Introduction to Mutual Funds

The biggest advantage to investing in mutual funds is the ability to readily achieve a diversified portfolio to meet investment objectives. A diversified portfolio helps reduce risk by offsetting losses from some securities with gains in others. There are four basic types of mutual funds: stock (equity), bond, hybrid and money market. Money market funds are referred to as short-terms funds because they invest in securities that generally mature in one year or less, while stock, bond and hybrid funds are known as long-term funds. An investor in a mutual fund is a shareholder who owns shares of the fund. A share is typically represented by its net asset value (NAV). Each share represents proportionate ownership in all of the fund's underlying securities. The securities are selected by a professional investment adviser to match the fund's objectives as described in the prospectus. Below is a partial listing of factors to consider when making investment decisions regarding the use of mutual funds:

- Quality and experience of investment company management, specifically the fund manager
- Risk adjusted rates of return for the fund and their consistency over various time periods and comparisons to other related funds (benchmarks)
- Compliance with the investment style of the fund as described in the prospectus ("style drift")
- Quality of existing holdings
- Tax efficiency of the fund
- Mutual fund fee structure

Proprietary Mutual Funds

A proprietary mutual fund is a fund that the thrift or thrift affiliate acts as an investment adviser. When acting as a discretionary trustee, the savings association should determine whether applicable law would allow the purchase of shares of a proprietary mutual fund as such a purchase would be a conflict of interest. Many states have adopted statutes that would permit the purchase of shares of a proprietary mutual fund for a discretionary fiduciary account. The statutes are very different in regards to fees that may be charged, disclosures and consent. Savings associations should make sure that they are carefully following every aspect of the appropriate state statute. Even if there is a state statute that permits purchases of proprietary mutual fund shares for discretionary fiduciary accounts, a savings association must determine whether such an investment meets the prudence requirements of the applicable state law. The prudence analysis should be documented and available for review by examiners. The savings association should provide beneficiaries who are entitled under state law to receive account statements a copy of the mutual fund's prospectus. It is good risk management practice to also provide disclosure of the affiliated relationships, the nature of the services provided and the amount of fees paid to the savings association, its subsidiaries or affiliates.

If the savings association is acting as a trustee or other fiduciary for employee benefit accounts, it should be fully aware of all the ERISA restrictions regarding such conflict of interest transactions and meet any applicable Department of Labor (DOL) guidelines. The DOL has issued a prohibited transaction class exemption (PTE 77-4) that permits the investment of employee benefit accounts for which a savings association is a fiduciary in a proprietary mutual fund, provided certain conditions are met. The DOL has

also issued several advisory opinion letters (93-12A and 93-13A) that address secondary services provide by a bank to a proprietary mutual fund without a waiver or credit of fees.

Mutual Fund Fee Structure

Mutual funds have certain costs of operating. Costs are important because they lower the return of the fund. A fund that has a sales load and high expenses will have to perform better than a low-cost fund just to stay even with the low-cost fund. Information regarding the costs to the fund can be located in the fee table near the front of the fund's prospectus. The fee table can be used to compare the costs of different funds. The fee table breaks costs into two main categories: 1) sales loads and transaction fees (paid when a fund share if bought, sold or exchanged) and 2) ongoing expenses (paid periodically during the investment in the fund).

Sales Loads: The first part of the fee table will indicate if the fund charges any sales loads. No-load funds do not charge sales loads. There are no-load funds in every major fund category. Even no-load funds have ongoing expenses, however, such as management fees. When a mutual fund charges a sales load, it usually pays for commissions to people who sell the fund's shares, as well as other marketing costs. A front-end load is a sales charge that is paid when shares are bought. This type of load, by law, cannot be higher than 8.5 percent. An example of a front-end load would be where an investor has $1,000 to invest in a mutual fund with a 5 percent front-end load, $50 will go to pay the sales charge and $950 will be invested in the fund. A back-end load (also called a deferred load) is a sales charge that is paid when shares in the fund are sold. It usually starts out at 5 or 6 percent for the first year and gets smaller each year after that until it reaches zero (say, in year six or seven of the investment). An example of a back-end load would be where an investor has $1,000 invested in a mutual fund with a 6 percent back-end load that decreases to zero in the seventh year. Assume for purposes of this example that the value of the investment remains at $1,000 for seven years. If the shares were sold during the first year, the investor would receive $940 (ignoring any gains or losses). $60 would go to pay the sales charge. If shares were sold during the seventh year, the investor would receive back $1,000.

Ongoing expenses: The second part of the fee table indicates the kinds of ongoing expenses that will be paid while remaining invested in the fund. The table shows expenses as a percentage of the fund's assets, generally for the most recent fiscal year. High expenses do not assure superior performance. Higher expense funds do not, on average, perform better than lower expense funds. But there may be circumstances in which it is appropriate to pay higher expenses. For example, higher expenses will be incurred for certain types of funds that require extra work by its managers, such as international stock funds, which require sophisticated research. Higher expenses may also be paid for funds that provide special services, like toll-free telephone numbers, check-writing and automatic investment programs. A difference in expenses that may look small can make a big difference in the value of the investment in the fund over time. An example of this would be where an investor has $1,000 invested in a fund. Assume for purposes of this example that the investor receives a flat rate of return of 5 percent before expenses. If the fund has expenses of 1.5 percent after 20 years, the investor would end up with roughly $1,990. If the fund has expenses of 0.5%, the investor would end up with more than $2,410. This is a 22 percent difference.

One type of ongoing fee that is taken out of fund assets has come to be known as a rule 12b-1fee. It most often is used to pay commissions to brokers and other salespersons and occasionally to pay for advertising and other costs of promoting the fund to investors. It usually is between 0.25 percent and 1.00 percent of assets annually. A rule implemented in 1993 effectively capped 12b-1 fees at 0.75 percent but this rule also permitted "administrative service fees" of an additional 0.25 percent per year. Funds with back-end loads usually have higher rule 12b-1 fees.

A savings association should document carefully its reasons for choosing particular mutual funds as investment vehicles for discretionary accounts. These reasons could include the specific characteristics of a unique investment style or that the investment return supports increased fees. If the institution does not adequately support its decision making process, it may be subject to questionable prudent investment practices.