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Mutual Funds

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Mutual Funds

What is it?

A mutual fund is an investment company that pools money from many people and invests it in stocks, bonds, or other securities. Each investor owns shares, which represent a part of these holdings. Investors can buy shares (or portions) directly from the fund or through brokers, banks, financial planning professionals, or insurance agents. All mutual funds will redeem (buy back) your shares on any business day and must send you the payment within seven days.

When you buy shares, you pay the current net asset value (NAV) (the value of one share in a fund) per share, plus any sales charge (known as a sales load). When you sell your shares, the fund will pay you NAV less any other sales load. As with individual stocks, the share price of mutual funds fluctuates and the value of an investment may be more or less than its original cost.

Mutual funds can be a great way to invest because:

- They are a collection of many stocks and/or bonds, so your investment risk is spread out (keep in mind that, as with all investments, mutual funds carry risks)
- They are managed by professional fund managers who invest the pooled money into individual securities
- Costs associated with the underlying security are often lower than what you would pay on your own because the fund buys and sells large amounts of securities at a time

Caution: Mutual funds are not guaranteed or insured by any bank or government agency--even mutual funds sold by banks.

How do investors make money with mutual funds?

Money is made from a mutual fund when the stocks, bonds, or other securities increase in value or issue dividends.

- The price of the securities a fund owns may increase. When a fund sells a security that has increased in price, the fund has a capital gain. At the end of the year, most funds distribute these capital gains (minus any capital losses) to investors.
- If a fund does not sell but holds on to securities that have increased in price, the fund's NAV increases. If you sell your shares, you make a profit (capital gain).
- A fund may receive income in the form of dividends and interest on the securities it owns and passes it along to the fund's shareholders.

Usually, you can accept payment for distributions and dividends, or you can reinvest them in the fund, often without paying an additional sales load.

How can taxes affect mutual funds?

Taxes can significantly reduce the net returns on your mutual fund investment, so you should pay close attention to them.

Tax-exempt funds

Some funds, such as municipal bond funds, are designed to avoid federal taxation altogether.

Tax-efficient funds

One of the objectives of tax-efficient mutual funds is to keep shareholder tax liability to a minimum. For example, a fund may attempt to minimize trading that generates capital gains, which would require shareholders to pay taxes if the fund is held in a taxable account,

Nontaxable return of capital

It's possible for a mutual fund to make a distribution to you without your having to pay tax on it. This generally occurs when a distribution involves recovery of all or a portion of your cost basis (i.e., the amount of your investment) in the fund. Such a distribution is not subject to taxation because it does not represent investment earnings. It still must be reported on your tax return, however.

Income from dividends

Many funds pay dividends on a monthly, quarterly, or annual basis. Dividends are distributed to shareholders on a pro rata basis. They must be reported on your return (whether reinvested or paid in cash) in the year of distribution.

For tax years beginning on or after January 1, 2003 and before January 1, 2011, qualifying dividends paid to individual shareholders from domestic corporations (and qualified foreign corporations) are taxed at long-term capital gains tax rates. (For tax years prior to January 1, 2003,) stock dividends were taxed at ordinary income tax rates, generally resulting in significantly higher tax liability.)

> **Caution:** Absent further legislative action, stock dividends will again be taxed as ordinary income beginning in 2011.

However, dividends from mutual funds to individual shareholders may or may not qualify for taxation at capital gains rates. In general, qualifying corporate stock dividends that a mutual fund receives and passes through to its own shareholders qualify for taxation at capital gains rates. To the extent that mutual fund dividends are attributable to other types of earnings (e.g., interest), however, the dividends will be taxed as ordinary income.

> **Caution:** When it comes to dividends qualifying for long-term capital gain tax treatment, special holding period requirements apply to mutual fund shareholders. For stock dividends to qualify for taxation at the long-term capital gain tax rates, the stock must generally be held for at least 61 days during the 121-day period beginning 60 days before the ex-dividend date. Mutual funds that hold dividend-paying stock and meet this requirement may pass through qualifying dividends to mutual fund shareholders. However, mutual fund shareholders must themselves hold their mutual fund shares for at least 61 days during the 121 day period beginning 60 days before the mutual fund shares' ex-dividend date to be able to take advantage of the lower capital gain rates on the dividends that are passed through.

> **Example(s):** (From IRS Publication 550) You bought 10,000 shares of ABC Mutual Fund common stock on July 1. ABC Mutual Fund paid a cash dividend of 10 cents per share. The ex-dividend date was July 9. The ABC Mutual Fund advises you that the portion of the dividend eligible to be treated as qualified dividends equals 2 cents per share. Your Form 1099-DIV from ABC Mutual Fund shows total ordinary dividends of $1,000 and qualified dividends of $200. However, you sold the 10,000 shares on August 4. You have no qualified dividends from ABC Mutual Fund, because you did not hold the ABC Mutual Fund stock for more than 60 days.

Short-term capital gains

Short-term capital gain distributions (representing the fund's net gains from the sale of securities held in its portfolio for one year or less) made by a fund are generally treated the same as dividends for tax purposes.

Long-term capital gains

Long-term capital gain distributions (representing the fund's net gains from the sale of securities held in its portfolio for more than one year) are made to the fund's shareholders on a pro rata basis. Shareholders must report the amount distributed in their tax returns as a long-term capital gain (regardless of how long the shares have been held), subject to capital gains tax rates.

Sale of shares

When you redeem shares of a fund, you generally must pay tax on any capital gain realized. The taxable amount of the gain, if any, will generally be equal to the difference between the sale price and the price for which you originally purchased the shares. The amount of tax to be paid on a gain depends on the rate at which the gain is taxed, which in turn depends on how long you owned the fund shares prior to selling them. Generally speaking, when you sell shares after holding them for more than a year, any gain from the sale will be a long-term capital gain. In contrast, if you sell shares that you owned for a year or less, any resulting gain will be a short-term capital gain, taxed at ordinary income tax rates. Since long-term capital gains rates are generally more favorable than ordinary income tax rates, the same gain can produce different tax liabilities depending on the holding period.

> **Tip:** Keep in mind that capital losses from other investments can be used to offset capital gains. These losses can even be carried forward and used to offset gains in future years.

Exchange of shares

An exchange of shares from one fund to another is generally treated the same as a sale of shares for tax purposes.

What are the costs associated with mutual funds?

Like taxes, mutual fund fees and expenses are important because they have an impact on your net returns. Here are some of the common costs associated with mutual funds:

- Sales loads and transaction fees (paid when you buy, sell, or exchange your shares)
- Ongoing expenses, such as 12b-1 fees and management fees (paid while you remain invested in the fund)

> **Caution:** High expenses do not ensure superior performance.

> **Tip:** A fund's costs are laid out in the fee table near the front of the fund's prospectus. You can use the fee tables to compare the costs of different funds.

What types of mutual funds are there?

There are several major types of mutual funds. Most mutual funds invest one of the three major asset classes; there are stock (or equity) funds, bond funds, and money market funds. There are many variations within these three main categories. There also are funds that combine multiple types of investments. For example, asset allocation funds combine all three major asset classes. Some funds invest in other mutual funds rather than individual securities (a so-called fund of funds, for example).

In addition to the securities in which they invest, mutual funds may be categorized by their investing strategy. For example, tax -efficient funds strive to minimize investors' tax liability. Some funds are actively managed; others simply attempt to replicate an index.

How do you choose a mutual fund?

Each kind of mutual fund has different risks and rewards. Generally, the higher the potential return, the higher the risk of loss. Shop around. Compare a mutual fund with others of the same type. Decide whether the goals and risks of any fund you are considering are a good fit for you. Before investing in a mutual fund, carefully consider its investment objectives, risks, fees, and expenses, which can be found in the prospectus available from the fund. Read it carefully before investing. Don't hesitate to get expert help if all the information leaves you overwhelmed, or if you'd prefer to have someone else do the detailed research for you.

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