares at $1.45 per share
4	N/A	1,538 shares at $1.30 per share
5	N/A	1,667 shares at $1.20 per share

Total Shares	5,556	6,945
Ending Value	$4630	$8,334

In this example, both you and your cousin lost money (remember, you each started with $10,000), but your cousin lost less by dollar-cost averaging. She had cash sitting on the sidelines that did *not* lose value. And when the fund rebounds, your cousin also will be in better shape because she owns more shares of the fund than you do.

The second reason we like dollar-cost averaging is that it instills discipline. Investors often chase past returns, buying funds after a hot performance streak. And they'll sell funds when returns slow or decline. Bad idea: That's a form of market-timing. But dollar-cost averaging prevents you from market-timing, because you're buying all the time. Heck, you may even *forget* that you're investing if you set up an automatic-investment plan with a mutual fund family.

Which leads us to the final reason we love dollar-cost averaging: It's a crafty way to invest in some great mutual funds that might be inaccessible otherwise. Many fund companies will waive their minimum initial investment requirement if you agree to set up an automatic-investment plan and invest a little each month or quarter.

What to Do

While market-timing is out of the question for all investors (but some still try), whether you invest all at once or a little at a time depends on how much time you have to invest and whether your primary goal is maximizing return or minimizing risk.

The shorter your time horizon, the greater chance you take of losing money with a lump-sum investment. However, if you had $20,000 to invest, it probably wouldn't make much sense to invest $1,000 a year for the next 20 years. Funds go up more often than they go down, and when they go down, they eventually bounce back. It is almost certain that the NAV you would pay 10 years from now would be higher than the NAV you would pay today.

We suggest combining the two strategies: Invest as much as you can today, and vow to invest a little more each month or quarter. That'll keep you disciplined *and* have you investing right away.

Fund Costs

Too bad mutual funds aren't more like plumbers.

When you call a plumber to unclog your kitchen sink, you know what it's costing you. The plumber presents you with a bill for services rendered, and you pay the bill with cash, a check, or a credit card. Mutual funds are different. You'll never write a check to a fund for its services. Instead, those costs come right off the top of your investment or straight out of your returns. Because costs are deducted this way, many investors aren't aware of how much they're paying for their mutual funds.

Mutual fund fees can be broken down into two main categories: one-time fees and ongoing annual expenses. Not all funds charge one-time fees, but all funds charge ongoing annual fees of some sort. Return figures that you see for mutual funds do *not* take one-time fees into account, but ongoing expenses that all investors pay are deducted from return figures that you see.

One-Time Fees

There are three types of one-time fees that you may pay, all of which are usually charged when you buy or sell a fund. Remember, not all funds charge these fees; to find out if a fund does charge fees, consult its prospectus.

1. Sales Commissions. Commissions are commonly called loads. If you have to pay a sales charge when you buy a fund, that's known as a front-end load; a sales charge when you sell is a back-end load. (Some back-end loads phase out if you hold the fund for a certain number of years.) You might also pay a level load, or a percentage of your return each year for a series of five or so years.

Loads come directly out of your investment. For example, if you made a $10,000 investment in a fund that carried a 4.5% front-end load, only $9,550 dollars would be invested in the fund. The remaining $450 would go to the advisor who sold you the fund.

The fee goes to the advisor who sells you the investment; it's his or her compensation for doling out financial advice. So if you're buying a load fund, be sure you're getting investment advice in return.

2. Redemption Fees. Redemption fees differ from loads in that they are paid directly to the fund--in other words, they go back into the pot. You may have to pay a redemption fee if you hold a fund for only a certain period of time. In most cases, this time frame is less than 90 days, but it can be as long as a few years.

These fees are an attempt to discourage market-timers from moving in and out of a fund. Why are market-timers bad? Well, a large redemption or a rash of sales can force fund managers to sell securities that they don't really want to sell; they have to get the cash from somewhere to meet the redemption. And if management has to sell securities that have gained in value, it may also pass along a taxable capital-gains distribution to shareholders who remain behind. So in a sense, redemption fees are the friends of long-term investors, because they'll never have to pay them, and the fees hopefully keep timers at arm's length.

3. Account-Maintenance Fees. Some fund companies charge account-maintenance fees, but such fees are usually for smaller accounts. Some Vanguard funds, for example, charge shareholders a $10 account-maintenance fee if their account balances dip below $10,000. Shareholders pay this fee each year until their account values rise above $10,000.

On-Going Expenses

While the fees we've discussed so far are levied by only certain types of funds, all funds annually charge--and deduct from your return--the following fees.

1. Expense Ratio. Most fund costs are bundled into the expense ratio, which is listed in a fund's prospectus and annual report as a percentage of assets. For example, if ABC Fund has assets of $200 million and charges $2 million in expenses, it will report an expense ratio of 1%.

The expense ratio has several parts. The largest element is usually the management fee, which goes to the fund family overseeing the portfolio. There are also administrative fees, which pay for things such as mailing out all those prospectuses, annual reports, and account statements.

The 12b-1 fee can be another large component of the expense ratio. Roughly half of all funds levy these fees. A 12b-1 fee covers a fund's distribution and advertising costs and can be as high as 1% of assets. Those fees that fund families pay to no-transaction-fee networks, which we learned about in Funds 105, often get charged to fund shareholders via 12b-1 fees.

2. Brokerage Costs. These costs are incurred by a fund as it buys and sells securities. These costs are not included in the expense ratio, but instead are listed separately in a fund's annual report or statement of additional information. (We'll talk about these documents at length in later courses.)

This figure excludes some hard-to-pin-down expenses. When a fund invests in over-the-counter stocks (typically stocks traded on the Nasdaq exchange), it doesn't pay the broker a set fee. Rather, the cost of the transaction is built into the stock price. It is a trading expense, but fund companies don't report it separately.

3. Interest Expense. If a fund borrows money to buy securities--not a very common practice among mutual funds--it incurs interest costs. Those costs are taken out of return, as well.

What's Reasonable

As you can see, mutual funds are far from a free lunch. But you can keep more of what you earn by favoring low-cost funds. What is low cost? That depends on how long you plan to own an investment, and what type of fund you're talking about.

With bond funds, for example, you want to favor no-load funds with the lowest possible expense ratios. That's because the difference between the best- and worst-performing bond funds is pretty slim; because bond-fund returns differ by just small amounts, every dollar that goes to expenses really hurts your return. Our advice: Avoid bond funds with expense ratios above 1%.

On the stock side, a load fund may make a perfectly fine investment, if you're a long-term investor. Load-fund investors should also look for funds with low annual costs, such as those sponsored by American Funds. Their total costs (including sales fees) over a period of years are actually more moderate than many no-load funds.

You can find plenty of good funds investing in large-company stocks that charge less than 1% per year in expenses. As with bond funds, the range of returns doesn't vary much, so lower expenses give a fund a decided edge on the competition.

With small-company and foreign-stock funds, expect to pay closer to 1.5% annually. It just takes more effort--and money--to research tiny companies or foreign firms because there isn't much readily available information about them.

At Morningstar, we put a good deal of emphasis on mutual fund costs, not only because they seem so buried, but because we think favoring modest-cost funds is an easy way to improve your long-term results. We've found that over long time periods, lower-cost funds tend to outperform higher-cost funds. And costs are the only thing about a fund that are absolutely predictable, year in and year out.

Investor Relations: Important Fund Documents

The advertisement in the paper roars "Raging Bull Fund, a Great Investment Opportunity!" Underneath, five stars appear, as well as a growth of $10,000 graph that looks like a Himalayan ascent. Must be a great fund, right?

Well, maybe it is. But you need more than stars and performance numbers to judge a fund. You need to answer questions such as: What is the fund's investment strategy? What are that strategy's risks? How much does the fund cost? And who runs the thing, anyway?

What you need are three valuable fund documents: the prospectus, the Statement of Additional Information, and the annual report. When you request an information kit from a fund family, you are usually sent a prospectus and the most recent shareholder report. Sure, the documents are packed with legal jargon, convoluted sentences, and boilerplate information in order to fulfill the Security and Exchange Commission's disclosure requirements and to protect the funds from legal liability. But they're also must-reads for mutual fund investors.

Here's how to get what you need from the prospectus and the Statement of Additional Information.

The Prospectus

The prospectus tells you how to open an account (including minimum-investment requirements), how to purchase or redeem shares, and how to contact shareholder services. But more importantly, you'll find the six things you absolutely need to know about a fund before you decide to buy shares in the first place.

1. Investment Objective. The investment objective is the mutual fund's purpose in life. Is the fund seeking to make money over a long-term period? Or is it trying to provide its shareholders regular income each month? If you're investing for your child's education, you'll want the former. If you're looking for a monthly dividend check, you'll want the latter. But investment objectives can be notoriously vague. That's why you'll want to check out the next section.

2. Strategy. The prospectus also describes the types of stocks, bonds, or other securities in which the fund plans to invest. (It does *not* list the exact stocks that the fund owns, though.) Stock funds spell out what kinds of companies they look for, such as small, fast-growing firms or big, well-established corporations. Bond funds specify what sorts of bonds they generally hold, such as Treasury or corporate bonds. If the fund can invest in foreign securities, the prospectus says so. Most (but not all) restrictions on what the fund can invest in are also mentioned.

3. Risks. This section may be the most important one of the prospectus. Every investment has risks associated with it, and a prospectus must explain these risks. For instance, a prospectus for a fund that invests in emerging markets will reveal that the fund is likely to be riskier than a fund that invests in developed countries. Bond-fund prospectuses typically discuss the credit quality of the bonds in the fund's portfolio, as well as how a change in interest rates might affect the value of its holdings.

4. Expenses. It costs money to invest in a mutual fund, and different funds have different fees. Fortunately, a table at the front of every prospectus makes it easy to compare the cost of one fund with another. Here, you'll find the sales commission the fund charges, if any, for buying or selling shares. The prospectus also tells you, in percentage terms, the amount deducted from the fund's return each year to pay for things such as management fees and operational costs.

5. Past Performance. As the saying goes, "Past performance cannot guarantee future results." But it can give you an idea of how consistent a fund's returns have been. A chart known as the "Financial Highlights" or "Per Share Data Table" provides the fund's total return for each of the past 10 years, along with some other useful information. It also breaks out the fund's income distributions and provides the year-end NAV.

Some prospectuses include additional return information in the form of a bar chart, which illustrates the fund's calendar returns for the past 10 years. This chart is a good way to get a handle on the magnitude of a fund's ups and downs over time. The prospectus may also use a growth of $10,000 graph (also known as a mountain graph, because the peaks and valleys resemble the cross-section of a mountain) or a table comparing the fund's performance to indexes or other benchmarks to present return information. (Unless otherwise stated, total-return numbers do not take sales charges into account.)

6. Management. The Management section details the folks who will be putting your money to work. Hopefully, the fund actually tells you the name and experience of the fund manager or managers. However, some funds simply list "management team" or some other less-than-helpful phrase. If that's the case, consult the fund's Statement of Additional Information or annual report to see if more specific information is given there. Feel free to call up the fund itself, or check out the family's Web site.

If the prospectus does name names, check how long the current manager has been running the fund--the fund's past record may have been achieved under someone else. Find out whether the manager has run other funds in the past. A peek at those funds could give you some clues about the manager's investment style and past success.

Statement of Additional Information

While the prospectus is packed with great information, it shouldn't be your sole source of data on a fund. A fund's Statement of Additional Information (SAI) contains more great tidbits about the fund's inner workings. Be sure to ask for this document specifically: Funds routinely send out prospectuses and annual reports, but SAIs are considered second-tier documents.

If fund families think SAIs are secondary, why bother requesting one? For starters, the SAI often provides far more detail than the prospectus about what the fund can and cannot invest in. For another, this document is usually the place where you can find out who represents your interests on the fund's board of directors--and how much you pay them.

Finally, you can find more details about your fund's expenses here. Shareholders in Putnam Fund for Growth and Income PGRWX wouldn't know they shelled out $28 million in brokerage fees in 2001 unless they had read the fund's SAIs. SAIs also break down where 12b-1 fees go, if the fund charges them. (These are fees that the fund can use for marketing, rewarding brokers, and attracting more investors.) For example, Legg Mason Value Trust LMVTX spent $49 million of the $96 million in 12b-1 fees it collected in 2002 compensating brokers for selling the fund. It's your money; you should know where it's going.

Reference:: MorningStar.com

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JORDAN INVESTMEN
SIMULATION GAME

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The Jordan Investment Simulation Game has several ob

- **To manage a diversified Jordanian Portfolio**
- **To establish and follow principles of investment ob risk tolerance**
- **To maximize the portfolio's market value within "ac levels of risk**

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All Rules of the Simulation must be followed

- Each team has starting resources of JD 100,000 in r
  bearing account
- All stock purchases and sales are made in opening
  round as announced by the Simulation Leader
- All investments are valued at prices and rates at clo
  as announced by the Simulation Leader
- No more than 20% of the portfolio can be invested i
  of a single company
- All stock purchases must be made in “round lots”
- Commissions of .5% to buy or sell stocks/ 0.3% for

Teams may invest in a variety of instruments

Investment Options:

- **Equities: 10 “disguised” companies with brief bac information and pricing**
- **Bonds: Government instruments with various term interest rates**
- **Bank Savings Account: quoted at 1 month interest**

Simulation tools:

- Decision sheet to decide what percent of portfolio w
  which companies, Government bonds, savings acc
- Gross Domestic Product (real growth)
- Inflation Rate
- Rediscount Rate
- Amman Stock Exchange (ASE) Index
- Portfolio Year End Report with “marked to market”
  value.

Decision Sheet

Decision Sheet

Year 1:						Cash	
	Available						
	No. of Shares & bonds	Value	Buy	Nominal Value	Sell	Price	Cash
Exclusive Bank						124.5	
Citadel Bank						3.5	
Sweet Bank						2.43	
Cure House						2.09	
Technology Group						1.35	
Motor Engine Company						5.47	
Samara Group Industry						6.55	
Jordan Valley Group						1.13	
Pheladelphia						8.61	
Marvy Life Company						3.38	
Corporate Bonds No10/commission 00.3% / interest 9.25%						1.02	
maturity five years							
Development Bonds No.52 maturity 10 years commission 00.3% / interest 9.20%						0.95	
saving account / interest 3.7%							
Total							

Portfolio Year End Report

Year 1:							
	Portfolio- Year 1 End						
	Shares	Closing Price	Portfolio Value	interest earned	% of dividends/int	devidends/int	S
Exclusive Bank	0		0.00			0	
Citadel Bank	0		0.00			0	
Sweet Bank	0		0.00			0	
Cure House	0		0.00			0	
Technology Group	0		0.00			0	
Motor Engine Company	0		0.00			0	
Samara Group Industry	0		0.00			0	
Jordan Valley Group	0		0.00			0	
Pheladelphia	0		0.00			0	
Marvy Life Company	0		0.00			0	
Corporate Bonds 5 years maturity No10/commission 00.3% / interest 9.25%							
maturity 10 years commission 00.3% / interest 9.20%				0			
saving account / monthly interest 3.7%				0			
Total				**0**			

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Companies:

[Exclusive bank]

Established in 1930

Engaged in all commercial banking businesses

Exclusive world wide network includes a number of su and affiliate companies

Financial year ends in December Auditors: SABA and

Dividend Policy: Dividends are distributed once a year

Companies:

Citadel Bank

Established in 1973

Engaged in all commercial banking businesses

Financial year ends in December

Auditors: Arthur Andersen

Dividend Policy: Dividends are distributed once a year

Companies:

Sweet Bank

Established in 1978

Practicing all banking, financing and investment busi
non-usury base

Auditors: Ibrahim Al-abbasi and Co., Arthur Anderse

Dividend Policy: Dividends are distributed once a yea

Companies:

Cure House

Established in 1963

Engaged in the manufacturing, producing, marketing a
of medical pharmaceutical and its compounds and d

Auditors: SABA and Co.

Financial year ends in December

Dividend Policy: Dividends are distributed once a year

Companies:

Technology Group

Established in 1951

Engaged in the manufacturing , distributing and tradi
cement domestically and internationally

Auditors: Allied Accountants

Financial year ends in December

Dividend Policy: Dividends are distributed once a yea

Companies:

Motor Engine Company

Established in 1956

Engaged in the manufacturing and refining of petroleu hydrocarbonic components and re-manufacturing se components and distributing and marketing these tw products

Auditors: SABA and Co

Financial year ends in December

Dividend Policy: Dividends are distributed once a year

Companies:

Samara Group Industry

Established in 1976

**Engaged in producing all sorts of aluminum and manu
aluminum models for consumer usage and heavy in**

Auditors: Arabian Audit Group

Financial year ends in December

Dividend Policy: Dividends are distributed once a yea

Companies:

[Jordan Valley Group]

Established in 1938

Engaged in the transmission and distribution of elect

Auditors: Talal Abu-Ghazaleh and Co

Financial year ends in December

Dividend Policy: Dividends are distributed once a yea

Companies:

Pheladelphia

Established in 1986

Publishing both Arabic and English daily newspapers
manages an all commercial printing businesses.

Auditors: Allied Accountants

Financial year ends in December

Dividend Policy: Dividends are distributed once a yea

Companies:

Marvy Life company

Established in 1974

Engaged in running all categories of insurance

Auditors: Ibrahim Al-abbasi and Co.

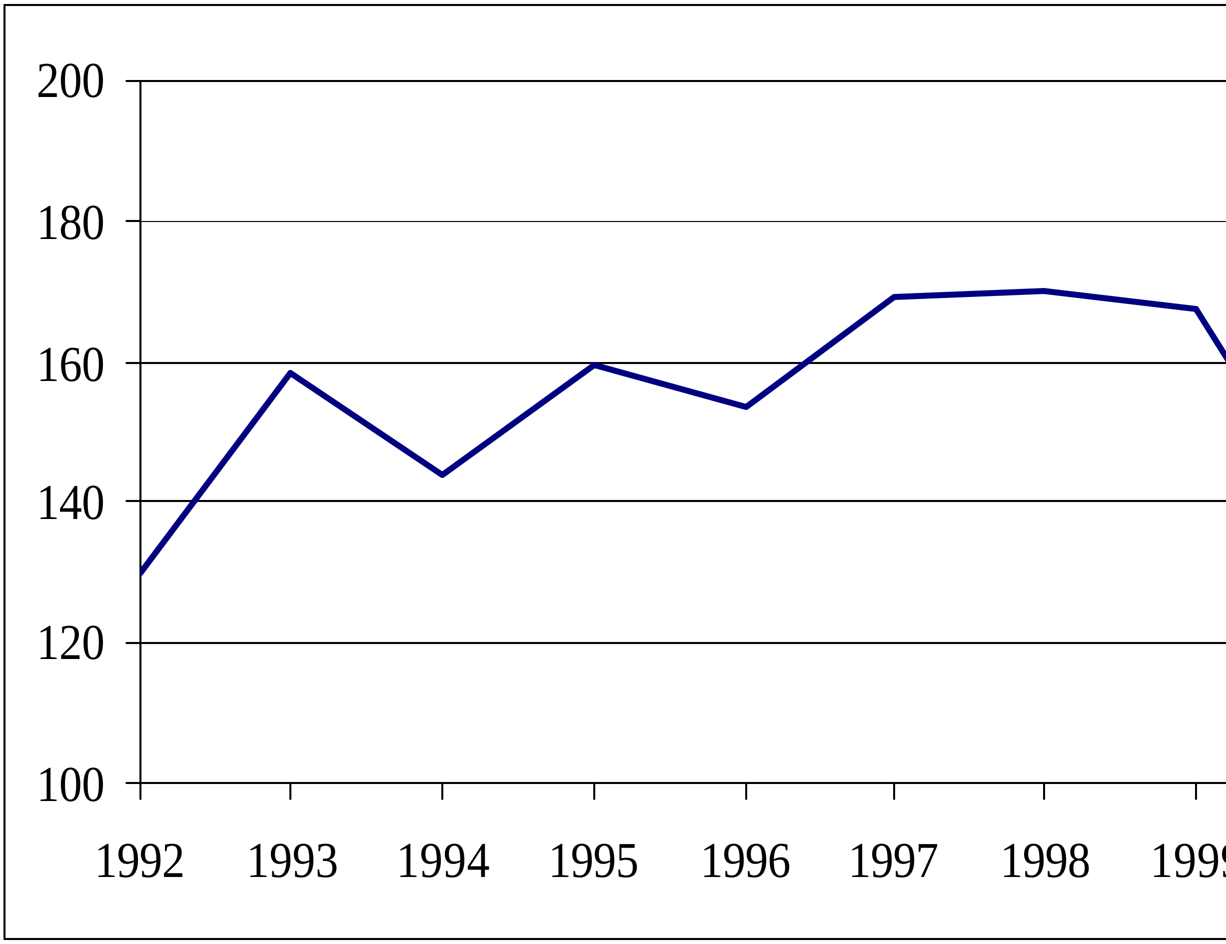
Financial year ends in December

Dividend Policy: Dividends are distributed once a yea

Bonds and Savings Account

- Corporate Bond No. 10
  - ✓ Five year maturity
  - ✓ 9.25% annual coupon
  - ✓ 0.3% commission
- Development Bond No. 52
  - ✓ Ten year maturity
  - ✓ 9.2% annual coupon
  - ✓ 0.3% commission
- Savings Account
  - ✓ 3.7% monthly interest

Amman Stock Exchange (ASE) Index



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Achievement of Market-Friendly Initiatives and Results Program

Investment Fund Management (Module 208)

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Investment Fund Management

Course Objectives:

- To understand the role of Investment Fund Manage
  legal, ethical and and professional requirements
- To become knowledgeable about setting fund mana
  objectives
- To be thoroughly familiar with asset allocation and
  meeting fund objectives
- To understand the principles of modern portfolio te
- To understand the importance of effective client rel
  fund management

Investment Fund Management are more than just giving money

Role of Investment Fund Manager:

- Creator of fund objectives
- Financial educator
- Investment information manager
- Investment decision maker
- Portfolio monitor
- Record keeper
- Client relations specialist

What is an Investment Fund?

A fund is a shared investment

- **Mutual fund vs. investment trust**
- **Shares vs. direct ownership of fund assets**
- **Net asset value (NAV)**

Principle Securities Laws Regulating the Investment Ma Industry

- The Investment Company Act of 1940
- The Securities Act of 1933
- The Securities Exchange Act of 1934
- The Investment Advisors Act of 1940

Investment funds have certain benefits

- Small initial investment
- Easy to buy and sell
- Regulated
- Professionally managed

Investment Fund Management is a dynamic process

- Legally Establishing the Fund
  - ✓Investment Policy Statement
  - ✓Risk/Return Trade-off
- Setting Fund Objectives
- Asset Allocation optimization
- Performance Evaluation

Investment Funds have historical risk reward informatio

Morningstar Quicktake® Report | Snapshot

Cohen & Steers Realty Shares CSRSX

Category: Specialty-Real Estate

Day Change

YTD Return

Net Assets ($mil)

Total Returns

	1999	**2000**	**2001**	**08-02**
Fund	2.7	26.6	5.7	7.2
+/- Cat	5.4	-0.2	-3.8	-0.1
+/- Index	-18.4	35.7	17.6	26.6

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Funds have a variety of types of objectives

- **Types of objectives**
  - ✓**Growth**
  - ✓**Income**
  - ✓**Capital Preservation**
  - ✓**Hedging**

Objectives dictate types of investments for the fund

- Equity
- Fixed Income
- Money Market
- Commodities
- Real Estate
- Blend

Net Asset Value is the key measure for investment fund

- Differences between NAV and stock prices
  - ✓Stock prices change throughout the day
  - ✓Stocks have fixed number of shares outstandin
  - ✓Can compare "fair" stock prices with earnings or cash flow
  - ✓Investment funds performance require examina return

How to calculate a fund’s total return

- **Total return (per cent) equals**

$$\frac{\text{Ending Position-Beginning Position}}{\text{Beginning Position}} \times 100$$

- **Example**

A fund purchased at JD 100 per share now is selling at JD 108 per share

$$\frac{\text{JD } 108 - 100}{\text{JD } 100} \times 100 = 8\ \%\ \text{total return}$$

But total return is more complicated

- Fund income
- Fund capital gains
- Distributions
- Yield
- Management fees

Tax Issues

- “Headaches” for investors – no control over gains/
- Distributions and taxes
- Avoiding over taxation

Ways for clients to invest in funds

- Direct purchase – No load funds
- Fund families
- Broker sold – Load fund

What the investor is looking for:

- How has fund performed?
- How risky has it been?
- What does the fund own?
- Who runs the fund?
- What does it cost?

Modern Portfolio Management Principles are based on c

- **Ways to diversify**
  - ✓**By asset class**

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Asset Allocation is the process of determining what per
investment will be put in various asset classes

- **Asset Classes**
  - ✓**Equities – stocks, shares**
  - ✓**Fixed Income – bonds, short-term notes**
  - ✓**Cash – money market, time deposits**
  - ✓**Commodities – gold, silver, oil**
  - ✓**Collectibles – art, coins**
  - ✓**Derivatives – options, futures, etc.**

Modern Portfolio Management Principles are based on c

- Ways to diversify
  - ✓By asset class
  - ✓By sub-asset class

Asset Allocation is the process of determining what per investment will be put in various asset classes

- Asset Classes
  - ✓Equities – stocks, shares
    - Growth, value
    - International, large cap, small cap
  - ✓Fixed Income – bonds, short-term notes
  - ✓Cash – money market, time deposits
  - ✓Commodities – gold, silver, oil
  - ✓Collectibles – art, coins
  - ✓Derivatives – options, futures, etc.

Investor Methods of Investing in Funds

- Market Timing
- Lump Sum Investing
- Dollar (JD) Cost Averaging

Example I

You and your cousin receive $10,000 from a wealthy r
who says you must invest the money in an investm
Do you

- wait until you feel the market is right?
- invest the entire amount immediately?
- put a little into a fund at a time?

Fund Costs

- One time fees
  - ✓Sales commissions
  - ✓Redemption fees
  - ✓Account maintenance fees
- On-going expenses
  - ✓Expense ratio
  - ✓Brokerage costs
  - ✓Interest expense
- What’s reasonable?

Investor Relations—The key to successful fund manage

- The Prospectus
  - ✓Investment objective
  - ✓Strategy
  - ✓Risks
  - ✓Expenses
  - ✓Past performance
  - ✓Management
- Statement of additional information
- Relations with brokers
- Relations with regulators

Investor Relations—The key to successful fund manage

- Office management
- Record keeping
- Responding to inquiries
- Financial reporting to investors
- Web site

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The Jordan Investment Simulation Game has several ob

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Simulation tools:

- **Decision sheet to decide what percent of portfolio w which companies, Government bonds, savings acc**
- **Gross Domestic Product (real growth)**
- **Inflation Rate**
- **Rediscount Rate**
- **Amman Stock Exchange (ASE) Index**
- **Portfolio Year End Report with “marked to market” value.**

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Decision Sheet

Decision Sheet

Year 1:						**Cash**	
	Available						
	No. of Shares & bonds	Value	Buy	Nominal Value	Sell	Price	Cash
Exclusive Bank						124.5	
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saving account / interest 3.7%							
Total							

AMIR Program أمير

Portfolio Year End Report

Year 1:							
	Portfolio- Year 1 End						
	Shares	Closing Price	Portfolio Value	interest earned	% of dividends/int	devidends/int	S
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saving account / monthly interest 3.7%				0			
Total				**0**			

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