THE INFORMED INVESTOR

MUTUAL FUNDS

No. 2

Millions of investors have come to rely on mutual funds as their primary investments. The growth of funds has been explosive, with individuals, retirement plans and others putting well over $1 trillion in the funds by the mid-90's.

If you are thinking of investing in a mutual fund, you should remember that they are only one of many types of investments and that, as with any investment, you should know and understand the nature and risks of mutual funds and options available to you before you invest any of your money.

This edition of "*The Informed Investor*" provides a concise overview of how these funds work, and attempts to answer the questions prospective mutual fund investors most frequently ask about them. It is not an exhaustive treatment of the subject, but rather a guide that can help you begin your investigation of mutual funds with some basic understanding of the product.

WHAT IS A MUTUAL FUND?

Mutual funds belong to the class of firms known as investment companies. While companies may offer a "family" of funds under a single umbrella name and common administration - for example, the Vanguard Group, Fidelity Investments, or Strong Funds - each fund offered is a separately incorporated investment company. These are entities that pool investor money to buy the securities that make up the fund's portfolio.

The idea behind this pooling of investor money is to give each investor the benefits that come from the ownership of a diversified portfolio of securities chosen and monitored daily by experienced, professional advisers.

The funds create and sell new shares on demand. Investors' shares represent a portion of the fund's portfolio and income proportional to the number of shares they purchase. Individual shareholders of the mutual funds have voting rights in the operation of the fund, just as most holders of common stocks in corporations have the right to vote on certain issues involving the running of the company.

The key attribute of a mutual fund, regardless of how it is structured, is that the investor is entitled to receive on demand, or within a specified period after demand, an amount computed by reference to the value of the investor's proportionate interest in the net assets of the mutual fund. This means that the owner of mutual fund shares can "cash in," or redeem his or her shares at any time.

Mutual funds, therefore, are considered a liquid investment. The investor's selling (redemption) price may be higher or lower than the purchase price. It all depends on the performance of the fund's portfolio.

The fund has an adviser who charges a fee for managing the portfolio. The adviser decides when and what securities to buy and sell, and

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is responsible for providing or causing to be provided all services required by the mutual fund in carrying on its day-to-day activities. All fund investors get this built-in portfolio management whether they own 50 shares or 10,000.

The adviser generally purchases many different securities for the portfolio, since investment theory holds that diversification reduces risk. It is this diminished risk that is one of the attractions of mutual funds.

The fund also has a custodian, usually a financial institution such as a bank, which holds all cash and securities for the fund.

Mutual funds are regulated by both the federal Securities and Exchange Commission and the securities regulators of each state.

TYPES OF MUTUAL FUNDS

Mutual funds can be classified by their investment objectives and the types of securities they hold.

- Aggressive Growth Common Stock funds invest primarily in common stocks to maximize capital gains. They may invest in out-of-favor companies or companies in new industries. Current income, that is dividends, is not a significant factor.

- Income Funds seek a high level of current income by investing in both equity securities (generally high yielding common and preferred stocks) and debt instruments (e.g., high yielding bonds).

- Money-market Funds invest in securities with short-term maturities. Portfolios can include commercial paper issued by corporations, negotiable certificates of deposit, short-term corporate obligations, and U.S. government issued or backed securities, such as Treasury bills and notes.

- Corporate Bond Funds seek income by investing primarily in the bonds of corporations.

- Municipal Bond Funds invest in bonds issued by states and municipalities to finance public projects.

- U.S. Government Income Funds invest in a variety of government securities.

- Specialty funds focus on a single industry sector or geographical area, such as pharmaceuticals or companies in the “Pacific rim” countries.

A fund seeks to attain its invesment objectives by choosing a portfolio that fits its investment policies or strategies.

The fund's portfolio has investment risk directly related to the securities it contains as well as to general market and business conditions. For example, an aggressive growth fund, because the prices of securities in its portfolio are more volatile, is generally riskier than an income fund, which may invest in conservative stocks and bonds whose prices do not fluctuate greatly but that pay high dividends or interest. Regardless of the investment strategy or portfolio, no fund can escape market risk.

DISCLOSURE: WHERE TO GET THE FACTS

The key disclosure documents for mutual funds are the prospectus and the Statement of Additional Information (SAI). The prospectus explains, among other things, the fund's investment objectives, risks, sales charges, expenses, fees, and services. The SAI includes the fund's audited financial statements, a list of securities in the fund's portfolio at the end of its fiscal year, a list of the fund's officers and directors, and other important information. Sometimes the SAI will elaborate on information in the prospectus, but frequently it contains important information that does not appear in the prospectus at all. The prospectus must include appropriate instructions as to how to obtain the SAI and whether any of the material contained in the SAI has been incorporated by reference into the prospectus.

Details of the fund's investment objectives and policies may appear in the SAI. A fund that advertises performance data must disclose total return in the SAI. Restrictions on the type of investments a fund may make are often disclosed only in the SAI.

It follows that you may not get a complete picture of the mutual fund if you don't read the SAI before you send money.

Federal law entitles you to a prospectus when you invest in mutual funds. There is no federal requirement that you be furnished an SAI.

You should obtain the prospectus and SAI from the salesperson or directly from the company before you make the decision to invest.

YOU SHOULD NOT AGREE TO BUY ANY MUTUAL FUND SHARES UNTIL YOU HAVE READ BOTH THE PROSPECTUS AND THE SAI (EVEN IF YOU ARE PRESENTED WITH THE OPPORTUNITY AND THE SALESPERSON PRESSURES YOU TO BUY).

There has been a trend in recent years to consolidate a number of funds into a "complex" or "series" and then produce one massive disclosure document covering them all. You must be even more careful about these so-called "telephone book disclosure" of fund complexes. Trying to track a single fund through such a "telephone book" can be daunting, even for professionals.

MUTUAL FUND SALES CHARGES (LOADS) AND OTHER EXPENSES

Sales Charges or "The Load"

Sales charges on mutual funds are often referred to as the "load." There are no-load funds, front-end load funds and back-end load funds. Look in the front of the prospectus for a summary of fees. Federal law requires they be disclosed.

Funds that sell their shares to investors without a direct sales charge are called "no-load" funds. No-load fund shares are sold to investors at the fund's net asset value per share. The fund calculates net asset value each day by adding the value of its securities and other assets, subtracting liabilities, and dividing by the number of fund shares outstanding.

Some mutual funds use a sales organization of distributors and dealers - for example, brokerage houses and large financial planners. These funds sell their shares not at net asset value but at a higher offering price, or "asked price." The difference between net asset value and the offering price goes to the fund's sales organization. For example, assuming a load of 8% for $10,000 invested in a fund, $9,200 would be used to purchase fund shares; the rest would be commission.

A load fund can charge up to 9.3 percent of the amount invested. If there is no load, all of the investor's money is used to purchase fund shares.

Some funds use an indirect charge, known as a Rule 12b-1 fee, named for a Securities and Exchange Commission rule, which can range from one-tenth to one-and-one quarter percent of the fund's average annual assets. Over a period of a year the Rule 12b-1 fee, which has the effect of lowering the shares' net asset value by subtracting the fee from the fund, can cost the investor more than the sales fee charged by load funds.

Loads can be classified as front-end and back-end. You pay the front-end load when you purchase shares, as in the example cited above. You pay the back-end load when you redeem your shares. If, for example, you cash in shares worth $10,000 and were charged a 4% back-end load, you would receive a final payout of $9,600.

One type of back-end load is the "contingent deferred sales charge," which is usually expressed as a percentage of the original purchase price or value of shares redeemed. In most cases, the longer you hold the shares, the lower the contingent deferred sales charge.

Another fee that acts like a back-end load is the redemption fee. This fee can be as high as 2% and is charged when you redeem your shares. Funds can have both a redemption fee and a back-end load.

Prices for most mutual funds appear in the business or financial sections of newspapers. For a no-load fund, the sale price and net asset value are identical. For a load fund, the sale price is the "offer price" or "asked price."

If you are investing in any fund with a load, make sure you know exactly how much the sales charges are. The broker dealer who sells you the shares is not required to disclose sales charges on the confirmation slip that is provided after the sale is complete. You must ask for this information.

Fund Expenses

Sales charges or loads are distinct from fund operating expenses; that is, a fund will have operating expenses whether or not it charges a load. These expenses are usually deducted from the fund's dividend and interest income and directly affect the investor's rate of return.

Expenses include the adviser's fee for managing the portfolio, the custodian's and transfer agent's fees, the fund's brokerage commissions, expenses for annual meetings, etc.

Some funds also charge an annual Rule 12b-1 fee, as mentioned above, which permits them to use fund assets to pay for advertising and other marketing costs.
For a full understanding of fund expenses, you must review both the prospectus and the SAI.

Contractual Plans

To maintain a personal regular investment program, some investors buy shares periodically under a contractual plan. These accumulation shareholders make a commitment to pay for new shares on a regular basis over a period of several years.

One drawback of the contractual plan is that if you redeem your shares early or discontinue payments, you may have to pay a substantial penalty. This factor might make contractual plans unsuitable for some investors. Such plans are illegal in some states. Check with your state securities regulator to make sure.

HOW YOU MAKE (OR LOSE) MONEY ON A MUTUAL FUND

Remember that a mutual fund uses money paid to it by shareholders to buy the securities for its portfolio consistent with its stated investment objectives. These securities may generate interest income and pay dividends. They, like all stocks, may also go up or down in price.

If debt instruments (bills, bonds, notes, etc.) in the portfolio earn interest, the fund distributes the interest to shareholders as dividends. Stock dividends the fund receives are also distributed to shareholders as dividends.

If, for example, the fund purchases a common stock at $5 a share and later sells it at $10 a share, it realizes a capital gain, which is passed to shareholders as a capital gains distribution.

When redeeming shares, the money investors receive depends on how well the portfolio has performed since the shares were purchased. The fund will multiply net asset value at redemption time by the number of shares the investor is redeeming, subtract applicable loads and fees, and send the proceeds to the investor. If net asset values have declined, investors will receive less than their original investment.

Since you have to pay income tax on capital gains, you must match the net asset values at which shares were purchased against the net asset values at which shares were sold. If you made money on the redemption of mutual fund shares you will have to pay the capital gains tax. If you lose money there may be a tax advantage in taking a capital loss. There is more than one way to perform these computations; you may want to consult a tax adviser as to the method that best fits your circumstances.

MUTUAL FUND PERFORMANCE

Investors should keep two related principles in mind when they examine mutual fund advertisements and disclosure materials:

No mutual fund can guarantee future performance. Any such guarantee is illegal.

The past performance of a fund does not predict its future performance.

Nevertheless, fund performance is one of several factors that should be examined. When comparing several funds with similar objectives and characteristics, an investor would probably select a fund that has consistently outperformed the others.

The two primary measures of performance are yield and total return.

Yield is the income generated over a specified time period divided by the fund's current price per share.

While yield is a measure of current performance—how much income an investment generates—total return measures per share change in total value over a specified time period. All fund activity that has an effect on net asset value (dividends, capital gains, unrealized capital gains and losses, etc.) is represented in this measure. It provides, therefore, a more complete picture of fund performance than the yield or net asset value alone. The investor may approximate total return by using data that appears in the "Per Share Changes and Capital Income" section of the prospectus.

Changes in yield do not reflect a corresponding increase or decrease in the fund's net asset value. A fund may increase yield by purchasing investments that are riskier but offer higher interest payments—for example, junk bonds. But, the higher yield may be offset by a deteriorating capital position or a lower total return.

AFTER YOU INVEST

A prospective investor should review disclosure documents before investing. But shareholders should do their homework as well. Although federal law requires that prospectuses be amended annually, it does not require sending new versions to shareholders. If you have not recently examined the prospectus for a fund you own, you should monitor your investment by obtaining and reading the most recent prospectus, SAI and financial statements—these may contain important changes. Careful reading of quarterly and annual reports is also necessary to keep up with changes in your investment.

TIPS ON BUYING MUTUAL FUNDS

1. ***Determine your financial objectives and how much money you have to invest.*** Make sure the fund's objectives coincide with your own. Don't change your objectives or exceed the amount set aside for investment unless you have good reason.

2. ***Always obtain all available information before you invest.*** Request the prospectus, the Statement of Additional Information and the latest shareholder report from each fund you are considering.

3. ***Never invest in periodic payment plans unless you are virtually certain that you will not have to redeem early.*** If you redeem early or do not complete the plan, you may have to pay sales charges of up to 51% of your investment.

4. ***Be on the alert for incorporation by reference.*** You will have "no excuse" for not knowing this information, if a problem arises. You may be legally presumed to know materials incorporated by reference in a prospectus or other documents.

5. ***Always determine all sales charges, fees and expenses before you invest.*** Fees such as 12b-1 fees can cost you dearly and charges for reinvestment of dividends and capital gains distributions can substantially add to your costs. Shop around among the many funds offered and compare the various fees and costs connected with funds that appeal to you.

6. ***Learn the costs of redemption.*** Sometimes investors are surprised to learn that they have to pay to get out of funds through back-end loads or redemption fees. Find out the redemption costs before you invest so you won't be unpleasantly surprised when you redeem your shares.

7. ***Never treat the risks of investment in a fund lightly.*** Weigh the risks of the funds you want to buy against your ability to tolerate the ups and downs of the market and your investment goals. Be extra cautious when considering investing in funds with high yield/high risk portfolios. Junk bond problems, for example, invariably affect the fund's performance.

8. ***Don't be misled by the name of a fund.*** Some funds have been given names denoting safety, stability and low risk, despite the fact that the underlying investments in the portfolio are volatile and highly risky.

9. ***Don't base your decisions solely on advertising and sales materials.*** Unlike the prospectus and the SAI, advertising and sales literature are not reviewed by the Securities and Exchange Commission before they are issued. The picture presented in a fund's advertisement might be rosier than that revealed by the prospectus and SAI.

OTHER SOURCES OF INFORMATION

Learn all you can about mutual funds in general. If you need or desire additional general information on funds and investing, ask your broker-dealer, the investment companies or state securities regulator for relevant brochures, pamphlets and other publications. Local libraries are often well stocked with books that discuss mutual funds in great detail.

IF A PROBLEM ARISES

The securities administrator in your state, province or territory is responsible for policing investments for fraud. If you believe you have encountered an investment fraud, contact your state securities regulator's office.

The Council of Better Business Bureaus and Better Business Bureaus in the United States and Canada answer inquiries on companies located in the areas they serve. Before putting money in any investment plan, it is a good idea to contact your Better Business Bureau for a reliability report on the company you intend to deal with. For more information, contact the BBB office that serves your area. They are listed in the white pages.

GLOSSARY

Back-end Load - Charge imposed by a mutual fund when an investor redeems shares. Redemption fees and contingent deferred sales charges are examples.

Contingent Deferred Sales Charges - Back-end load imposed on an investor who redeems shares. It is usually expressed as a percentage of the original purchase price or of the value of shares redeemed. In most cases, the longer the investor holds his shares, the smaller the deferred sales charge.

Distribution - Payments made to shareholders by the mutual fund. Interest and stock dividends earned by the fund's portfolio are passed to shareholders as dividends, while capital gains are passed as capital gains distributions.

Dividend Reinvestment Fee - Fee charged when an investor uses dividends paid by a mutual fund to purchase additional shares of the mutual fund.

Exchange Fee - Fee charged when an investor switches from one mutual fund to another in the same family of funds.

Front-end Load - Sales charge applied at the time the investor purchases shares.

Investment Companies - The companies that pool investor monies to purchase securities. The Investment Company Act of 1940 created three types of investment companies: face-amount certificate companies, unit investment trusts and management companies.

Management Companies - There are two types: open-end and closed-end. Open-end funds, which sell and buy shares back on demand, are called mutual funds. Closed-end funds have a fixed number of shares. After the initial public offering, shares in closed-end funds trade only on exchanges. The price is determined by the market and does not necessarily reflect the net asset value of the shares.

Management Fee - A fee paid by the mutual fund to its investment adviser and charged against fund assets, generally 1% or less per year.

Net Asset Value - In effect, the share price of a fund computed daily by adding the value of the fund's securities and other assets, subtracting liabilities, and dividing by the number of shares outstanding. For a mutual fund with a front-end load, net asset value is identical to the "asked price" or "offering price."

Prospectus - A disclosure document which should provide the investor with full and complete disclosure of all material information needed by the investor to make a decision whether or not to invest. The prospectus generally incorporates the SAI by "reference." (See SAI definition.)

Redemption Fee - A fee charged to an investor who redeems shares. It is generally expressed as a percentage of the value of shares redeemed.

Rule 12b-1 Fee - An asset-based sales load, permitted by SEC Rule 12b-1, representing annual charges of up to 1-1/4% for specific sales or promotional activities of the mutual fund. Over time, the amount paid in Rule 12b-1 fees can surpass the amount paid in sales fees charged by load funds.

SAI - A disclosure document called a Statement of Additional Information. The SAI is not required to be furnished by mutual funds to investors unless investors specifically request it. Investors are responsible for information in the SAI, even if they don't request it.

Total Return - A computation of mutual fund performance which measures changes in total value over a specified time period. Included in the computation are distributions paid to investors, capital gains distributions and unrealized capital gains and losses. Since all fund activity which has an effect on net asset value is represented, this measure provides a picture of performance which is more complete than yield.

Yield - A measure of mutual fund performance, which is figured by dividing the income generated (dividends, capital gains distribution, etc.) per share for a specific time period by the fund's current price per share. For example if, during a year, a single share of a fund had paid income totaling $1 and its share price was $10, the annual yield for that year would be figured by dividing 1 by 10, which equals one tenth, or a yield of 10%.