

## Mutual Fund Basics

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### Introduction to Mutual Funds and their Advantages

Mutual funds have been around for a long time, dating back to the early 19th century. The first modern American mutual fund opened in 1924, yet it was only in the 1990's that mutual funds became mainstream investments, as the number of households owning them nearly tripled during that decade. With recent surveys showing that over 88% of all investors participate in mutual funds, you're probably already familiar with these investments, or perhaps even own some. In any case, it's important that you know exactly how these investments work and how you can use them to your advantage.

A mutual fund is a special type of company that pools together money from many investors and invests it on behalf of the group, in accordance with a stated set of objectives. Mutual funds raise the money by selling shares of the fund to the public, much like any other company can sell stock in itself to the public. Funds then take the money they receive from the sale of their shares (along with any money made from previous investments) and use it to purchase various investment vehicles, such as stocks, bonds and money market instruments. In return for the money they give to the fund when purchasing shares, shareholders receive an equity position in the fund and, in effect, in each of its underlying securities. For most mutual funds, shareholders are free to sell their shares at any time, although the price of a share in a mutual fund will fluctuate daily, depending upon the performance of the securities held by the fund.

### Advantages

It may not be obvious at first why you would want to purchase shares in different securities through a mutual fund "middleman" instead of simply purchasing the securities on your own. There are, however, some very good reasons why millions of Americans opt to invest in mutual funds instead of, or in addition to, buying securities directly. Mutual funds can offer you the following benefits:

- **Diversification** can reduce your overall investment risk by spreading your risk across many different assets . With a mutual fund you can diversify your holdings both across companies (e.g. by buying a mutual fund that owns stock in 100 different companies) and across asset classes (e.g. by buying a mutual fund that owns stocks, bonds, and other securities). When some assets are falling in price, others are likely to be rising, so diversification results in less risk than if you purchased just one or two investments.
- **Choice:** Mutual funds come in a wide variety of types. Some mutual funds invest exclusively in a particular sector (e.g. energy funds), while others might target growth opportunities in general. There are thousands of funds, and each has its own objectives and focus. The key is for you to find the mutual funds that most closely match your own particular investment objectives.
- **Liquidity** is the ease with which you can convert your assets--with relatively low depreciation in value--into cash. In the case of mutual funds, it's as easy to sell a share of a mutual fund as it is to sell a share of stock (although some funds charge a fee for redemptions and others you can only redeem at the end of the trading day, after the current value of the fund's holdings has been calculated).
- **Low Investment Minimums:** Most mutual funds will allow you to buy into the fund with as little \$1,000 or \$2,000, and some funds even allow a "no minimum" initial investment, if you agree to make regular monthly contributions of \$50 or \$100. Whatever the case may be, you do not need to be exceptionally wealthy in order to invest in a mutual fund.
- **Convenience:** When you own a mutual fund, you don't need to worry about tracking the dozens of different securities in which the fund invests; rather, all you need to do is to keep track of the fund's performance. It's also quite easy to make monthly contributions to mutual funds and to buy and sell shares in them.
- **Low Transaction Costs:** Mutual funds are able to keep transaction costs -- that is, the costs associated with buying and selling securities -- at a minimum because they benefit from reduced brokerage commissions for buying and selling large quantities of investments at a single time. Of course, this benefit is reduced somewhat by the fact that they are buying and selling a large number of different stocks. Annual fees of 1.0% to 1.5% of the investment amount are typical.
- **Regulation:** Mutual funds are regulated by the government under the Investment Company Act of 1940. This act requires that mutual funds register their securities with the Securities and Exchange Commission. The act also regulates the way that mutual funds approach new investors and the way that they conduct their internal operations. This provides some level of safety to you, although you should be aware that the investments are not guaranteed by anyone and that they can (and often do) decline in value.

- **Additional Services:** Some mutual funds offer additional services to their shareholders, such as tax reports, reinvestment programs, and automatic withdrawal and contribution plans.
- **Professional Management:** Mutual funds are managed by a team of professionals, which usually includes one mutual fund manager and several analysts. Presumably, professionals have more experience, knowledge, and information than the average investor when it comes to deciding which securities to buy and sell. They also have the ability to focus on just a single area of expertise. (However, it should be noted that this apparent benefit has not always translated into superior performance, and in fact the majority of all mutual funds don't manage to keep up with the overall performance of the market.)

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