THE Wealth REPORT

Mutual funds are a highly utilized investment choice. However, investors should ask several crucial questions before selecting a mutual fund for their portfolio.

MUTUAL CONSIDERATION

Things to know before buying mutual funds

Overview

As American companies (and profits) took off in the early part of the 20th century, everyone wanted in on the action. There was just one problem: Investing wasn't that accessible. Trading took place on the floors of stock exchanges, and big-ticket orders went to the top of the stack. And, of course, online brokerage companies didn't exist until the last decade of the 1900s. Good money managers were hard to find and typically had high account minimums. The ordinary investor had very few options.

This changed in 1924 when Massachusetts Investment Trust had an idea for normal investors to "mutually" pool their money together in a common "fund."[1] Collective buying power meant they could hire a top-notch money management team and get stock traders to take them seriously.

Voilà! Just like that, the first mutual fund was born.

Today, mutual funds are among the most widely held investment vehicles in the world. In the U.S. alone, over $25.5 trillion is held in mutual fund accounts.[2] But as with any investment, it's important to understand what you're buying. Let's break down what you need to know before adding mutual funds to your portfolio.

Questions to Ask Before Buying Mutual Funds

1. How is the mutual fund managed?

Mutual funds are managed in two ways: actively or passively. Active funds aim to outperform a specific benchmark, such as the S&P 500 or Russell 2000 index. To achieve this, fund managers are continually buying and selling securities to maximize the funds' returns.

Passively managed funds are designed to match a specific index's performance. Because managers are more "hands-off," passively managed mutual funds may have lower fees than those that are actively managed.

2. What is the fund's goal?

Mutual funds come with a clear directive the management team must follow while running the fund. For example, one fund might have a directive to find the best U.S. large company stocks.

Another might only invest in short-term government bonds. This sets “guardrails” around how the money is invested and allows the investor to purchase funds that match their goals or values. For example, conservative investors might feel more comfortable with a government bond fund manager who can’t buy risky stocks.

3. How accessible are my funds?

It’s important to be able to turn your investments back into cash when you need the money. Some investments can be easily sold, while others are tougher to liquidate. Mutual funds tend to be fairly liquid, since investors can sell fund shares at any time.

However, there are some types of mutual funds that aren’t as liquid as others. For example, closed-end mutual funds can only be sold after a specific period or when the fund matures. Certain funds may also be less liquid if they carry investments such as real estate or other alternative types.

4. Are there any hidden fees?

You might assume that all the costs of owning a mutual fund are fully disclosed. After all, that’s what the fund management fee is, right? Well, it isn’t quite that simple. Mutual funds are legally allowed to charge expenses to the fund over and above the standard expense ratio.

A few additional fees a mutual fund might charge include:[3]

- Redemption fee
- Exchange fee
- Account fee
- Management fees
- Fund operating expenses
- Purchase fee

Investors can generally find all expenses listed in a fund’s prospectus under the headings of “Shareholder Fees” and “Annual Fund Operating Expenses.” Part of our due diligence process is to combine what we believe to be the best funds moving forward at the absolute best cost available.

5. What share classes does the mutual fund offer?

Each mutual fund can be packaged into different “share classes.” It is the same fund, just packaged in multiple ways. Imagine a 12-ounce can of Coca-Cola. It could be packaged in a standard can, a Christmas collection can, an Elvis memorabilia can, etc. But regardless of its packaging, it’s still a Coke.

Mutual funds work in a similar way and can have a significant expense to the investor. Take the American Funds Growth Fund of America, for example. It is offered in 17 different share classes at a wide variety of costs.[4]

An important item to consider is that each class will have different services, distribution arrangements, fees and expenses, which will lead to different performance results.

Final Thoughts

Knowing what questions to ask is crucial when deciding which mutual funds are right for your portfolio. Our investment management team can help you analyze fund options and find the share class that fits your goals. We can also review your current mutual fund holdings and assess how much you're really paying in fees. Contact our office to learn more!

[1] MFS. "First Fund: The Origins and Legacy of Massachusetts Investors Trust (MIT)." https://www.mfs.com/en-us/individual-investor/about-mfs/our-history/first-fund-the-origins-and-legacy-of-massachusetts-investors-trust.html. Accessed Aug. 5, 2024.
[2] Statista. "Total net assets of US-registered mutual funds worldwide from 1998 to 2023." https://www.statista.com/statistics/255518/mutual-fund-assets-held-by-investment-companies-in-the-united-states/. Accessed Aug. 1, 2024.
[3] Investor.gov. "Mutual Fund Fees and Expenses." https://www.investor.gov/introduction-investing/investing-basics/glossary/mutual-fund-fees-and-expenses. Accessed Aug. 2, 2024.
[4] Capital Group. "The Growth Fund of America." https://www.capitalgroup.com/individual/investments/fund/agthx. Accessed Aug. 5, 2024.