How a Mutual Fund Works

Mutual funds can be traced all the way back to 1774 when Dutch merchant Adriaan van Ketwich proposed a financial arrangement that involved pooling money from multiple investors to make investing available to the masses rather than a rich man's game alone. Others date its origins to 1822 when King William I of the Netherlands was thought to have created the first closed-end investment company.[1] However, the first modern mutual fund wasn't introduced until 1924.[2]

Today, mutual funds are among the most popular ways for beginner or passive investors to grow their money because they're easy to understand. In the simplest terms, a mutual fund is akin to a basket of investments holding stocks, bonds, short-term debt, or a blend thereof that is typically chosen and managed by one or more investment professionals.

Each mutual fund has a unique objective that the fund manager attempts to meet by following a specific management strategy. It might invest in stocks from around the globe or a particular region or country or stocks of companies that pay high dividends or have quickly growing revenues. Its managers might also select stocks they believe are undervalued or bonds they believe are less prone to credit risk.

No matter the goal of the fund, buying shares in a mutual fund is similar to buying shares in a publicly-traded company in that every share you buy of a mutual fund represents your partial ownership in the fund and the money it makes. The key distinction is that with a mutual fund, you buy shares of a portfolio of company stock or other securities rather than the stock of a single company.

A mutual fund is an open-end investment—that is, one that can issue and redeem shares whenever it wants. After you buy shares in a mutual fund, you can sell them back to the fund—either directly or through a broker—for roughly the shares' net asset value (NAV).[3]

The fund's NAV is simply the value of the fund's assets minus its liabilities and is calculated once every trading day, generally after the close of exchanges. The NAV of a single share is calculated by dividing the fund's NAV by the number of outstanding shares.[4]

Mutual fund investors don't actually own the underlying holdings—the stocks or bonds—that have been purchased by the fund. Rather, they benefit from owning shares of the fund that owns those holdings whenever the values of the holdings increase.

Types of Mutual Funds

There are countless mutual funds in the investment universe, but they can be divided into four basic categories:

- **Stock funds**: As the name suggests, these funds invest in company stocks.
- **Bond funds**: These funds are invested in bonds and other debt securities.
- **Money-market funds**: These invest in quality short-term government securities.
- **Target-date funds**: These funds are appropriate for investors with a specific retirement date in mind, which typically appears in the name of the fund.[5]

From there, the categories of funds get more specialized. For example, stock funds may be further categorized as growth funds, which emphasize stocks with above-average returns; income funds, which refer to dividend-producing funds; index funds, which seek to produce similar returns as an index like the S&P 500; or sector funds, which focus on a certain market sector like health care.

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1.Simplicity: Mutual Funds Are Easy to Understand

Because of their simplicity, mutual funds require no experience or knowledge of economics, financial statements, or financial markets to be a successful investor.

For beginners, here is a simple definition of mutual fund: A mutual fund is an investment security type that enables investors to pool their money together into one professionally managed investment. Mutual funds can invest in stocks, bonds, cash and/or other assets. These underlying security types, called holdings combine to form one mutual fund, also called a *portfolio*[1] .

For a simple definition, mutual funds can be considered baskets of investments. Each basket holds dozens or hundreds of security types, such as stocks or bonds. Therefore, when an investor buys a mutual fund, they are buying a basket of investment securities. Simple!

Yes, there are many things to know about mutual funds but compared to the broad world of financial products, mutual funds are quite easy to use and understand.

2. Accessibility: Mutual Funds Are Easy to Buy

Mutual funds are offered at brokerage firms, discount brokers online, mutual fund companies, banks, and insurance companies. Even beginning investors can easily open an account at a no-load mutual fund company, such as Vanguard Investments, and open an account within minutes[2] .

3. Diversification: Mutual Funds Have Broad Market Exposure

One mutual fund can invest in dozens, hundreds, or even thousands of different investment securities, making it possible to achieve diversification by investing in just one fund. However, it is smart to diversify into several different mutual funds[1] .

4. Variety: Mutual Funds Come In Many Different Categories and Types

As you grow your portfolio of mutual funds, you will want to diversify into various mutual fund categories and types. You can invest in mutual funds that cover the main asset classes (stocks, bonds, cash) and various sub-categories or you can even venture into specialized areas, such as sector funds or precious metals funds.

5. Affordability: Mutual Funds Have Low Minimums

Most mutual funds have minimum initial investment requirements of $3,000 or less. In many cases, if the investor initiates a systematic investment program, the initial investment may be much lower. Some minimums can be as low as $100. Subsequent investments may be lower than $100. If you invest through a 401(k) plan or other employer-sponsored retirement plan, there is no minimum to get started[1] .

6. Low Expense: Mutual Funds Can Cost Less to Manage Than Other Portfolio Types

Costs as a percentage of assets in the portfolio may be lower for an actively-managed mutual fund when compared to an actively-managed portfolio of individual securities. When you add up transaction costs, annual fees paid to a brokerage firm, and the cost for research tools or investment advice, mutual funds are often less expensive than the typical portfolio of stocks.

Several variables may influence the cost of managing a portfolio of mutual funds, such as the fund's expenses, the amount of trading activity, the size of transaction, and taxes.

7. Professional Management: Mutual Funds Have a Team of Professionals Researching and Analyzing Investments So You Don't Have To!

Perhaps the greatest benefit of mutual funds is that investors can save countless hours of time, energy and frustration involved with the research and analysis required to find quality investments to hold in a portfolio. That's not to speak of the skill, desire and patience required to do a job well in any professional pursuit. Mutual funds enable investors to do more of the things in life they enjoy rather than spending time and energy on investment matters[1] .

8. Flexibility: Mutual Funds Have Several Uses and Applications

All of the above benefits of mutual funds overlap into simplicity and flexibility. You can invest in just one fund or invest in a wide variety. Automatic deposit, systematic withdrawal, 401(k) plans, annuity sub-accounts, dividends, short-term savings, long-term savings, and nearly limitless investment strategies make mutual funds the best overall investment type for both beginners and advanced investors.

Bottom Line on Buying Mutual Funds

Since mutual funds are easy to understand and a smart investment choice for almost all types of savers and investors, these security types are the standard investments in 401(k) plans and IRAs. However, although mutual funds are relatively simple to use, they are not for everyone and investors should be careful to select the best funds that align with their goals and tolerance for risk.

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