How to Buy a Mutual Fund

- ## Tips
  - Diversify your portfolio, mixing bond funds with stocks funds, and including domestic and overseas funds.
  - Rebalance your funds annually to spread risk and avoid overexposure in any one area of the market.
  - A fund's past performance doesn't necessarily indicate future success. Seek out a diverse family of funds that have shown steady growth.

The following is adapted from "The Complete Money and Investing Guidebook" by Dave Kansas. From Wall Street Journal.

Picking the right mutual funds is a lot like selecting the right kinds of stocks to purchase. Among the similar strategic rules of thumb: watch the fees, diversify your holdings to mitigate your risk and don't chase performance — think long-term.

Let's start with diversification. If your company has a 401(k) plan, you probably have a good number of funds to choose from. You don't want to put all your eggs in one basket, so holding a diversified portfolio is important. A smart fund strategy mixes bond funds and stocks funds as well as funds that invest in domestic and overseas markets.

A smart strategy also includes "rebalancing." Each year, you should look at your mix of funds to make sure they still dovetail with your strategy of diversification. If one strategy has done especially well, it will grow to become an outsized part of your fund portfolio. Each year, rebalancing your funds allows you to avoid overexposure to any particular portion of the market. In the tech boom of the late 1990s, those who didn't rebalance found themselves in a bad position when tech stocks collapsed in 2000–2001. Anyone who rebalanced suffered fewer losses and found themselves in a position to better handle the downturn.

The rebalancing act is crucial to avoid a familiar pitfall for fund investors: Chasing performance. Each year, newspapers such as *The Wall Street Journal* list the top-performing funds. A lot of investors then plow their money into these top-performing funds. But among investors, there's a golden rule: Past performance is no guarantee of future performance. Indeed, last year's best-performing fund can quickly become this year's laggard. Chasing performance is one of the most common fund investing errors. Rebalancing and sticking with your diversification strategy can help avoid this.

There are thousands of funds out there and dozens of strategies. Here are some:

Index funds are mutual funds that invest in a portfolio of securities that represents a particular market (like the entire stock market), or, a particular piece of a market (say, like, international stocks or small companies). These funds are built to replicate the performance of their relevant market – so they should track that market's indexes. For example an S&P 500 index fund aims to provide the exact same return as the S&P 500 index. They're low-cost, low-maintenance funds.

Actively-managed funds are actively-managed by humans. The portfolio managers, research the vast investment universe and then pick and purchase things that match their investment strategies. Usually, they're trying to outperform certain indexes. For example, instead of trying to track the S&P 500 index, an active US stock fund manager tries to beat it.

Investors pay these managers for their work. Then they cross their fingers and hope that the manager gets it right and beats the index. Often, however, the managers don't. It's hard to beat an index over many years. **Lifecycle funds / Target date funds** invest in a combination of stock and bond funds. Essentially, these funds are mutual funds that are made up of investments in other mutual funds. The fund's allocation to its underlying investments change over time as you near retirement.

The ratio of money allocated to stocks versus bonds gradually becomes more conservative as the investor grows older. So, for example, a 2040 retirement fund (named for the date that the investor hopes to retire) might be 85% stocks and 15% bonds now but 50% bonds/cash and 50% stocks in 2040.

These work well when you'd rather not pick and choose what to buy on your own, but instead have somebody else manage it for you. You only need to figure out what in which year you plan to retire – and pick the fund that most closely matches that date.

Some target-date funds, like Vanguard's, invest only in index funds, while other providers, like Fidelity or T. Rowe Price, invest in actively-managed funds.

Lifestyle funds invest in a mix of stock funds and bonds funds that doesn't change over time. They usually come in a few flavors signifying an investor's tolerance for risk: conservative, moderate or aggressive. Some lifestyle funds slap on an extra fee on top of the expenses of the underlying funds; these are funds that you should probably avoid.

Balanced funds invest in a mix of stocks and bonds. These funds typically have a somewhat conservative mix of about 60% in stocks and 40% in bonds.

Tax-managed funds attempt to keep taxable capital gains and other distributions to fund holders to a minimum. That's why they're often recommended for investors who buy them via normal, taxable brokerage accounts (and not via IRA's or 401ks).

A number of investing advocates encourage investors to focus on index funds, rather than actively managed funds. Research data show that actively managed funds have a tough time beating funds that track an index. In addition, the simplified nature of index, or "passive," investing means that index funds are cheaper and carry fewer fees.

After settling on a strategy for your anticipated needs, picking from the world of funds can be bewildering. Thousands of funds are competing for your attention. When considering a fund, a good first step is looking at the fund's prospectus. Like a company's IPO prospectus, a fund prospectus tells you a great deal about what a fund is doing. It contains information about investment goals, risk posture, fee information, past performance data and amount of assets held.

If you're a 401(k) investor, you have access to a menu of funds selected by your employer. Hopefully, your company has done a thorough job and offers you a comprehensive list of good funds that will allow you to build a well-balanced investment portfolio.

If you're looking to invest outside of your employer-sponsored plan, you have several options:

1. You can purchase mutual funds through the fund companies directly, whether it's Vanguard, T. Rowe Price or Fidelity, to name just a few.

2. You can buy fund via a "supermarket" which offers funds from many different providers. Many fund companies like Vanguard will allow you to set up brokerage accounts where you can buy funds from elsewhere. Many of the online brokerages that house your IRA or regular brokerage account also offer fund supermarkets.

You want to pay close attention to fees when dealing with any supermarket. While they provide the convenience of one-stop shopping, one statement and easy online access, some funds carry transaction fees, akin to a brokerage's commission. So if you invest a little money each month into three funds that carry a $35 transaction fee, those costs can quickly add up and eat into your returns. For example, Schwab makes you pay a lot to buy Vanguard mutual funds.

Obviously, the supermarkets want you to buy their house brands, so those funds are unlikely to cost you any extra fees. You can be sure it'll cost you less to buy Schwab funds through your Schwab brokerage account that it would to buy Vanguard's funds.

Supermarkets usually have a list of no-transaction-fee funds (these fund companies pay the supermarket a fee to get on the list, so it's not entirely free; the expense ratio might be slightly higher) and transaction fee funds (those who don't). Before you commit to any one supermarket, check out their wares and fee structure. If the Vanguard fund you're after will cost a fee every time you make a deposit, look elsewhere or go to the fund company directly.

3. Lastly, you can buy funds via a human broker or certain financial planners. This route is often less cost-effective than others – brokers will tack on extra fees like sales charges and your planner may do the same. If you really want professional help, it's probably most cost-effective to find a financial planner that charges by the hour and can unearth some good and cheap no-load funds for you.

There are a few other factors to consider when buying a fund: **Timing.** If you're investing outside of a tax-deferred account, like a 401(k) or IRA, timing may matter. Funds are required to distribute capital gains and dividends to shareholders. These distributions are taxable – so if you buy into a mutual fund right before a distribution, you're essentially paying taxes for some sort of gain that you didn't even benefit from.

While most distributions are made in December, some are made earlier. If you're looking to buy a fund anytime after Sept. 1, be sure to ask about the company's distribution — if there is a taxable distribution, make your purchase after it passes.

The type of account that will hold the mutual fund . You want to take full advantage of your tax-sheltered retirement accounts — namely 401(k)s and IRAs — because taxes there are a non-issue.

For your taxable brokerage account, consider tax-efficient investments such as: tax-managed funds, exchange-traded funds, index funds, municipal bond funds, and stocks you plan to hold for more than a year (at which point, any gain gets taxed at 15%; it'll be higher if you sell sooner).

In a regular brokerage account subject to taxes, you generally want to stay away from mutual funds that generate hefty tax bills from capital gains distributions or dividends, which are better off inside your retirement accounts. These include: real estate investment trusts, or REIT funds; actively-managed stock funds; high-yield junk bond funds; corporate bond funds; and stocks you plan on trading frequently.