



## Understanding Mutual Funds



Provided to you by

**David E Parker, CPA**  
CERTIFIED FINANCIAL PLANNER™



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Written by Javelin Marketing, Inc.

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# Mutual Funds

## A Tool for You

Some investors enjoy selecting individual investments and monitoring their progress on a regular basis. This can be rewarding and fun if you have the time, experience and patience to research your investments and monitor their progress.

Like many people, you may already have a busy schedule or are uncomfortable with selecting your investments. Many people in this position sometimes choose to invest in Mutual Funds, which are investment vehicles that pool your money along with other investors into a portfolio of individual securities such as stocks and bonds. The portfolio is created and managed by investment professionals whose full time job it is to make investment decisions that benefit shareholders such as you.

If you purchase mutual fund shares, you essentially own a piece of that portfolio and can potentially benefit in several ways. First, the securities in the portfolio may pay dividends or interest income, which will in turn be passed along to you in the form of fund distributions. Second, the portfolio managers may sell securities that have appreciated in value and pass the gains along to you. And third, if the value of your mutual fund shares happen to rise, you can potentially sell them for more than you paid.

Keep in mind, however, that mutual fund investments fluctuate in value and your mutual fund shares may be worth more or less than their original costs when redeemed.

# Mutual Fund Selling Points

There are many reasons why people select Mutual Funds in their own portfolios. Here are some of the most common reasons:

- ***Diversification***–To guard against market volatility risk many people opt for a diversified approach. Investing in a mix of securities, or diversification, may help reduce risks if one security declines in value, others may increase in value and potentially help compensate for a loss in value. Fund managers facilitate this process by often investing in a wide variety of securities. Please note that diversification doesn't guarantee against market loss in a declining market.
- ***Benefits and Costs***–As an investor in a mutual fund you may be able to take advantage of a variety of services such as live customer service, online customer service, automated reports, and systematic investment plans, to name a few. Fees and costs associated with Mutual Funds can vary greatly from fund to fund but many investors find they are still lower than the costs of buying individual securities.
- ***Liquidity and Choice***–Mutual Funds vary in composition and investment objective. Whether you wish to invest in high technology companies or Municipal Bonds there is probably a fund suited to your investment objective. These funds can generally be bought or sold on any business day – which can make it easy to alter a portfolio as investor's objectives change over time.

# Fund Options



## Mutual Fund Risk and Reward Potential

There are many types of mutual funds with a wide variety of investment objectives and risk and return characteristics. Below please find an overview of fund categories listed from higher risk/return potential to lower.

- **Aggressive growth equity funds** attempt to invest in securities whose stock prices will increase over time (capital appreciation). Often times fund managers invest in companies with the potential for rapid growth—companies in emerging industries or small but rapidly expanding businesses. These funds entail more risk and short-term price volatility than other types of funds, but they may also offer the potential for higher long-term returns than other types of funds.
- **Sector Funds** focus on a particular industry or sector in the pursuit of capital appreciation. Individual sector funds may invest in oil companies, municipal bonds, or automotive stocks for example. Since sector funds concentrate on a single sector, they are less diversified than other funds, placing shareholders at risk if there is a downturn in the specific sector invested in.
- **Overseas Equity Funds** seek to obtain capital appreciation by investing in stocks of companies outside the United States. Overseas Equity Funds may invest in a particular country, region, or specific business sectors located in other regions of the world. Investing overseas can be more risky than domestic equities, with additional risks including foreign currency fluctuations and geopolitical risks.

- **Domestic Growth Funds** pursue capital appreciation by investing in companies that are perceived to have stronger than average growth potential. Generally speaking, growth funds have less short-term price fluctuation than aggressive growth funds, in part, because they invest in more stable companies. They are typically more risky than growth and income stock funds.
- **Growth and Income Stock Funds** differ from purely Growth funds in that they invest for both capital appreciation and dividend income to be distributed to shareholders. Some of these funds are weighted more towards providing dividend income and others toward growth. Typically Growth and Income stock funds have less price volatility and risk than pure growth funds, but more than Domestic Growth Funds
- **Balanced Funds** pursue capital appreciation by investing in both stocks and bonds. Many people consider Balance Funds a more conservative investment than stock only funds as they offer the diversification inherent in mixing stock and bond holdings.
- **Taxable Bond Funds** are often sought by investors seeking current income rather than capital appreciation as their investment objective. The risk/reward characteristics of taxable bond funds is determined by the bonds purchased by the funds and vary greatly. A more aggressive bond fund investor may favor high yield or "junk bonds" issued by corporations, with less than investment grade investment ratings, that pay a higher interest rate to compensate for the added risk; while a more conservative investor may chose a fund comprised of government or high grade corporate bonds.
- **Tax-Exempt Bond Funds** are designed to provide tax-free income by investing in bonds issued by government municipalities. The risk in these bond funds correlates to the credit rating of the issuing government body. Even though they are classified as "Tax-Exempt" funds, income received from these funds may be subject to the alternative minimum tax.
- **Money Market Funds** pursue current income by investing in short-term money market instruments, such as U.S. Treasury bills, certificates of deposit, and commercial corporate notes. Money Market funds are designed to maintain a stable share price of \$1, and are widely considered the least risky mutual funds. It is important to keep in mind that there is no guarantee these funds will be able to maintain a stable \$1 per share price, and they are not insured or guaranteed by the U.S. government.

# Mutual Fund Options and What's Suitable for You

Choosing the right Mutual Funds for your portfolio from the thousands of domestic and international funds available is an individual decision that will vary from person to person. *Please note that all mutual funds are investments involving risk and are offered by prospectus only. Investment return and principal value will fluctuate so that upon redemption an investor's shares may be worth more or less than original value. An investor should carefully consider the investment objectives, risks, charges and expenses before investing. The fund prospectus contains this and other information about the investment company. For a copy of the prospectus, please contact your financial advisor. Please read the prospectus carefully prior to investing.*

## ***Reaching your goals:***

Before investing, it is important to carefully consider what your desired goals are and when you expect to achieve them. For example, a young couple just starting out will likely be concerned with saving for retirement, buying a house, or saving for their children's education as opposed to a retired couple who may be focused on preserving existing capital and living on a fixed income. You may find it beneficial to sit down with a financial professional and carefully review your specific situation.

The time horizon you have to work with is key to picking the right mutual fund. Generally speaking, a longer time horizon that a young couple has to plan for retirement allows for a greater risk tolerance to ride out market fluctuations than does a retired couple that is living on a fixed income and fixed assets.

Once you have established your investment objectives, time horizon, and risk tolerance, you can determine your asset allocation the manner in which you choose to distribute your money among investment options.

Your age and station in life could play an important role in the types of investments that are suitable. For example, if you do not plan to retire for another 40 years or so, it could make more sense for you to invest in stock mutual funds in the hope that you will achieve higher returns over a long-term period. On the other hand, a retired couple living on a fixed income might be more concerned about preserving their existing capital and receiving regular income payments. These objectives are often met with investments that have income-producing potential, such as bond funds.

# Mutual Fund Classes

## A Shares:

Class A shares typically charge a front-end sales charge. When you buy Class A shares with a front-end sales charge a portion of the dollars you pay is not invested. Class A shares may impose an asset-based sales charge, but it generally is lower than the asset-based sales charge imposed by the other classes. An "A" share mutual fund may also offer you discounts, called breakpoints, on the front-end sales charge if you:

- make a large purchase;
- already hold other mutual funds offered by the same fund family; or
- commit to regularly purchasing the mutual fund's shares.

## B Shares:

Class B shares typically do not charge a front-end sales charge, so the full amount that you pay is immediately invested. However, they do impose asset-based sales charges that may be higher than those that you would incur if you purchased Class A shares. Class B shares also normally impose a contingent deferred sales charge ("CDSC"), which you pay when you sell your shares. For this reason, these should not be referred to as "no-load" shares. The CDSC normally declines and eventually is eliminated the longer you hold your shares. After the CDSC is eliminated, Class B shares, in many cases, will convert to Class A shares. This conversion, however, could occur a few years after the CDSC is eliminated. If they convert, they will begin to charge the same asset-based sales charge as the Class A shares. If you intend to purchase Class B shares, you may want to discuss with your financial adviser whether Class A shares would be preferable. The expense ratio charged on Class A shares is generally lower than for the Class B shares, and the mutual fund may offer large-purchase breakpoint discounts from the front-end sales charge for Class A shares. To determine if Class A shares may be more advantageous refer to the mutual fund prospectus, which may describe the purchase amounts that qualify for a breakpoint discount.

## C Shares:

Class C shares usually do not impose a front-end sales charge on the purchase, so the full dollar amount that you pay is immediately invested. Often Class C shares impose a small charge if you sell your shares within a short time of purchase, usually one year. Class C shares typically impose higher asset-based sales charges than Class A shares, and since their shares generally do not convert into Class A shares; their asset-based sales charge will not be reduced over time. Class C shares are often used for asset-allocation purposes. Class C shares do not impose a sales charge at the time of purchase, but they may impose a CDSC or other redemption fees. Additionally, in most cases your expense ratio would be higher than Class A shares, and even higher than Class B shares if you hold for a long time.

# Turnover

The turnover rate in a fund is not necessarily a bad thing, but as mentioned, it does increase your tax bill if the fund is selling stocks with lots of short-term gains. Additionally, as mentioned in the previous section on cost, turnover costs you money. If turnover does hurt a fund's return, wouldn't there be a correlation between a fund's turnover rate and its after-tax return? In many cases there is.<sup>1</sup>

To optimize your mutual fund returns, or any investment returns, know the effect that taxes can have on what actually ends up in your pocket. Mutual funds that trade quickly in and out of stocks can have what is known as "high turnover." While selling a stock that has moved up in price does lock in a profit for the fund, this is a profit for which taxes have to be paid. Turnover in a fund sometimes creates taxable capital gains, which are paid by the mutual fund shareholders.

The SEC requires all mutual funds to show both their before- and after-tax returns. The differences between what a fund is reportedly earning, and what a fund is earning after taxes are paid on the dividends and capital gains, can be tangible. If you plan to hold mutual funds in a taxable account, please check out these historical returns in the mutual fund prospectus to see what kind of taxes you might be likely to incur.

If you would like to know if your funds have high turnover and resulting high tax impact, please call for a free analysis on the funds you own.

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<sup>1</sup>During the past decade, for example, the highest-turnover quartile of funds (165% annually) provided an annual pre-tax return of just 9.8 percent, while the lowest-turnover quartile (13%) returned 11.5%, an advantage of 1.7% per year a cumulative extra profit of nearly 30%. What is more, the high-turnover quartile of funds took nearly 30% more risk (standard deviation of 20.6% vs. 16.2 percent). John Bogle, Ex Chairman, Vanguard Fund 4/12/06. And turnover also increases taxes (short-term gains are taxed at 35%, long-term at 15%) leading to this conclusion by Lipper: Taxable investors owned approximately half of the \$8.391 trillion invested in open-end mutual funds, and on average over the last 10 years gave up on an annual basis 1.6 percentage points to 2.4 percentage points in return because of taxes. Taxable equity and fixed income funds shareholders surrendered over 20% and approximately 45% of their load-adjusted returns because of taxes, respectively. Source: Taxes in the Mutual Fund Industry 2006, Lipper.

# Free Online Resources

There is no substitute for carefully reading the prospectus of a mutual fund or variable annuity before making a purchase. Regulatory agencies such as FINRA and Securities and Exchange Commission (SEC) offer a variety of online resources to assist the investing public, here are a few:

- **SEC Mutual Cost Calculator**  
[www.sec.gov/investor/tools/mfcc/mfcc-int.htm](http://www.sec.gov/investor/tools/mfcc/mfcc-int.htm)
- **SEC Mutual Funds**  
[www.sec.gov/answers/mutfund.htm](http://www.sec.gov/answers/mutfund.htm)
- **SEC Variable Annuities: What You Should Know**  
[www.sec.gov/investor/pubs/varannty.htm](http://www.sec.gov/investor/pubs/varannty.htm)
- **FINRA Investment Choices**  
[www.finra.org/Investor/Choices/investment\\_choices.asp#invmf](http://www.finra.org/Investor/Choices/investment_choices.asp#invmf)
- **FINRA Variable Annuities: Beyond the Hard Sell**  
[www.finra.org/Investor/Alerts/alert\\_variable\\_annuities.htm](http://www.finra.org/Investor/Alerts/alert_variable_annuities.htm)
- **FINRA Understanding Mutual Fund Classes**  
[www.finra.org/Investor/alerts/alert\\_mfclasses.htm](http://www.finra.org/Investor/alerts/alert_mfclasses.htm)
- **FINRA Investor Newsletter**  
[www.finra.org/investor/tools/e-mail.asp](http://www.finra.org/investor/tools/e-mail.asp)

If you do not have Internet access at home you might try visiting your local public library to access the Internet free of charge, alternatively you can call for a free print out the above-mentioned web pages.<sup>2</sup>

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<sup>2</sup> Websites provided were last visited on 02/14/07 and are on file at Javelin Marketing, Inc.

# About David E Parker, CPA



Dave Parker has over 30 years experience helping clients with their financial concerns. Dave is over 50 and is a life long Michigan resident.

Since 2003, Dave is working with Washtenaw Intermediate School District helping employees with their 403(b) and 457 retirement plans.

Dave as a member of Financial Educators Network started giving Retirement Planning Today seminars at Concordia College in 2008. He became a CERTIFIED FINANCIAL PLANNER in 2000. CPA in 1980. Dave enjoys movies, reading and tennis.

Dave offers:

**One Stop Shopping:** You would enjoy the convenience of having all of your business finances handled under one roof, including personal financial planning, asset management, tax preparation and reduction strategies.

**Time Is Money:** As a business owner since 1980, Dave understands that time is money. He is direct and to the point, providing you with management reports that highlight the pros and cons of any financial situation, so you can make an informed decision quickly. He is adept at budgeting and increasing retirement cash flow without your having to go out-of-pocket.

**Expertise:** As a 30-year veteran of the financial services industry, David is both a CPA and Certified Financial Planner™, passing rigorous tests and continuing education to ensure clients receive the most professional advice possible.

**Technology:** Dave brings you the latest in technology for managing your finances. If you wish, you can now go online to monitor the performance of your investments as well as your financial plan, making adjustments and saving time.

References on Request

# About Retire on Time

Retire On Time is a d/b/a of Parker Financial Services. Presently there are 2 employees. There are various associates affiliated with the company, including an attorney and various financial planners. Retire On Time has over \$32 million in client's assets under management.

- **Financial Planning** – Includes Future Net Worth Projections, Coordination of Tax & Investment Planning, Determine the Probability of Never Out–Growing Your Income, Cash Flow Projections, Charitable Giving Alternatives
- **Retirement Planning** – Includes Cash Flow Projections to make sure you can retire on time and not outlive the money.
- **Investment Planning** – Includes Allocating & Rebalancing Assets, Verify Suitability of Investments, Existing Annuity Analysis, Oversee Third Party Professional Money Managers, Determine Appropriate Degree of Aggressiveness vs. Safety
- **Tax Reduction Strategies & Services** – Individual, Business and Estate Tax Planning, Preparation & Tax Reduction. Audit representation.
- **Estate Planning** – Includes assistance with living trusts and elimination of estate taxes. Attorney on site by appointment.

**Phone today with questions or to see if we can help you.  
There is no charge for an initial meeting.**

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This booklet is presented solely as educational material about some aspects of Mutual Funds. It is not intended to recommend or dissuade the purchase or sale of any particular Mutual Fund or of Mutual Funds in general. Mutual Funds are sold by prospectus, which contains more complete information including risk factors, fees, surrender charges and other costs. You should obtain a prospectus from your financial representative. Please read the prospectuses carefully before you make a purchase or invest.

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