Here's the lowdown on mutual funds

Advantages and Disadvantages of Mutual Funds

• Advantage - Diversification. Mutual funds offer the easiest method of reducing portfolio risk through diversification. Though not all Mutual Funds are well diversified (such as sector funds), all investors should seek diversification to protect themselves from company and industry related risk.

• Advantage - Professional Management. For a modest annual management fee the fund employs a professional portfolio manager(s) that provides: industry and firm analysis, security selection, portfolio balance, and market/firm timing decisions.

• Advantage - Recordkeeping. One of the most underrated services a mutual fund provides is its recordkeeping. Funds account for and report information on: dividends, interest, capital gains, and other distributions. In addition, they produce timely summary reports for the individual on account activities. At tax time, this service is invaluable. At other times, this service helps the individual make more informed investment decisions.

• Disadvantage - Taxable Distributions. Funds are obligated to distribute to shareholders a portion of the interest and capital gains realized annually on their investments. Because of this, shareholders have little choice but to pay the taxes on the gains (viewed as additions to regular income by the IRS) the year they are reported. Though some types of funds usually generate less taxable gains than others, distributions and their tax status are determined by the fund management and its portfolio strategies.

Mutual Fund Costs - Loads and Fees

A Load is a sales commission deducted from your investment and paid to a salesperson (broker, financial planner, etc.). There is no truth to the often heard rhetoric, that Load funds outperform No-Load funds. As a matter of fact, when including the Load in the calculation, No-Load funds routinely outperform Load funds. As an example, $10,000 invested in a fund with a 5% front-end Load would give you $9500 actually invested; just getting back to even would take a 5.27% return!

In addition to Loads, there are several kinds of Fees that may be charged by funds; these Fees shouldn't be confused with the funds annual management fee. All mutual funds have an annual management fee, whether they have any additional Loads and Fees or not. Below is a list of currently used Loads and Fees you might want to avoid (hint).

• Front - End Load: 0% to 8.5% of initial investment, goes solely to compensate salespeople for selling the fund.

• Back - End Load: 0% to 7.25% of initial investment upon sale, again this doesn't go to the fund management but to salespeople.

• Redemption Fee: up to 2%, not the same as a back-end load, this fee is charged to discourage frequent trading and typically disappears after a stated amount of time.

• 12b-1 Fee: 0% to 1.25% of fund assets each year, unlike a Load that is paid only once, this fee is charged every year one owns the fund. This Fee goes solely to pay for advertising and sales expenses.

The number of funds charging a front-end load has declined recently and at the same time 12b-1 fees have become much more common. This tactic allows many load funds to appear like low-load funds (watch out). Before investing, request a prospectus and annual report on each fund you're interested in. The prospectus is required to list the Annual Fund Operating Expenses (or Charges) near the beginning, where they must summarize all of their loads and fees.

No-Load's charge only a management fee + (optionally) up to a 0.25% 12b-1 fee.

Mutual Fund Categories

Explanations of the different mutual fund categories (Aggressive Growth, Growth, Bond, International Stock, Small Capitalization Stock, etc.) are found almost everywhere; therefore, I'm not planning to include the same here. If you seek such explanations try: books on mutual funds and investments, literature from mutual fund companies, or some online sources.

Risks of Mutual Funds

Though not a simple subject, it's important to understand the risks involved in mutual fund investing. Below is a basic introduction to the subject.

1. Individual Company / Industry Risk - a well diversified mutual fund

See MUTUAL FUNDS, pg 7