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Understanding mutual funds

Investing fundamentals series

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Mutual funds are versatile investment products for people like you, who want their savings to grow. First introduced to Canada in the 1930s, they have helped generations of Canadians achieve their financial goals.

How does a mutual fund work?

Perhaps the easiest way to think of a mutual fund is as a basket which holds a number of individual investments – typically stocks, bonds or a mix of both. This basket of investments may consist of millions of shares in dozens of companies and is referred to as the fund's portfolio.

A mutual fund investor buys a fraction of the overall portfolio – measured in "units". It's similar to the concept of buying shares in a company. Mutual fund purchases are based on the dollar value invested, rather than a number of whole units. This allows you to put all of your investable money to work for you.

> **You invest $500 in a mutual fund valued at $43 per unit. You will own exactly 11.6279 units of that fund. This allows all of your investment dollars to work for you, down to a fraction of a unit.**

Expanding universe

Stocks and bonds are the most common holdings in mutual funds, but the industry is constantly evolving to provide investors with new opportunities that may include investments in:

- Precious metals
- Privately held companies
- Real estate
- Infastructure
- Currencies

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Why invest in a mutual fund?

Most people do not have the time or inclination to research the merits and risks of individual stocks and bonds.

One benefit of a mutual fund is that it is managed by a team of highly trained professionals.

By pooling investment capital from many individuals, a mutual fund allows its portfolio manager to invest in a diversified selection of companies.

Other benefits may include:

Performance potential: Portfolio managers aim to deliver superior risk-adjusted returns over the long term.

Flexibility: You can buy mutual funds with relatively low initial investments (often as low as $500), and even smaller amounts (often as low as $50) on a monthly basis.

Liquidity: You can sell a portion of your mutual fund at its current price on any weekday. Note: Fees may apply, depending on the fund.

Tax-efficiency: Corporate class funds and funds with tax-efficient income streams can help reduce taxes and increase your investment returns.

Cost efficiency: It would be costly, time-consuming and, in some cases, impossible to create a similar portfolio on your own.

On top of these benefits, Canadian mutual funds are carefully regulated to protect investors and foster fair and efficient capital markets.

What is diversification?

“Don’t put all of your eggs in one basket” is especially good advice when it comes to investing.

Each individual stock or bond comes with its own unique risk – and potential reward. Holding a variety of different investments can help lower the overall risk of your investment portfolio. When some holdings decline in value, others may rise, offsetting the potential loss.

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How do I make money on a mutual fund?

1 Selling for capital gains

The holdings of most mutual funds are traded throughout the business week, and their prices can fluctuate as investors buy and sell each stock or bond. Selling a mutual fund for more than you initially paid for it will generate a capital gain. This may be reduced by any associated fees or charges for selling, but we will not include these in the following example.

Buy at $10

Jack buys 200 units of a mutual fund at $10 per unit ($2,000).

Sell at $12

Three years later, Jack decides to sell his mutual fund when it reaches $12 per unit, for a total sale of $2,400.

The mutual fund's value fluctuates, sometimes rising, sometimes falling.

2 Collecting distribution income

Some mutual funds aim to provide an income stream to investors, generally consisting of dividends from stocks, interest from bonds or capital gains from profitable sales of either. This income is distributed on a per-unit basis to fund holders according to a set schedule. Distributions can fluctuate, but in the following example, they remain the same. She has earned a 2% return from her distributions and she still owns her mutual fund, which has risen by 3% over the course of the year. While the price gain is subject to future fluctuations, she has earned a return of 5% on the year.

Buy at $10

Jill buys 200 units of an income-focused fund at $10 per unit ($2,000).

5% return

The distributions are paid in cash to her account, totalling $40 by the end of the year.

Let's assume it generates enough income to pay a quarterly distribution of 5 cents per unit. Over the course of a year, Jill recieves 20 cents per unit.

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3 Compounding

Another benefit of mutual funds is that they provide the option of compounding returns over time. Rather than taking the distributions in cash, Jill could have chosen to have them re-invested in the fund.

In the example below, let's say the fund was priced at $10 on each distribution reinvestment date.

Buy at $10

Jill now owns 201 units after three months.

Unit no. increase

As the number of units increases, so too does the total distribution.

After 6 months, she would hold 202.005 units, because you can own fractions of a mutual fund unit.

Different funds for different goals

Income funds

- Invest in lower risk bonds and preferred shares, income funds aim to provide a steady stream of cash.

Growth funds

- Typically invest in stocks, with the goal of profiting from rising share values.

Asset allocation funds

- Invest in a blend of stocks and bonds, with a goal of providing growth, while mitigating the impact of periodic price declines. They're also known as "balanced" funds.

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Talk to a financial advisor to learn more about which investments suit your financial goals. mackenzieinvestments.com