The ABCs of Mutual Fund Investing Tutorial

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Successful Fund Investing
The public's acceptance of the mutual fund as an investment vehicle is well established. As of year-end 2011, investment companies in the U.S. managed approximately $13 trillion in assets in over 8,000 funds. In the U.S., nearly half of all households and some 90 million individuals are fund investors. It is an accepted fact that, with few exceptions, investing for most non-professional investors means investing in mutual funds.

The mutual fund has become the investment of choice to save for college educations, for the purchase of a home, and/or for building a retirement nest egg. It is a convenient medium to accumulate and grow financial assets over time for any of these purposes. Whether you are a do-it-yourselfer, a client of an investment professional, or a participant in a self-directed, employer-sponsored retirement plan, the lessons contained herein will help you understand the fund investing process.

The Mutual Fund Concept

A mutual fund is an investment company that pools money from investors to purchase securities – stocks, bonds, and cash/cash equivalents. The underlying securities in a mutual fund are referred to, in the aggregate, as a fund’s portfolio. As you will see in Lesson 4, the make-up of a fund’s portfolio is determined by the investment objective of the fund, e.g., long-term capital appreciation or current income.

Legally known as an “open-end” fund or company, a mutual fund is one of three basic types of investment companies. The other two – “closed-end” funds and unit investment trusts (UITs) – are structurally different and account for less than US$500 billion in total assets under management. The open-end nature of the conventional mutual fund means that it continuously sells and buys back fund shares (technically known as units) from the fund’s shareholders (technically known as unitholders). While similar in nature, exchange-traded funds (ETFs) are stocks. They track market indexes and trade like stocks, but are not considered to be, and are not permitted by the SEC to call themselves, mutual funds.

A mutual fund’s portfolio is managed, either passively or actively, by investment professionals on behalf of the fund’s shareholders. A fund must distribute annually all income it receives, as well its capital gains, to the fund’s shareholders.

A fund’s operational functions (see Exhibit: Mutual Fund Operational Structure) are generally undertaken by service providers known as third-party advisers (TPAs). What is known as a fund’s expense ratio captures these operational costs in a single figure, which is expressed as a percentage of average assets under management. However, as you will see in Lesson
Exhibit: Mutual Fund Operational Structure

**Shareholders**

**Board of Directors**
Oversees the fund’s activities, including approval of the contract with the management company and certain other service providers.

**Mutual Fund**

**Investment Advisor**
Manages the fund’s portfolio according to the objectives and policies described in the fund’s prospectus.

**Principal Underwriter**
Sells fund shares, either directly to the public or through other firms (e.g., broker-dealers).

**Administrator**
Oversees the performance to other companies that provide services to the fund and ensures that the fund’s operations comply with the applicable federal requirements.

**Transfer Agent**
Executes shareholder transactions, maintains records of transactions and other shareholder account activity, and sends account statements and other documents to shareholders.

**Custodian**
Holds the fund’s assets, maintaining them separately to protect shareholder interests.

**Independent Public Accountant**
Certifies the fund’s financial statements.
there are additional fund costs that are not included in the expense ratio. All these costs are deducted from the fund’s asset base and, thus, born proportionately according to a shareholder’s investment in the fund.

Simply stated, a mutual fund provides for someone else to diversify and manage your investments, handle the administrative tasks, and provide access to a variety of securities and markets at a relatively low level of investment.

A Brief History of Mutual Funds

Historians are uncertain of the exact origins of investment funds. There are some indications that the idea of pooling assets for investment purposes began in the Netherlands in the late 18th century or the early 19th century. Closed-end investment funds did take root in Great Britain and France in the 1800s, making their way to the United States in the 1890s.

The creation of the Massachusetts Investors’ Trust in Boston in 1924, which went public in 1928, is cited as the arrival of the modern mutual fund in the U.S. In 1929, there were 19 open-ended funds competing with nearly 700 of the closed-end variety. The market crash of 1929 wiped out the highly leveraged closed-end funds, but a small number of opened-ended funds managed to survive.

The creation of the Securities Exchange Commission (SEC), the passage of the Securities Act of 1934, and the Investment Company Act of 1940 put the mutual fund business on a solid regulatory basis with safeguards for investors. At the beginning of the 1950s, the total number of open-end mutual funds just topped 100. The mutual fund industry experienced slow but steady growth over the next three decades. During the 1990s, mutual fund growth accelerated – the fund count jumped to over 3,000 with total assets surpassing the $1 trillion mark.

In response to the mutual fund scandals of the 2002-2004 periods, corrective regulatory and industry practices were enacted. This is an ongoing process as the authorities and responsible industry participants seek to protect fund investors. The mutual fund business is still growing. It is a very profitable business. There’s nothing inherently wrong with that aspect of the mutual fund industry. However, fund investors need to be aware of this circumstance and seek out high-quality, low-cost fund companies that serve the investor’s interests rather than vice-versa.

What Funds Can and Cannot Do for Investors

Mutual fund investing is infinitely less complicated than investing directly in stocks and bonds. The latter approach requires fairly sophisticated levels of financial expertise, experience, and time. While fund investing is not without its challenges, the fundamentals of successful mutual fund investing, which I hope to provide herein, are more easily understood and implemented.
Among many of the advantages and positive aspects of mutual funds, here are those that can help individual investors the most:

- **Instant Diversification** – A basic characteristic of mutual funds is the diversity of their investment portfolios. In most cases, they are comprised of about 50 to 100 different holdings, but can, in many instances, run into the several hundreds, if not thousands, for broad market-based stock funds and bond funds. Even non-diversified, so-called “focused,” mutual funds will have a portfolio consisting of at least 20 – 25 holdings. It is a recognized principle of investing that diversifying investments reduces risk. A mutual fund allows investors to obtain more diversification in a portfolio than they would ever be able to manage effectively on their own, and at a fraction of the cost.

- **Professional Management** – Managerial expertise/experience and organizational back-up are the key features that investment companies bring to the table with both actively and passively managed mutual funds.

- **Convenience** – Buying and selling shares of a mutual fund is a simple process. You can become a mutual fund investor by contacting some fund companies directly. Other funds' shares are bought/sold through financial intermediaries – brokerage firms, financial planners, insurance companies, and banks. Employees of employer-sponsored defined-contribution pension plans can invest in mutual funds provided for in the plan's investment menu. Lastly, mutual funds are liquid investments, i.e., investors can readily buy shares from and sell shares back to a fund on any business day of the year, regardless of what's happening in the market.

Along with these positive aspects, investors also need to be aware of the downside, or the less-than-positive sides, of mutual fund investments as well. Mutual funds are not a perfect investment vehicle:

- **Mutual Funds Have Risk** – You must remember that the underlying securities in a mutual fund’s portfolio are subject to the market’s ups and downs just like any other investment. Mutual funds tend to smooth out the inevitable bumps in the investing process; but they are not risk free. Fund marketing publicity often times emphasizes attention-getting performance metrics, particularly focusing on recent returns. These can be misleading, or at least looked at skeptically. As a rule, fund investors should avoid the “hot” funds and concentrate on those with positive long-term performance records.

- **Be Cost Conscious** – Simply remember that a fund’s costs and expenses reduce a fund’s total return, which is the source from which investors profit from investing in a fund. It is a matter of record that higher-cost funds under perform lower-cost funds over the long-term. No one argues that legitimate investment advice, if needed, about fund investing, as well as a fund’s operating expenses, are rightfully charged to fund investors. Nevertheless, smart fund investors are cost-conscious investors.
• **Tax Consequences** – Many mutual funds are managed without regard to their capital gains. It is possible that a manager’s trading can produce capital gain liabilities for fund investors while at the same time their fund is experiencing a down year in total return.

## Lesson 1

### How a Mutual Fund Works

An investment company, e.g., a financial intermediary such as Fidelity Investments or Vanguard, acting as a fund sponsor, organizes a mutual fund as a corporation. However, it is not an operating company with employees and a physical place of business in the traditional sense. A mutual fund is a “virtual” company, typically externally managed. It relies upon third parties or service providers, either fund sponsor affiliates or independent contractors, to manage the fund’s portfolio and carry out other operational activities.

The fund sponsor raises money from the investing public, who become fund shareholders. It then invests the proceeds in securities (stocks, bonds, and/or money market instruments) in accordance with the fund’s investment objective. A fund provides shareholders with professional investment management, diversification, liquidity, and investing convenience. For these services, the fund sponsor charges fees and incurs expenses for operating the fund, all of which are charged proportionately to fund shareholders.

Mutual fund shares are bought and sold on the basis of a fund’s share’s net asset value (NAV). Unlike a stock’s price, which changes constantly according to the forces of supply and demand, NAV is determined by the daily closing value of the underlying securities in a fund’s portfolio on a per share basis.

#### 1.1 Management Styles – Active and Passive

Mutual funds are “managed” in two ways – actively, which is commonly referred to as a managed fund, and passively, which is commonly referred to as an index fund. The former involves a human element – a single manager, co-managers, or a team of managers. In all cases, a fund’s management is supported by investment research analysts and, in some cases, a sub-adviser.

In contrast, passively managed mutual funds, or index funds, have a “manager,” but in this instance the investment professional (designated as a manager) is responsible for the configuration and maintenance of the index that the fund tracks. The overall fund strategy and the buying and selling of securities are on autopilot, determined by the composition of the tracking or benchmark index.

For example, the money going into the S&P 500 index fund is automatically, and mechanically, invested proportionately into stocks in the fund according to the percentage of their market-capitalization weight. For example, if IBM’s market-cap represents 1.7% of the S&P 500 Index, for every $100 invested in a S&P 500 index fund, $1.70 goes into IBM stock.
Index fund investors should be aware that because some indexes are comprised of a very large number of securities, an index fund might only hold a representative sampling of all the securities in the index. This will still be a relatively large number, but it will not match all the securities in the index.

There has been, and there will continue to be, considerable debate about the merits of actively managed mutual funds versus passively managed index mutual funds. It is a well-known fact that over an extended period of time, index funds have been able to outperform the majority of managed funds – the precise percentage varying from one year to another between 60 to 80 percent. Most investment professionals would agree that this issue does not require an either-or decision; both types of funds can have a place in a fund investor's portfolio.

1.2 Buying-Selling Fund Shares – NAV Pricing

Mutual fund shares are priced at their net asset value, commonly referred to as NAV. This price is derived by dividing the total value of the securities in a fund’s portfolio, less any liabilities, by the number of shares outstanding. Unlike stocks and bonds, whose prices are moved by supply and demand forces, fund prices are determined by the value of a fund’s underlying securities. A fund share’s NAV is computed once a day based on the day’s closing market prices. All buy and sell orders for a mutual fund’s shares are processed at the NAV of the trade date. However, because of a mutual fund’s pricing methodology, investors, both buyers and sellers, must wait until the day following the trade day to get the transaction price.

Fund investors need to understand that since mutual funds are legally obliged to pay out (distribute) virtually all their income and realized capital gains, a fund’s NAV, in most instances, is relatively unimportant in gauging a fund’s performance, which is best judged by its total return.

1.3 How Fund Investors Make Money – Total Return

A mutual fund’s performance is measured in terms of its total return. This measurement is calculated as the sum of the change in a fund’s net asset value (NAV), its dividend distributions (portfolio income from dividends and interest), and its capital gains distributions (from the sales of securities) over a given period of time. While a fund’s long-term results are the most convincing, prudent investors should also look at a fund’s year-to-year total returns – steady results are better than drastic swings.

A fund’s total return metrics only have meaning if they are compared to appropriate, long-term performance market benchmarks, or indexes, as well as the total returns of its peers, i.e., funds and/or fund categories of a similar nature. Widely used indexes, among others, are the S&P 500 Index (broad stock market index), the DJ Wilshire 5000 (total stock market index), and Barclays Capital Aggregate Bond (total bond market).
Lesson 2
Types of Mutual Funds

Thousands of mutual funds come in an array of “shapes and sizes” based on a wide variety of investing objectives. My purpose here is to provide investors with a coherent fund line-up and a brief explanation of the major fund categories and their components. With this broad overview of the various types of funds, you should be better informed of what’s available to properly diversify your chosen portfolio asset-allocation (See Lesson 4).

2.1 Equity (Stock) Funds

Stock mutual funds are mainly categorized by the size of the company and the investment style of the stock. Company size is not determined by sales or assets but by the market-capitalization, or market-cap, of its stock, which is calculated by multiplying a company’s shares outstanding by its market price per share. A stock’s investment style is categorized as growth (above average earnings increases), value (undervalued stock price), or blend (a mix of growth and value, also referred to as core). Thus, the three metrics for each size and style characterization produce nine possible stock fund categories for investors to choose from depending on their risk tolerance and expectations for investment return.

Market perceptions equate larger size and value with safety and smaller size and growth with more risk. However, smaller size and growth are both associated with bigger, more robust returns. Obviously, the mid-cap stocks fall somewhere in between, as evaluated by these very general risk-return parameters.

2.2 Fixed-Income (Bond) Funds

In similar fashion to stocks, bond mutual funds are categorized by duration (a bond’s sensitivity to interest rates) and credit quality (potential for default). The three categories of bond duration are short-term (1-3 years), intermediate-term (4-6 years), and long-term (7 years+). A bond’s credit quality is categorized as high (government and investment grade debt rated AAA and AA), medium (debt rated as A and BBB), and low (BB and lower – referred to as “junk bonds”).

Bonds with shorter maturities and high credit quality are the safest, but will have lower yields than longer term bonds of lesser credit quality. The three metrics for bond duration and credit quality produce nine possible bond fund categories for investors to choose from. Appropriate bond selections depend on the investor’s time-horizon, risk tolerance, and expectations for investment return. In addition to these nine basic categories, bond funds are also categorized by the type of issuer. These include the U.S. government, its agencies, foreign governments and companies, U.S. corporations, and municipal entities. A further distinction is made for taxable and tax-exempt (municipals) bond funds.
2.3 International Funds

International fund investing covers several different fund categories. Foreign funds (also referred to as international funds) invest in equities excluding those of an investor's home country. Global or world funds include equities from anywhere in the world with and without exclusions. Additional foreign equity funds are differentiated by geography – regional funds and single country funds – and economic status – developed market, emerging market, and frontier market funds. Foreign bond funds usually include a mix of corporate and government issues, but they also can be bond-type specific.

2.4 Asset-Allocation Funds

These funds are hybrids because their portfolios that are comprised of a mix of stocks and bonds, and, in some instances, cash-equivalents. They are also referred to as balanced, target-date, and life-cycle funds. The allocations can be fixed, reconfigured over a given time period (age-based), or respond to market conditions. A fund-of-funds (FoF) is a mutual fund that invests in other mutual funds rather than buying individual stocks and bonds. The emphasis of a FoF is on diversification among various investing styles and asset classes and providing investors with one-stop shopping.

2.5 Specialty Fund Categories

- **Stable Value Funds:** This type of fund is a popular choice in pension and 401(k)-like retirement plans. They generally offer a diversified portfolio of guaranteed income contracts (GICs) that promise to pay interest at a set rate for a certain period of time. The bond-like quality of a GICs, while providing a steady income flow, do not offer a growth of capital that long-term investors are (or should be) looking for. Also, high expenses can be an issue with these funds.

- **Sector Funds:** This type of mutual fund invests in companies that operate in a particular industry or type of business and include the following: communications, financial services, healthcare, natural resources, precious metals, real estate, commodities, technology, and utilities. Fund investors need to be aware that because the holdings of these mutual funds are concentrated in the same industry, there is an inherent lack of diversification associated with these investments.

- **Alternative Funds:** This is a term applied to a category of non-traditional fund investing that covers investment styles that are outside the mainstream asset classes of cash equivalents, stocks, and bonds. Due to the unconventional nature of alternative assets, valuation of some of these assets can be difficult. Also, they tend to be less liquid and lack reliable long-term track records. Examples of alternative investments would include, among others, the following:
  - **Bank Loan Funds** invest in floating-rate bank loans underwritten by commercial banks and other financial institutions. These funds are relatively new to the mutual fund line-up and are not suitable for risk-averse investors. However, they do offer attractive yields if you can live with their volatility.
• **Long/Short Funds** are a type of mutual that mimics some of the trading strategies employed by a hedge fund. They use leverage, derivatives, and short positions in an attempt to maximize total returns, regardless of market conditions.

• **Socially Responsible Funds**, as the name implies, select what are called “socially responsible investments” (SRI), which means avoiding companies in such businesses dealing with alcohol, gambling, tobacco, and those with poor environmental, community, and labor practices.

### 2.6 Money Market Funds

Money market fund portfolios are comprised of short-term (90 day average maturity) securities consisting mainly of certificates of deposit, commercial paper, bankers acceptances, repurchase agreements, and U.S. Treasury bills, which, as cash-equivalents, are high quality, liquid money market instruments. These funds are low-risk, low-return investments, which are useful as a money management tool, but are unsuitable as a long-term investment option.

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### Lesson 3

#### Sources of Mutual Fund Information

In this day and age of information overload, the mutual fund industry is no exception. Mutual funds are regulated and supervised by the Securities & Exchange Commission (SEC), which requires that mutual funds provide certain documents to their shareholders and/or prospective shareholders. The funds themselves maintain websites, which also contain, in many cases, helpful summary performance data and educational information. A number of investment research firms provide analytical reports and data on mutual funds, which are available by paid subscription and/or are free of charge. In recent years, financial websites and the financial press have proliferated and can be, if used discriminately, a useful source of mutual fund information.

Among this “ton” of information on mutual funds, I’ve selected a few “pounds” of key items and services that I think can be of most help to fund investors:

#### 3.1 Fund Documentation

As mentioned above, the SEC has documentation requirements with which funds must comply. These include providing a fund Prospectus (both Summary and Regulatory), a Statement of Additional Information (SAI), and an Annual Report (some funds also provide quarterly and semi-annual reports). In the case of the fund Prospectus and SAI, these are lengthy, hard-to-understand documents written by lawyers and accountants to comply with regulatory dictates.
You’ll have to ask for a Statement of Additional Information, which simply elaborates on much of the same information contained in a fund Prospectus. However, a critical piece of information can only be found in the SAI’s “Management of Funds” section, under a caption called “Ownership of Fund Shares.” Here you’ll find how much money the fund’s manager(s) have invested in the fund. Obviously, the more the better, which is a clear indication that their interests and yours are closely aligned.

A fund’s semi-annual (sometimes quarterly) and annual fund reports are fairly easy reads and provide the manager’s current take on the investment environment in general and the specific short-term prospects for the fund. Also, in these reports will be a detailed listing of the individual securities in a fund’s portfolio.

### 3.2 Investment Research Firms

In terms of independent mutual fund information and data, one name stands out from all the others – Morningstar. It has almost a three decade history as a reliable provider of a variety of research tools, services, publications, fund reports, and extensive online information from its website – www.morningstar.com – that is unmatched in the mutual fund industry. Premium Membership, either annual or monthly, gets you a full package of stock and fund information. You can get a limited amount of information from the website as a free member. Many public libraries subscribe to a Morningstar service that gives library users access to Premium Membership services. Morningstar’s one-page fund reports are arguably the best source of evaluative mutual fund information for the investing public (See Lesson 5).

Lipper Leading Fund Intelligence (www.lipperweb.com) is recognized name in the mutual fund information business. Its benchmark fund indexes are found in any number of financial publications. In similar fashion to Morningstar, Lipper provides, through its website, a comprehensive package of individual fund reports, research tools, and general fund information, which has both free-of-charge and fee-based elements.

If you are in a 401(k) or 403(b) retirement plan, the plan-provider will make available “fact sheets” and other relevant data on the offerings in the plan’s investment menu.

### 3.3 Websites for Fund Data and Education

Besides the Morningstar website, the American Association of Individual Investors (AAII) is a membership organization for individual investors and has services and products for fund investors. Websites such as Yahoo!Finance, MSN Money, and SmartMoney are considered good sources of mutual fund data; however, you have to now how to use the information provided.

In terms of the quality of fund information and educational value, fund company websites vary greatly – some are well done and easy-to-understand, while others leave much to be desired. Nevertheless, fund websites are another easily accessed source of information and should definitely be consulted, if for no other reason than the fact that they are cost free.
Investopedia.com (a Forbes Digital company) reportedly has the largest financial education website on the Internet (www.investopedia.com), which contains a large assortment of mutual fund educational material.

3.4 Recommended Reading

It’s been reported that there are more than 80,000 personal finance books in print. Finance professionals generally agree that only a couple of dozen of these are really worth reading. If your investing focus is on mutual funds, you only need to read one of these: John C. Bogle’s, the founder and former chairman of the Vanguard Group, Bogle on Mutual Funds. The book provides comprehensive coverage of the ABCs of mutual fund investing and Bogle’s insights are invaluable and timeless.

In addition to this investment education tutorial, the Fund Investor’s Schoolhouse has other similar publications, which would be helpful to investors looking for mutual fund investing guidance, in its Resource Center and Library:

- The Fund Investor’s Explanationary
- Morningstar’s One-Page Wonder
- An Insider’s Guide to International Investing
- The Fund Investor’s Tool Box
- Simplify Fund Investing With Style Boxes

Lesson 4

Constructing a Mutual Fund Portfolio

Creating a framework for building a retirement nest egg is the first step in a journey that generally takes place during your so-called productive years, i.e., those of active employment. Whether this is done independently or through a retirement plan, the process of putting together a mutual fund portfolio to accomplish this task requires, among other elements, a meaningful understanding of the fundamentals of investment risk and return.

Risk is an essential component of investing. Investors need investment risk in order to generate a sufficient return on their invested capital to reach their retirement savings goals. Since you cannot avoid risk, and, as an investor, it’s not in your best interests to do so, you manage it through an investment strategy called asset allocation. Mutual funds make it relatively easy to implement your asset allocation decision and diversify your portfolio’s risk-return parameters.

4.1 The Asset Allocation Process

Generally, investment professionals traditionally view stocks (equities), bonds (fixed-income), and cash/cash-equivalents (money market instruments) as the three principal asset classes, sometimes also referred to as financial asset classes. Frequently, real estate and
commodities are considered to be additional asset classes that investors can also consider. For the sake of simplicity, we’ll employ the traditional approach of using stocks, bonds, and cash/cash-equivalents as our principal asset classes to explain the asset allocation process.

Each of these asset classes has investment risk-return characteristics that differentiate one from the other. Historically, stocks have carried more risk and are associated with an annual rate of return in the range of 8.0% to 10.0%. Investment grade bonds are considered relatively safe and their annual returns have averaged in the 4.0% to 6.0% range. Cash equivalents, as opposed to non-interest bearing depository accounts, usually provide annual returns just above the average rate of inflation (+/- 3.0%) of 3.0% to 4.0%.

Fund investors use asset classes to balance their views on risk and return. For example, an aggressive investor who’s comfortable with market volatility and a relatively high level of risk might have an asset allocation of 80% stock funds, 20% bond funds, and no, or only a nominal, position in cash/cash-equivalent funds. In contrast, a safety-conscious fund investor might have a mutual fund position of 20% in stocks, 60% in bonds, and 20% in cash/cash equivalents.

Asset allocation is the most important investment decision investors make. It is widely recognized in investing circles that the apportionment of the three asset classes in an investment portfolio is the determinative factor of long-term performance. Whether you’re an experienced investment professional or a non-professional investor, mutual funds make a strategic asset allocation decision relatively easy to implement.

4.2 Portfolio Diversification

Simply stated, a fund investor first determines his/her portfolio’s asset allocation by making a broad, and very important, apportionment of risk and return using three asset classes—stocks, bonds, and cash/cash-equivalents. The investor then chooses from a wide variety of funds with particular investing styles to further diversify his/her investment risk and return within these classifications. Unless this distinction is appreciated by fund investors, it is not inconceivable that they confuse fund diversification with asset allocation.

As you have seen in Lesson 2, there is a large selection of fund types to choose from. It is not necessary or advisable to load up your portfolio with a large number of funds. A limited selection of broad market index funds and/or a judicious choice of quality managed funds numbering as few as five funds and topping out at twelve funds should provide for a healthy degree of portfolio diversification.

4.3 Using a Fund Style Box to Diversify a Portfolio

Several years ago, Morningstar’s Don Phillips invented the so-called style box (see Exhibit: Style Box), which is now widely used to pinpoint a fund’s investment objective. It is also a very useful tool for investors to use to examine an existing portfolio of mutual funds in order to easily visualize the weighted impact of your funds’ risk and return in your overall portfolio.
Exhibit: Style Boxes

### Style Box for Stock Mutual Funds

<table>
<thead>
<tr>
<th>Investment Style</th>
<th>Company Size (Market-Capitalization)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Value Stocks</td>
<td>Large (Large - Cap)</td>
</tr>
<tr>
<td>Blend Value/Growth Stocks</td>
<td>Medium (Mid - Cap)</td>
</tr>
<tr>
<td>Growth Stocks</td>
<td>Small (Small - Cap)</td>
</tr>
</tbody>
</table>

### Style Box for Bond Mutual Funds

<table>
<thead>
<tr>
<th>Interest Rate Sensitivity (Duration)</th>
<th>Credit Quality</th>
</tr>
</thead>
<tbody>
<tr>
<td>Short-Term (1-3 years)</td>
<td>High Credit Quality (AAA-AA) (Investment Grade)</td>
</tr>
<tr>
<td>Intermediate-Term (3-10 years)</td>
<td>Medium Credit Quality (A-BBB) (Investment Grade)</td>
</tr>
<tr>
<td>Long-term (10 years +)</td>
<td>Low Credit Quality (Non-Investment Grade)</td>
</tr>
</tbody>
</table>
In brief, a stock (equity) style box is divided up into nine, equal-sized squares in tic-tac-toe fashion. A stock fund’s risk-return characteristics are reflected in the three company sizes (large, medium, and small), which generally are assumed to run from the safest to more risky, respectively. The horizontal axis has three investment styles: value, blend (sometimes referred to as core), and growth, which, are assumed to run from moderate to high returns, respectively. Similarly, the bond (fixed-income) style box reflects a bond fund’s risk-return characteristics by using credit-quality (vertical axis) and duration, i.e., interest rate sensitivity expressed in years, (horizontal axis).

The Schoolhouse has an e-booklet, Simplify Fund Investing With Style Boxes, in its Library that provides fund investors with the information and guidance needed to become conversant with this valuable investing tool.

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Lesson 5

Evaluating a Mutual Fund: Morningstar’s Fund Report

While there are numerous ways you can go about the fund evaluation process, using a Morningstar Fund Report (not to be confused with a “Fact Sheet”) makes the process relatively easy. The objective is to make the complex simple. For the general investing public, the fund evaluative data points contained in Morningstar Fund Reports are a source for an abundance of “need-to-know” fund information. As an independent, reliable investment research service, its fund reports provide insights into mutual fund qualities that are beyond the reach of the non-professional investor:

5.1 Analyst Rating

Morningstar’s Analyst Ratings, which were officially launched on November 15, 2011, initially covered some 350 funds and, during the course of 2012, will gradually include all the other 1,500 funds included in its mutual fund research. While described by some observers as a “new” approach, the Analyst-Ratings – Gold, Silver, Bronze, Neutral, and Negative – are simply a logical combination of two, heretofore, existing Morningstar evaluative metrics.

Those investors who have used Morningstar’s one-page fund reports will recognize the Analyst-Rating as a merger of the firm’s “Analyst Pick” and “Stewardship Grade” rating methodologies. An Analyst-Rating reflects a synthesis of five fund evaluative aspects – Morningstar uses the term “pillars” – of a fund’s fundamental strengths and weaknesses: management, strategies, parent company, performance, and costs.

By combining the quantitative, qualitative, and forward-looking perspectives found in the analyst pick and stewardship metrics, the Analyst-Rating makes life simpler for mutual fund investors. While in the context of the Olympics, any medal is quite an achievement. In the context of mutual fund investing, I’d suggest going for the Gold (the top rating)!
5.2 Risk-Return Profile

In a perfect world for investors, they would be able to achieve high returns with low risk, which is sometimes available, but not very often. Most non-professional investors tend to focus on return with little attention to risk. Mutual fund marketing materials generally post performance numbers in bold, large type-face, while the risk commentary is buried in barely decipherable text.

Generally, risk and return in the investing world can be measured on a simple scale of high, above-average, average, below-average, and low. Common sense tells us that investors should be looking for funds with returns that exceed the risks or, at the very least have a match of risk and return.

5.3 Costs and Expenses

Simply stated, it is widely recognized that low-cost funds out perform high-cost funds over the long-term. Understanding fund costs and expenses and their impact on your investment is a key to successful mutual fund investing:

- **Sales Charges (Loads):** If you invest through an investment intermediary – stockbroker, financial planner, or investment adviser – for their advisory services, you will pay a fee in one form or another. A common form is purchasing a “load fund,” one which carries a sales charge that goes directly to the intermediary. Just a reminder here that “no-load funds,” those without a sales charge, can be purchased directly from a number of fund companies. Also, employer-sponsored retirement plans generally waive the sales charge on load funds in the plans’ investment options.

- **Operating Expenses:** All mutual funds incur expenses for portfolio investment management and administrative functions such as accounting, legal, and custodial services. In some cases, a fund will also have a 12b-1 fee, which covers so-called marketing expenses, that is generally paid to investment intermediaries to compensate them for their selling effort. The aggregate of a fund’s operating expenses, expressed as a percentage of average assets under management, are referred to as a mutual fund’s expense ratio.

- **Other Fees and Expenses:** To protect a fund against speculative investors’ market-timing practices, some funds will charge a redemption fee on fund investments held for less than 90 days. This fee can extend out to as much as one year, and then it disappears. Obviously, long-term fund investors need not be concerned about this fee.

5.4 Turnover Rate

A fund’s trading activity incurs brokerage transaction costs – commissions, price-spread differences, and market impacts. These costs are charged to the fund but are not included in a fund’s expense ratio. A fund’s portfolio turnover is an indicator of transaction costs.
All mutual funds buy and sell securities. There is no “correct” amount of portfolio turnover that a fund should have. As a general rule, fund investors should favor relatively low portfolio-turnover funds, which are less prone to capital gains tax consequences, managerial mistakes, and added costs. This measurement applies more so to equity funds than bond and money market funds.

5.5 Performance (Total Return)

In the context of mutual fund investing, a fund’s performance is expressed as its total return, which is comprised of the changes in its price (net asset value), the income from dividends and/or interest, and its capital gains distributions. A fund’s total return is expressed annually as a net percentage of its average assets. Total return is also expressed, generally, as an annual average percentage for periods of 1, 3, 5, 10, and 15 years. The total return figure needs to be compared to an appropriate market index, as well as category and peer funds. Obviously, reasonable consistencies of total returns that match or out perform these benchmarks are indicators of positive fund investment quality.

5.6 Analyst Opinion

The only source of a written analyst assessment is found in ”Morningstar’s Take,” which is periodically updated, giving investors a valuable qualitative professional opinion of a fund’s overall performance. Stating the obvious, in selecting a fund you should be looking for a positive commentary.

Conclusion

Successful fund investing requires learning some fundamentals about the investing process and the mutual fund as an investment vehicle. Understanding what you own, why you own it, and patiently contributing regularly to a diversified portfolio of funds based on an appropriate asset allocation for your investment objective can be accomplished by applying the mutual fund basics you have learned from the lessons you have been studying herein.