IN THIS CHAPTER

» Understanding mutual funds

» Looking at how funds can make you money

» Identifying the four types of mutual funds

» Knowing where to buy funds

Chapter 1

Mutual Funds 101

There's a good chance you or someone in your family already owns some mutual funds. They can seem complicated — especially today, given how many options there are on the market, which leads people to buy the first fund their financial planner suggests. All too often, Canadians end up disappointed with their funds' performance, because they've been sold something that's either unsuitable for them or just too expensive.

But not to worry! 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 complex — a mutual fund is just a money-management tool that operates under clear rules. Yes, it involves a lot of marketing mumbo-jumbo and jargon, 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 throughout the book, but after you read this first chapter, you'll know the basics.

Getting the Scoop on Mutual Fund

REMEMBER

A *mutual fund* is a pool of money that a company gets from investors like you and me and divides 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. So, 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 details 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. Their 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 them with your money.

Under professional management, the fund invests in *stocks* (shares in companies) and *bonds* (loans from government and businesses) and potentially other assets depending on the fund. That could include physical infrastructure, like toll roads, airports, and highways, or more recently *bitcoin*, a digital currency that many people use to buy and sell goods (often illicit goods) online 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.

Mutual fund investing is not as confusing as it may seem. A fund company buys and sells the units to the public at what's called a *net asset value.* You get this number by dividing the total net asset value of the fund or company by the number of shares outstanding. This number is known as the net asset value per share (NAVPS). This value increases or decreases proportionally as the value of the fund's investments rises or falls. Say in January you pay $10 each for 100 units in a fund that invests in technology stocks, such as Microsoft, Apple, and NVIDIA. 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, several companies in the fund launch a bunch of game-changing artificial intelligence tools. 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.

Open-and closed-end funds

Say you've made a profit on that technology fund you held. Where can you go from here? Well, that depends on you. You can hang in there and see if the fund can climb higher, 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 rowdy 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.

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 such as a share, often at a loss. The fund usually won't buy the units back or may buy only a portion.

WARNING

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 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, because, as a Yale paper on the history of investment management regulation says, companies were more focused on selling funds than portfolio construction. (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 exist that protect investors who keep their eyes open.

REMEMBER

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 one 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 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 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 five percent; each year you'll get interest of $50 (or five 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 (if you're reading this in 2024, you know all about inflation), which nearly always makes the value of both shares and bonds drop rapidly. That's because inflation eats away at the money's value, which makes it less attractive to have the money tied up in such long-term investments where it's vulnerable to steady erosion.

Capital gains versus dividend income

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.

REMEMBER

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.

Take a look at another example: Say you bought units of a new mutual fund at $24.77 on the first day of April 2023, and it rose to $25.48 by the end of May. Economic volatility then caused the price to go up and down until October, after which the fund began a prolonged fall to $21.83 by the end of March 2024. That's a loss of 2.9 cents on every unit an investor held.

Say the fund also pays out a quarterly *distribution*, a special or scheduled payment to unitholders, of 14.5 cents per unit at the end of June and September; 15.2 cents at the end of December; and 16.0 cents at the end of March, 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 would be your return during the year? On a per-unit basis, you started with $24.77 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 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. In that case, the fund's official return for the year ending March 31, 2023, would be 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 Costa Rican crocodile farm shares you purchased, 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 details. 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 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

There are a few terms to remember when looking at an average annual compound return. Review these terms — *average*, *annual* and *compound* — and their explanations few times.

- **Average:** That innocuous-looking average usually levels 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. The COVID-19 pandemic also sent mutual funds and equities into a spiral in 2020, but the markets have recovered from pandemic lows.
- **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 may need in the short term (to buy a house, say) in an investment that may be down from its purchase value when you go to cash it in. With money you 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).

  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 concept 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 earned, until it becomes a very nicely furnished hall of mirrors.

Here's another example of compounding: Mr. Simple and Ms. Compound each have $1,000 to invest, and the bank's offering 10 percent a year. Now, say Mr. Simple puts his money into the bank, but each year he takes the interest earned and hides it under his mattress. 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 the RBC Select Balanced Portfolio, the largest fund by assets in Canada, from its launch in 1986 through the end of June 2023, produced an annual average compound return of about 6.1 percent. If your granny had been prescient enough to put $10,000 into the fund when it was launched, it would have been worth $87,165 in 2023.

The main reason why Canadians had more than $1.8 trillion in mutual funds at the end of 2022 is that funds let you make money in the stock and bond markets almost effortlessly. By the way, that $1.8 trillion figure 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 segregated funds in Chapter 19.) It also doesn't include billions in exchange-traded funds (ETFs), a mutual-fund-like vehicle that trades on a stock exchange, and is a rapidly growing part of the Canadian market and could one day become even more popular that mutual funds. (You can read more about ETFs in Chapter 15.)

Of course, no law says you have to buy mutual funds in order to invest. You may 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.

TIP

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 two main 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.

Folks' memories run deep, and after ugly stock market meltdowns in the 1920s and 1970s, mutual funds and stocks generally had unhealthy reputations for many years. For generations, Canadians and people worldwide 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 eight percent.

As Table 1-1 shows, the Canadian mutual fund industry has seen some impressive growth — interest exploded after rates on five-year GICs dropped well below that magic eight percent back in the 1990s. At that point, Canadians decided they were willing to take a risk on equity funds. (Inflation reached record levels in 2022 and 2023 — the impact rising prices might have on mutual funds remains to be seen but at the time I'm writing this, GICs are more attractive than they've been in decades.)

Table 1-1 shows the growth of assets under management in the Canadian mutual fund industry from 2010 to the end of December 2022. Yes, growth did decline in 2022, partly because it was a down year for markets, but also because ETFs have started to eat into mutual funds' popularity, which we explain in Chapter 15.

TABLE 1-1 Growth of the Mutual Fund Industry in Canada

Year	Total Assets $Billions
2012	803
2013	999
2014	1,141
2015	1,231
2016	1,339
2017	1,477
2018	1,423
2019	1,630
2020	1,784
2021	2,083
2022	1,809

Industry statistics provided by the Investment Funds Institute of Canada.

Finding Your Type (of Funds)

Mutual funds fall into four main categories. In Chapters 10 to 20 we go into all kinds of funds, 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. 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.

With so many options, there's bound to be a fund that works for you and your financial goals.

Figuring out Where to Buy

So how do you actually buy a fund? 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. 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).

You can buy a mutual fund from thousands of people and places across Canada, in one of four basic ways:

- **Buying from professional advisors:** The most common method of making a fund purchase in Canada is to go to a stockbroker, financial planner, or other type of advisor 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 often paid a commission on the funds they sell. Find out more in Chapters 2 and 8.

  Examples of fund companies that sell through advisors, planners, and stockbrokers are Mackenzie Financial Corp., Fidelity Investments Canada Ltd., CI Fund Management Inc., AGF Management Ltd., and Franklin 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.

- **Online purchases:** The simplest way to buy funds these days is online at a banks' website. Banks don't 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. 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. Learn more in Chapter 7.

- **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 advisors who sell them, they often come with lower expenses. We go into more in Chapter 9.

- **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, which operate online. Mostly but not always owned by the big banks, they sell funds – sometimes from other companies, sometimes from their own – usually free of commissions and sales pitches. We talk more about discount brokers in Chapter 6.