

Chapter 1

What Is a Mutual Fund?

In This Chapter

- ▶ Understanding mutual funds
 - ▶ Looking at how funds can make you money
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Unless you've been living in a cave high in the mountains for the past decade, railing against the evils of humankind, you've heard a lot about mutual funds. Chances are you or someone in your family already owns some. Mutual funds seem complicated — even though they are incredibly popular — so lots of people shy away. Many people aren't sure where to start, or they just buy the first fund their banker or financial planner suggests. All too often Canadians end up disappointed with their funds' performance, because they've been sold something that's either unsuitable or just too expensive. It's a shame, because building a portfolio of excellent funds is easy if you follow a few simple rules and use your own common sense. This stuff isn't complicated — a mutual fund is just a money-management service that operates under clear rules. Yes, it involves a lot of marketing mumbo-jumbo and arcane terminology, but the basic idea could be written on a postage stamp: In return for a fee, the people running the fund promise to invest your money wisely and give it back to you on demand.

The fund industry is competitive and sophisticated, which means plenty of good choices are out there. In this chapter, we show how funds make you money — especially if you leave your investment in place for several years. We also touch on the different types available, and quickly describe the main places you can go to buy funds. We discuss these topics in greater detail later in the book, but after you read this first chapter you'll know the basics.

Mutual Fund Basics



A mutual fund is a pool of money that a company gets from investors like you and me and divides up into equally priced units. Each unit is a tiny slice of the fund. When you put money into the fund or take it out again, you either buy or sell units. For example, say a fund has total assets — that is, money held in trust for investors — of \$10 million and investors have been sold a total of 1 million units. Then each unit is worth \$10. If you put money into the fund, you're simply sold units at that day's value. If you take money out, the fund buys units back from you at the same price. (Handling purchase and sale transactions in units makes it far simpler to do the paperwork.) And the system has another huge advantage: As long as you know how many units you own, you can simply check their current price to find out how much your total investment is worth. For example, if you hold 475 units of a fund whose current unit price is \$15.20, then you know your holding has a value of 475 times \$15.20, or \$7,220.



Owning units of a mutual fund makes you — you guessed it — a unitholder. In fact, you and the other unitholders are the legal owners of the fund. But the fund is run by a company that's legally known as the fund manager — the firm that handles the investing and also deals with the fund's administration. The terminology gets confusing here because the person (usually an employee of the fund manager) who chooses which stocks, bonds, or other investments the fund should buy is also usually called the fund manager. To make things clear, we refer to the company that sells and administers the fund as the management company or fund sponsor. We use the term fund manager for the person who picks the stocks and bonds. His or her skill is one of the main benefits you get from a mutual fund. Obviously, the fund manager should be experienced and not too reckless — after all, you're trusting him or her with your money.

Under professional management, the fund invests in stocks and bonds, increasing the pool of money for the investors and boosting the value of the individual units. For example, if you bought units at \$10 each and the fund manager managed to pick investments that doubled in value, your units would grow to \$20. In return, the management company slices off fees and expenses. (In the world of mutual funds, just like almost everywhere else, you don't get something for nothing.) Fees and expenses usually come to between 0.3 percent and 3 percent of the fund's assets each year, depending on how a fund invests. Some specialized funds charge much more.

Confused? Don't be, it isn't rocket science. This example should help. Units in Canada's biggest mutual fund, Investors Dividend Fund — run by the country's largest fund company, Investors Group — were bought from and sold to people like you and me at \$21.83 each at the end of March 2008. So if you

invested \$1,000 in the fund that day, you owned 45.8 units (\$1,000 divided by \$21.83). The price you pay for each unit is known as the fund's net asset value per unit. The net asset value is the fund's assets minus its liabilities, hence the "net" (which means after costs and debts are taken away), divided by the number of units outstanding.

So a fund company buys and sells the units to the public at their net asset value. This value increases or decreases proportionally as the value of the fund's investments rises or falls. Let's say in March you pay \$10 each for 100 units in a fund that invests in oil and gas shares, always a smelly and risky game. Now, say, by July, the value of the shares the fund holds has dropped by one-fifth. Then your units are worth just \$8 each. So your original \$1,000 investment is now worth only \$800. But that August, a bunch of companies in which the fund has invested strike oil in Alberta. That sends the value of their shares soaring and lifts the fund's units to \$15 each. The value of your investment has now grown to \$1,500.

Where can you go from here? You've made a tidy profit after a bit of a let-down, but what happens next? Well, that depends on you. You can hang in there and see if more oil's in them there hills, or you can cash out. With most funds, you can simply buy or sell units at that day's net asset value. That flexibility is one of the great beauties of mutual funds. Funds that let you come and go as you please in this way are known as open-end funds, as though they had a giant door that's never locked. Think of a raucous Viking banquet where guests are free to come and go at will because the wall at one end of the dining hall has been removed.

That means most mutual funds are marvelously flexible and convenient. The managers allow you to put money into the fund on any business day by buying units, and you take money out again at will by selling your units back to the fund. In other words, an investment in a mutual fund is a liquid asset. A liquid asset is either cash or it's an investment that can be sold and turned into good old cash at a moment's notice. The idea is that cash and close-to-cash investments, just like water, are adaptable and useful in all sorts of situations. The ability to get your cash back at any time is called liquidity in investment jargon, and professionals prize it above all else — more than they prize red Porsches with very loud sound systems or crystal goblets in lovely velvet-lined boxes with their initials engraved in gold.



The other type of fund is a *closed-end fund*. Investors in these funds often are sold their units when the fund is launched, but to get their money back they must find another investor to buy the units on the stock market like a share, often at a loss. The fund usually won't buy the units back, or may buy only a portion. You can make money in closed-end funds, but it's very tricky. As craven brokerage analysts sometimes say when they hate a stock but can't pluck up the courage to tell investors to sell it: "Avoid."

The Nitty Gritty: How a Fund Makes You Money

We'll stick with the example of Investors Dividend, a huge and well-run fund generally available only through Investors Group agents across the country. Investors Dividend's \$12.3 billion in assets as of mid-2008 made it Canada's biggest mutual fund. That's \$1 million 12,400 times over, or about \$373 for each of the approximately 30 million people living in Canada. The fund, which dates to 1961, invests in shares of large Canadian banks and blue-chip companies. This behemoth lumbers along in the middle of the performance pack of similar funds. Like other mutual fund companies, Investors Group, based in Winnipeg, sells units of Investors Dividend to the public every business day and buys them back from other investors at the same price.

The somewhat sleazy dawn of the mutual fund

The modern mutual fund evolved in the 1920s in the United States. In 1924, one Edward Leffler started the world's first open-end fund, the Massachusetts Investors Trust. It's still going. Mr. Leffler's fund had to be purchased through a broker, who charged a sales commission, adding to an investor's cost. Four years later, Boston investment manager Scudder Stevens & Clark started First Investment Counsel Corp., the first no-load fund (a fund you buy with no sales commission). The fund was called no-load because instead of purchasing it through a commission-charging broker, investors bought it directly from the company.

Nothing was wrong with those early open-end funds. They were run well and they survived the Great Crash of 1929 and the subsequent Depression, in part because the obligation to buy and sell their shares every day at an accurate value tended to keep managers honest and competent. But closed-end funds were

the main game in the 1920s. (Closed-end funds don't buy back your units on demand, meaning you're locked into the fund until you find another investor to buy your units from you on the open market.) And a crooked game it was. By 1929, investors were paying ridiculous prices for closed-end shares. Brokers charged piratical sales commissions of 10 percent, annual expenses topped 12.5 percent, and funds kept their holdings secret. Needless to say, most collapsed in the Crash and ensuing Depression.

Following that debacle, mutual funds in Canada and the United States were far more tightly regulated, with laws forcing them to disclose their holdings at least twice a year and report costs and fees to investors. Plenty of badly run funds are still out there, not to mention plenty of greedy managers who don't put their unitholders' interests first, but at least now clear rules that protect investors who keep their eyes open exist.



With most companies' funds you're free to come and go as you please, but companies often impose a small levy on investors who sell their units within 90 days of buying them. That's because constant trading raises expenses for the other unitholders and makes the fund manager's job harder. The charge (which should go to the fund, and usually does) is generally 2 percent of the units sold, but it can be more. Check this out before you invest, especially if you're thinking of moving your cash around shortly after you buy.

Returns — *What's in it for you?*

The main reason why people buy mutual funds is to earn a return. A return is simply the profit you get in exchange for either investing in a business (by buying its shares) or for lending money to a government or company (by buying its bonds). It's money you get as a reward for letting other people use your cash — and for putting your money at risk. Mutual fund buyers earn the same sorts of profits but they make them indirectly because they're using a fund manager to pick their investments for them. The fund itself earns the profits, which are either paid out to the unitholders or retained within the fund itself, increasing the value of each of its units.

When you invest money, you nearly always hope to get:

- ✔ **Trading profits** or capital gains (the two mean nearly the same thing) when the value of your holdings goes up. Capital is just the money you've tied up in an investment, and a capital gain is simply an increase in its value. For example, say you buy gold bars at \$100 each and their price rises to \$150. You've earned a capital gain of \$50, on paper at least.
- ✔ **Income** in the form of interest on a bond or loan, or dividends from a company. Interest is the regular fee you get in return for lending your money, and dividends are a portion of a company's profits paid out to its shareowners. For example, say you deposit \$1,000 at a bank at an annual interest rate of 5 percent; each year you'll get interest of \$50 (or 5 percent of the money you deposited). Dividends are usually paid out by companies on a per-share basis. Say, for example, you own 10,000 shares and the company's directors decide to pay a dividend of 50 cents per share. You'll get a cheque for \$5,000.

You also hope to get the money you originally invest back at the end of the day, which doesn't always happen. That's part of the risk you assume with almost any investment. Companies can lose money, sending the value of their shares tumbling. Or inflation can rise, which nearly always makes the value of both shares and bonds drop rapidly. That's because inflation eats away at the value of the money, which makes it less attractive to have the money tied up in such long-term investments where it's vulnerable to steady erosion.

Here's an example to illustrate the difference between earning capital gains and dividend income. Say you buy 100 shares of a company — a Costa Rican crocodile farm, for example — for \$115 each and hold them for an entire year. Also, say you get \$50 in dividend income during the year because the company has a policy of paying four quarterly dividends of 12.5 cents, or 50 cents per share, annually (that is, 50 cents times the 100 shares you own — \$50 right into your pocket).

Now imagine the price of the stock rises in the open market by \$12, from \$115 to \$127. The value of your 100 shares rises from \$11,500 to \$12,700, for a total capital gain of \$1,200.



Your capital gain is only on paper unless you actually sell your holdings at that price.

Add up your gains and income, and that's your total return — \$50 in dividends plus a capital gain of \$1,200, for a total of \$1,250.

Another example should make this crystal clear. Investors Dividend units were sold to the public at \$24.77 on the first day of April 2007 and rose to \$25.48 by the end of May. Things weren't so good the rest of the year: The unit price went up and down until October, when it began a prolonged fall, to \$21.83 by the end of March 2008. That was a loss of 2.9 cents on every unit an investor held.

The fund also paid out a quarterly distribution, a special or scheduled payment to unitholders, of 14.5 cents per unit at the end of June and September 2007; 15.2 cents at the end of December 2007; and 16.0 cents at the end of March 2008, for a total distribution of 58.7 cents. Distributions are made when a fund has earned capital gains, interest, or dividends from its investments.

So what was the investor's return during the year? On a per-unit basis, she started with \$24.77 at risk and during the following 12 months suffered a capital loss of \$2.94. However, thanks to the 58.7 cents of distributions, this loss was trimmed to about \$2.44 a unit. That represented about 9.8 percent of the starting figure of \$24.77, so the *percentage* return, the amount she earned or lost by being invested, was a loss of 9.8 percent. Calculating the return is actually a little more complicated than that because most investors would have simply reinvested the quarterly distribution in more units immediately after being paid out. In fact, returns for mutual funds always assume that all distributions are reinvested in more units. Investors Dividend's official return for the year ended March 31, 2008, was a loss of 9.5 percent.

Returns as a percentage



Returns on mutual funds, and nearly all other investments, are usually expressed as a percentage of the capital the investor originally put up. That way you can easily compare returns and work out whether or not you did well.

After all, if you tied up \$10 million in an investment to earn only \$1,000, you wouldn't be using your cash very smartly. That's why the return on any investment is nearly always stated in percentages by expressing the return as a proportion of the original investment. In the example of the crocodile farm, the return was \$50 in dividends plus \$1,200 in capital appreciation, which is just a fancy term for an increase in the value of your capital, for a total of \$1,250. At the beginning of the year you put \$11,500 into the shares by buying 100 of them at \$115 each. To get your percentage return (the amount your money grew expressed as a percentage of your initial investment), divide your total return by the amount you initially invested and then multiply the answer by 100. The return of \$1,250 represented 10.9 percent of \$11,500, so your percentage return during the year was 10.9 percent. It's the return produced by an investment over several years, however, that people are usually interested in. Yes, it's often useful to look at the return in each individual year — for example, a loss of 10 percent in Year 1, a gain of 15 percent in Year 2, and so on. But that's a long-winded way of expressing things. It's handy to be able to state the return in just one number that represents the average yearly return over a set period. It makes it much easier, for instance, to compare the performance of two different funds. The math can start getting complex here, but don't worry — we stick to the basic method used by the fund industry.

Fund returns are expressed, in percentages, as an average annual compound return. That sounds like a mouthful, but the concept is simple. Say you invested \$1,000 in a fund for three years. In the first year, the value of your investment dropped by 10 percent, or one-tenth, leaving you with \$900. In Year 2, the fund earned you a return of 20 percent, leaving you with \$1,080. And in Year 3, the fund produced a return of 10 percent, leaving you with \$1,188. So, over the three years, you earned a total of \$188, or 18.8 percent of your initial \$1,000 investment. When mutual fund companies convert that return to an "average annual" number, they invariably express the number as a "compound" figure. That simply means the return in Year 2 is added (or compounded) onto the return in Year 1, and the return in Year 3 is then compounded onto the new higher total, and so on. A return of 18.8 percent over three years works out to an average annual compound return of about 5.9 percent.

As the example demonstrates, the actual value of the investment fluctuated over the three years, but say it actually grew steadily at 5.9 percent. After one year, the \$1,000 would be worth \$1,059. After two years, it would be worth \$1,121.48. And after three years, it would be worth \$1,187.65. The total differs from \$1,188 by a few cents because we rounded off the average annual return to one decimal place, instead of fiddling around with hundredths of a percentage point.



Remember these important points when looking at an average annual compound return:

- **Average:** That innocuous-looking average usually smoothes out some mighty rough periods. Mutual funds can easily lose money for years on end — it happened, for example, when the world economy was hurt by inflation and recession in the 1970s.

✔ **Annual:** Obviously, this means per year. And mutual funds should be thought of as long-term holdings to be owned for several years. The general rule in the industry is that you shouldn't buy an equity fund — one that invests in shares — unless you plan to own it for five years. That's because stocks can drop sharply, often for a year or more, and you'd be silly to risk money you might need in the short term (to buy a house, say) in an investment that might be down from its purchase value when you go to cash it in. With money you'll need in the near future, you're better off to stick to a super-stable, short-term bond or money market fund that will lose little or no money (more about those later).

Of course, mutual fund companies sometimes use the old “long-term investing” mantra as an excuse. If their funds are down, they claim it's a long-term game and that investors should give their miraculous strategy time to work. But if the funds are up, the managers run ads screaming about the short-term returns.

✔ **Compound:** This little word, which means “added” or “combined” in this context, is the plutonium trigger at the heart of investing. It's the device that makes the whole thing go. It simply means that to really build your nest egg, you have to leave your profits or interest in place and working for you so you can start earning income on income. After a while, of course, you start earning income on the income you've earned, until it becomes a very nicely furnished hall of mirrors.

Another example will help. Mr. Simple and Ms. Compound each have \$1,000 to invest, and the bank's offering 10 percent a year. Now, let's say Mr. Simple puts his money into the bank, but each year he takes the interest earned and hides it under his mattress. Simple-minded, huh? After ten years, he'll have his original \$1,000 plus the ten annual interest payments of \$100 each under his futon, for a total of \$2,000. But canny Ms. Compound leaves her money in the account, so each year the interest is added to the pile and the next year's interest is calculated on the higher amount. In other words, at the end of the first year, the bank adds her \$100 in interest to her \$1,000 initial deposit and then calculates the 10-percent interest for the following year on the higher base of \$1,100, which earns her \$110. Depending on how the interest is calculated and timed, she'll end the ten years with about \$2,594, or \$594 more than Mr. Simple. That extra \$594 is interest earned on interest.

How funds can make you rich



The real beauty of mutual funds is the way they can grow your money over many years. “Letting your money ride” in a casino — by just leaving it on the odd numbers in roulette, for example — is a dumb strategy. The house will eventually win it from you because the odds are stacked in the casino operator's favour. But letting your money ride in a mutual fund over a decade or more can make you seriously rich.

An investment in Investors Dividend Fund from its launch in 1961 through the end of June 2008 produced an annual average compound return of about 8 percent. If your granny had been prescient enough to put \$10,000 into the fund when it was launched, instead of blowing all her dough on sports cars and wild men, it would have been worth \$5.4 million by mid-2008.

The main reason why Canadians had more than \$697 billion in mutual funds at the end of 2007 is that funds let you make money in the stock and bond markets almost effortlessly. By the way, that \$697 billion figure, which works out to an incredible \$21,121 or so for everyone in the country, doesn't even include billions more sitting in segregated funds, which are mutual fund-like products sold by life insurance companies. They're called segregated because they're kept separate from the life insurer's regular assets. You can read more on seg funds in Chapter 19.

Of course, no law says you have to buy mutual funds in order to invest. You might make more money investing on your own behalf, and lots of people from all walks of life do. But it's tricky and dangerous. So millions of Canadians too busy or scared to learn the ropes themselves have found that funds are a wonderfully handy and reasonably cheap alternative. The Canadian fund industry association, the Investment Funds Institute of Canada, reports the public had more than 52 million accounts with its member firms at the end of 2007. Buying funds is like going out to a restaurant compared with buying food, cooking a meal, and cleaning up afterward. Yes, eating out is expensive, but it sure is nice not to have to face those cold pots in the sink covered in slowly congealing mustard sauce.

What mutual funds buy

Mutual funds and other investors put their money into just two long-term investments:

- ✔ **Stocks and shares:** Tiny slices of companies that trade in a big, sometimes chaotic but reasonably well-run electronic vortex called, yes, the stock market.
- ✔ **Bonds:** Loans made to governments or companies, which are packaged up so that investors can trade them to one another.

Folk memories run deep, and after ugly stock market meltdowns in the 1920s and 1970s, mutual funds and stocks in general had unhealthy reputations for many years. For generations, Canadians, like people all over the world, preferred to buy sure things, usually bonds or fixed-term deposits from banks, the beloved guaranteed investment certificate (GIC). But as inflation and interest rates started to come down in the 1990s, it became harder and harder to find a GIC that paid a decent rate of interest — research shows most people are truly happy when they get 8 percent.

As Table 1-1 shows, the Canadian mutual fund industry really started growing like a magic mushroom on a wet morning in Victoria in the mid-1990s, after rates on five-year GICs dropped well below that magic 8 percent. At that point, Canadians decided they were willing to take a risk on equity funds.

Table 1-1 shows the growth of the Canadian mutual fund industry from 1970 to the end of March 2008.

<i>Year</i>	<i>Total Assets (\$Billions)</i>	<i>Year</i>	<i>Total Assets (\$Billions)</i>
1970	2.5	1989	23.5
1971	2.5	1990	24.9
1972	2.7	1991	49.9
1973	2.2	1992	67.3
1974	1.6	1993	114.6
1975	1.8	1994	127.3
1976	1.8	1995	146.2
1977	1.8	1996	211.8
1978	1.9	1997	283.2
1979	2.7	1998	326.6
1980	3.6	1999	389.7
1981	3.5	2000	418.9
1982	4.1	2001	426.4
1983	5.8	2002	391.3
1984	6.7	2003	438.9
1985	10.2	2004	497.3
1986	17.5	2005	570.0
1987	20.4	2006	660.2
1988	20.8	2007	697.3
		2008	700.1

Industry statistics provided by the Investment Funds Institute of Canada.

Types of Funds

Mutual funds fall into four main categories. Later in the book we devote chapters to each type, but this is a quick breakdown of the bare facts. The four main types of mutual funds are:

- ✔ **Equity funds:** By far the most popular type of fund on the market, equity funds hold stocks and shares. Stocks are often called “equity” because every share is supposed to entitle its owner to an equal portion of the company. In mid-2008, Canadians had \$178 billion in Canadian stock funds, \$93 billion in global stock funds, and another \$20 billion in U.S. equity funds. These funds represent an investment in raw capitalism — ownership of businesses. We look at the range of equity funds available to you in Chapters 10, 11, and 12.
- ✔ **Balanced funds:** The next biggest category is balanced funds. They generally hold a mixture of just about everything — from Canadian and foreign stocks to bonds from all around the world, as well as very short-term bonds that are almost as safe as cash. Chapter 13 gives you the scoop on balanced funds.
- ✔ **Bond funds:** These beauties, also referred to as “fixed-income” funds, essentially lend money to governments and big companies, collecting regular interest each year and (nearly always) getting the cash back in the end. We offer the thrilling details about these funds in Chapter 14.
- ✔ **Money market funds:** They hold the least volatile and most stable of all investments — very short-term bonds issued by governments and large companies that usually provide the lowest returns. These funds are basically savings vehicles for money you can’t afford to take any risks with. They can also act as the safe little cushion of cash found in nearly all well-run portfolios. Chapter 17 fills you in about these funds.

Where-to-Buy Basics

Chapter 3 goes into detail about some of the legal and bureaucratic form-filling involved in buying a fund (don’t worry, it’s not complicated). In essence, you hand over your money and a few days later you get a transaction slip or confirmation slip stating the number of units you bought and what price you paid. You can buy a mutual fund from thousands of people and places across Canada, in one of four basic ways:

- ✔ **Buying from professional advisers:** The most common method of making a fund purchase in Canada is to go to a stockbroker, financial planner, or other type of adviser who offers watery coffee, wisdom, and suggestions on what you should buy. These people will also open an account for you in which to hold your mutual funds. They are essentially salespeople and

they nearly always make their living by collecting sales commissions on the funds they sell you, usually from the fund company itself. Their advice may be excellent and they can justifiably claim to impose needed discipline on their clients by getting them into the healthy habit of saving. But always remember that they have to earn a living: The funds they offer will tend to be the ones that pay them the best commissions.

Examples of fund companies that sell exclusively through salespeople, planners, and stockbrokers are Mackenzie Financial Corp., Fidelity Investments Canada Ltd., AIM Trimark Funds, CI Fund Management Inc., AGF Management Ltd., and Templeton, all based in Toronto. Investors Group Inc. of Winnipeg, Canada's biggest fund company, also sells through salespeople, but the sales force is affiliated with the company.

- ✔ **Bank purchases:** The simplest way to buy funds is to walk into a bank branch. You also can call your bank's toll-free telephone number. But, increasingly, people are buying funds online, at banks' Web sites. Banks never charge sales commissions to investors who buy their funds. The disadvantage to this approach is limited selection, because most bank branches are set up to sell only their company's funds. And not all bank staff are equipped or trained to give you detailed advice about investing. But the beauty of this approach is that you can have all your money — including your savings and chequing accounts and even your mortgage or car loan — in one place, making it simple to transfer money from one account to another. Buying your mutual funds at your bank can also earn you special rates on loans.
- ✔ **Buying direct from fund companies:** For those who like to do more research on their own, excellent “no-load” companies sell their funds directly to investors. They're called no-load funds because they're sold with no sales commissions. No-load funds can avoid levying sales charges because they don't market their wares through salespeople. Because these funds don't have to make payments to the advisers who sell them, they often come with lower expenses. Examples of no-load companies include Beutel Goodman; GBC; Leith Wheeler; Mawer; McLean Budden; Phillips, Hager & North; Sceptre; and Saxon. Once again, limited selection of funds is a drawback.
- ✔ **Buying from discount brokers:** Finally, for the real do-it-yourselfers who like to make just about every decision independently, you can find discount brokers that operate on the Internet or over the phone. Mostly but not always owned by the big banks, they sell nearly every fund from nearly every company, usually free of commissions and sales pitches.

Discount brokers are a huge force in the United States and they've gained popularity in Canada. The advantages, and they're significant, are low costs and a wide selection of funds. But don't expect personal help from a discount broker. We talk more about discount brokers in Chapter 6.