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INVESTING

MUTUAL FUNDS

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The mission of The USAA Educational Foundation is to help consumers make informed decisions by providing information on financial management, safety concerns and significant life events.



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A MUTUAL FUND POOLS THE MONEY OF MANY INVESTORS TO INVEST IN A VARIETY OF STOCKS, BONDS OR OTHER SECURITIES.

A mutual fund pools the money of many investors to invest in a variety of stocks, bonds or other securities. Each fund has its own investment objective, with some funds investing more aggressively and others investing more conservatively.

When you invest money in a mutual fund, you receive shares of the fund. Each share represents an interest in the fund's portfolio and the value of your mutual fund shares will rise and fall depending upon the performance of the securities in the portfolio.

A mutual fund is managed by one or more professional managers. The fund's investment portfolio is designed to achieve specific objectives. Portfolios typically contain 50 to 200 different stocks, bonds and other securities. The composition of each portfolio varies according to the fund's investment objectives and the level of risk permitted.

While the returns of mutual funds are not guaranteed, they do offer many advantages, especially for the inexperienced investor. Mutual funds allow you to invest in a variety of industries and investments, which may be difficult to do individually without having large amounts of money to invest.

The purpose of this publication is to help you understand how mutual funds work and provide you the principles for creating a well-balanced portfolio.

There are currently over 10,000 mutual funds available with new funds being introduced each year. Before you begin investing in a mutual fund, make sure the investment strategy of the fund is in line with your financial goals and risk tolerance.

Four Major Fund Categories

Most mutual funds fall into one of four main categories — money market funds, bond funds, stock funds and asset allocation funds. Each type has different features and different risks and rewards. Generally, the higher the potential return, the higher the risk of loss.

Money market funds invest in very low-risk securities and are designed to provide a place for holding cash or cash equivalents. There are two types of money market funds: taxable and tax-free. The latter invest in municipal securities whose interest is generally exempt from federal income tax.

FOR MORE INFORMATION

The USAA Educational Foundation publication, *Stocks And Bonds*, offers more information. See "Resources" on the inside back cover of this publication to order a free copy.

Bond funds are also known as debt funds. When you purchase bonds, you are essentially making a loan to the bond's issuer. Bonds are issued by companies and federal, state and local governments.

Stock funds are also known as equity funds. When a fund manager purchases stock, the fund becomes an owner of the company that issued the stock.

Asset allocation funds include a diversified portfolio of investments which may include stocks, bonds, money market or other securities. Asset allocation funds diversify your investments to help capitalize on changes in market conditions and to help manage risk.

Advantages And Disadvantages Of Mutual Funds

Mutual funds have become one of the most popular forms of investing in the United States, with over $10.9 trillion in assets as of November 2009, according to the Investment Company Institute (ICI).

Like any investment, there are advantages and disadvantages you should consider before investing. Following is a list of mutual fund features and some of the advantages and disadvantages of investing in mutual funds.

FEATURES	ADVANTAGES	DISADVANTAGES
Diversification	You can invest in a variety of industries and categories of stocks, bonds and other securities reducing investment risk. With a broad investment base, total returns are not as threatened by a few unsatisfactory performers.	Because mutual funds have holdings in many companies, high returns from several investments may not make much difference in your overall return. It is possible to over-diversify your investments.
Liquidity	You can generally redeem or sell your shares at any time at their current net asset value.	When you sell your shares, you may have a gain that is taxable for federal income tax purposes or a loss of principal. Losses may be deductible for federal income tax purposes.
Flexibility	Mutual fund companies offer a variety of mutual funds with different financial objectives managed by one company. You can reallocate investments among those funds as your goals and objectives change.	Movement of your monies between mutual funds may result in a taxable gain for federal income tax purposes or a loss of principal. Losses may be deductible for federal income tax purposes.
Convenience	Most funds allow you to invest automatically with an allotment or automatic withdrawal from your checking account (also known as dollar-cost averaging). By making fixed, regular investments into a mutual fund, regardless of share price, you may lessen your risk of putting a large amount of money in a single investment at the wrong time. Generally, you can buy or sell shares by phone, mail or online.	Such automatic allotment or withdrawal plans do not assure a profit and do not protect against losses in declining markets.
Professional Management	Mutual funds are managed by professionals who research and evaluate the investment potential of hundreds of different companies and agencies. Individual investors usually cannot get the same level of investment advice without a large portfolio.	The investor cannot directly select the underlying fund investments and generally cannot control the amount of capital gains triggered by the fund. Mutual funds are not always tax efficient.
Regulation	The industry is regulated by the Securities and Exchange Commission (SEC) that imposes requirements designed to protect investors from abuse.	

There are various types of expenses associated with purchasing and owning shares of mutual funds. We begin with shareholders direct costs and then review the expense ratio, which is the one expense common to all funds.

Shareholder Costs

Sales charges. Many mutual funds, called **load funds**, impose a sales charge to buy shares of the fund. Sales charges, also known as sales load or commission, compensate stockbrokers and others who sell funds to investors. **No-load funds**, purchased from an investment management company or through a brokerage account, do not charge sales loads.

Transaction fees. Some funds charge their shareholders a **redemption fee** when they sell or redeem shares. Redemption fees are typically paid directly to the mutual fund and are designed to cover the costs associated with the redemption itself. Some funds also impose an **exchange fee** when a shareholder transfers from one fund to another fund within the same "family of funds". Some funds charge an annual **account fee**, typically a fixed amount deducted from the shareholder's account. Shareholders are often charged for accounts below the specified minimum balance.

Operating Expenses

Management fees. These fees are paid to the investment adviser for management of the investment portfolio. Management fees are paid out of the fund assets. The shareholder service fee, referred to as the **12b-1 fee**, gets its name from the SEC rule that authorizes them. This fee helps cover marketing and administrative costs.

Expense Ratio

The expense ratio reflects the cost of running the mutual fund, including the following:

- Salaries for portfolio managers, analysts and service representatives.
- The cost of printing shareholder reports.
- Other administrative costs, including an allowance for some fund company profit.

Rather than being deducted from your individual account, these expenses are taken from the assets of the entire mutual fund each day and are reflected in the fund's cost per share.

Expense ratios vary widely. Some types of funds are, by their nature, more costly to run than others. For example, the following relationships are generally true.

- Stock funds are more expensive than bond funds.
- International stock funds are more expensive than funds that focus on U.S. stocks.
- Actively managed funds are more expensive than index funds.
- Funds with smaller levels of invested assets are more expensive than those with larger sums.

Taxes And Mutual Funds

In addition to costs imposed by mutual funds themselves, federal, state and local taxes are another important expense that should be considered when making investment decisions.

Unless you own your shares inside a tax-advantaged account, such as an Individual Retirement Account (IRA), Coverdell Education Savings Account or an employer-provided 401(k) plan, you may be subject to federal income tax on earnings you receive from a mutual fund. Dividend and capital gain distributions are taxable, as are any capital gains you realize when you redeem shares.

As you select mutual funds for your portfolio, realize some are less tax-efficient than others. Funds with a high turnover rate tend to generate more capital gain distributions than those that hold securities for longer periods of time. Likewise, high-yield bond funds generate a large amount of taxable income. You may benefit from consulting a financial planning professional or tax accountant when deciding which funds to purchase within tax-advantaged accounts and which to purchase in taxable accounts.

You should also be conscious of how your own decisions affect your taxes. Those who rapidly buy and sell mutual funds may generate many capital gains and losses, potentially raising their taxes and certainly complicating their tax returns.

Many mutual funds are designed to minimize the tax burden of their investors. For example, some invest in **municipal bonds** which are issued by state and local governments to finance schools, roads, hospitals or stadiums. Called "munis" for short, a key attraction of municipal bonds is their tax treatment. In general, interest from municipal bonds is exempt not only from federal income tax but also from state and local income tax in the states and cities where they are issued. This tax treatment is passed through to municipal bond fund investors.

DO NOT BUY A DISTRIBUTION

Before investing in a mutual fund, research its schedule for dividend and capital gains distributions. You will find most mutual funds make these distributions in December. If you purchase a fund just before it makes a distribution, you will be liable for taxes even though you may not have profited from any gain.

Example: You invest $10,000 in a mutual fund, buying 1,000 shares at $10 per share. The next day, the fund issues a $1 per share capital gain distribution, reflecting gains realized when the portfolio manager sold some securities earlier that year. You will have to report the $1,000 capital gain distribution on your taxes, even though you have yet to profit from the investment.

Before investing in mutual funds, carefully consider your goals, how long you have to achieve them and your level of comfort with investment fluctuations. This will help you create the framework for a fund portfolio that meets your needs.

Risk And Reward

Perhaps one of the most important considerations in creating a portfolio is the amount of risk you wish to take. Generally, the more risk an investor takes with a given investment, the greater the return they should hope to receive.

Generally, stocks are considered to be riskier than bonds because their value tends to fluctuate more. To compensate for the greater risk, investments in stocks have historically provided a greater return.

Every investment has some element of risk. The relatively low returns associated with a money market fund, for example, leave the investor exposed to purchasing power risk. This is the risk that the buying power of your assets will decline over time if your investment returns do not equal or exceed the rate of inflation.

Deciding the mix of stocks, bonds and cash that is right for you depends on a variety of factors.

- Readiness for emergencies. Before investing in longer-term assets, you should save 3 to 6 months of basic living expenses in a cash account so you are ready for unexpected expenses such as a vehicle repair or a job layoff.
- Timing of your goal. The sooner you will need to use your money, the less you can generally afford to see it fluctuate in value.
- Your feelings about volatility. Each of us has a different level of comfort when it comes to seeing our investments rise and fall in value.

Pick The Right Mix

A sound mutual fund portfolio combines a variety of investments that behave differently at a given time. While one hopes that each investment will grow over time, each will inevitably have periods of weak and strong returns, reflecting the results of the markets in which it is invested. To the extent that some of your investments rise while others fall, you can reduce the overall level of volatility in your portfolio.

Dollar-Cost Averaging

Another advantage of mutual funds is that you can invest in them regularly with an allotment or automatic withdrawal from your checking account allowing you to take advantage of dollar-cost averaging.

This strategy focuses on investing a predetermined amount of money each month or pay period in order to take advantage of the daily fluctuations of the stock market. With dollar-cost averaging, you are putting into practice the recommendation of financial planning professionals to "pay yourself first." Following this strategy can also help you avoid the risk of trying to buy at "just the right time" or at "just the right price" with a lump sum of money.

Dollar-cost averaging does not guarantee a gain, nor can it prevent a loss when the markets are falling.

Researching And Selecting Individual Funds

Once you have set your goals, established your objectives, determined your time horizons and understand your risk tolerance, it is time to select a mutual fund. Carefully read each fund's prospectus and consider the following factors.

FACTORS TO CONSIDER WHEN EVALUATING MUTUAL FUNDS	
FACTOR	**KEY QUESTIONS**
Fund Objectives	• Does the fund match your goals and objectives for the long term?
Expenses	• How do the fund's expenses compare to the average comparable fund? • Are there sales charges or 12b-1 fees?
Portfolio Manager Tenure	• How long has the portfolio manager been in this role? • Does the fund have a strong performance record created by someone who has since left?
Fund Performance	• How does the fund's performance compare to that of its peers? • In addition to the past few months or year — how strong is the fund's long-term performance?
Risks	• Will you have the perseverance to hold the fund when the market is down? • How does the fund's risk level compare to similar funds?
Taxes	• Has the fund generated large taxable distributions? • Does it have a high portfolio turnover rate that may lead to tax inefficiency? • Is the fund about to make a large capital gain or dividend distribution?

Sources Of Fund Information

There are several sources of information to aid you in finding the right funds for your portfolio.

One especially important source is the mutual fund's prospectus. This is a comprehensive document that mutual fund companies are required to provide you — either in print or electronically — when you invest in a fund.

Pay special attention to these sections of a mutual fund **prospectus**.

- **Investment objective and strategies.** This section describes the purpose of the fund and how it plans to achieve it.
- **Risks.** This is a listing and description of the various risks associated with the fund, given its objectives and the types of investments it selects.
- **Risk/Return chart.** This bar chart shows the fund's annual returns for each of the previous 10 calendar years (or, if the fund has existed less than 10 years, for the life of the fund). It provides insight into the fund's historical volatility.
- **Before- and after-tax fund return chart.** Most funds are required to include a chart showing before- and after-tax fund returns for the past 1, 5 and 10 years, comparing them to an appropriate index. Money market funds are required to show only before-tax returns. Also, funds without annual returns for at least 1 calendar year cannot include any performance information. And funds with less than 5 or 10 years of performance would show returns since inception and omit the 5- and 10-year return numbers (as applicable).
- **Fee table.** This describes the fund's fees and expenses and makes it easy to compare the costs of different funds. It also translates percentages into dollars by showing you the costs associated with an investment of $10,000 over the past 1, 3, 5 and 10 years.

TICKER SYMBOLS

Like stocks, mutual funds are assigned ticker symbols to aid investors in researching, buying and selling shares. All mutual fund ticker symbols consist of five letters, always ending with an "X."

BEFORE INVESTING, REQUEST THE MOST RECENT REPORT OR VIEW IT ON THE FUND COMPANY'S WEB SITE.

Another excellent source of information is the fund's latest annual or semi-annual report, which provides information on the fund's performance along with commentary from the portfolio manager. These reports also provide a complete listing of the fund's holdings as of the last day of the reporting period. Before investing, request the most recent report or view it on the fund company's Web site.

In addition to the fund companies themselves, several research organizations, including CDA/Weisenberger, Lipper Analytical Services, Morningstar and Value Line provide independent analysis of mutual funds. They offer some information without charge, yet some reports are available only by subscription. You may find their printed subscription materials at your local library.

Mutual Fund Statistical Indicators

As you research mutual funds, you will encounter a variety of statistical measures of risk and other characteristics. These numbers are especially helpful when comparing funds.

Evaluating Mutual Fund Performance

Clearly, one of the most important characteristics of a fund is its investment performance. The best way to evaluate this is to compare a fund's results with those of a benchmark.

One approach to benchmarking is the use of market indexes, which track the performance of a specific group of securities. While the Dow Jones Industrial Average is perhaps the best-known market index, it is not used as a mutual fund benchmark as frequently as some of the other indexes listed in the table.

INDEX	TRACKS
Standard & Poor's 500	Large-cap U.S. stocks.
Russell 2000	Small-cap U.S. stocks.
Nasdaq Composite	Over 3,000 stocks traded on the Nasdaq stock market.
Dow Jones U.S. Total Stock Market Index	All U.S. stocks with available price data — broadest U.S. market measure.
MSCI EAFE (Europe, Australasia, Far East) **Nikkei (Japan)** **DAX (Germany)** **FTSE (Great Britain)** **CAC-40 (France)**	Certain foreign stock markets.
Dow Jones 20 Bond	Average price and yield of 10 public utility bonds and 10 industrial bonds.
Bond Buyer Municipal Index	40 actively traded investment-grade municipal bonds.

In addition to comparing a fund's performance with the return on a relevant index, investors can also compare the fund's performance with that of a group of similarly managed mutual funds.

For example, a fund focusing on large-cap value stocks may be compared to the average performance of all other large-cap value funds.

The fund's annual and semi-annual reports and prospectus should provide both of these comparisons for you. A variety of investment research sites on the Internet also furnish this information.

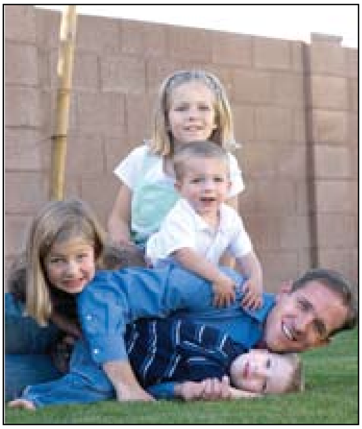
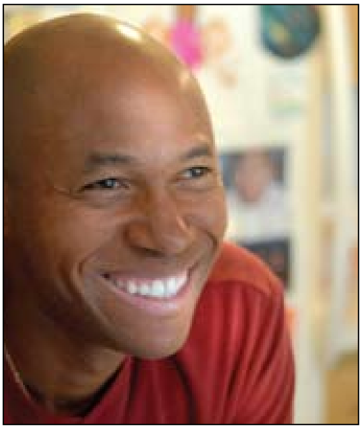
When comparing funds to benchmarks, take a long-term perspective. Even the best portfolio managers are not able to exceed their benchmarks over every time period.

FOCUSING YOUR INVESTMENT STRATEGY

To make the most of your investment activities, financial planning professionals recommend you consider implementing some time-tested strategies.

Invest For The Long Term	The more time you give your investment to grow and compound, the more likely you are to reach your financial goals. History shows that patient investors who focus on long-term goals can withstand fluctuations of the stock market.
Use Time, Not Timing	If you start early and invest regularly, you will be able to use time to your advantage. Do not try "timing" decisions to buy and sell based on the market fluctuations. No one has accurately predicted the market fluctuations over the long term.
Keep Emotions Out Of Your Actions	Investors' decisions tend to be influenced by short-term variables and the latest news. Think and act intellectually, not emotionally. Investing success requires patience, stamina and an unemotional approach. Do your homework; then stay on course.
Increase Your Knowledge	Learn all you can about investing and specific investments by regularly reading business periodicals, investment books and annual reports of companies whose securities you might want to purchase.
Avoid High-Risk Investments	Avoid futures, commodities and other risky forms of investing — at least until you know all about them and you are willing and able to accept their increased risks.
Avoid The Crowd	If you choose your investments by leaping into whatever is currently doing very well, you may be setting yourself up for recurring losses over time. You could find that the best performing stock in 1 year becomes one of the worst in subsequent years.
Diversify	Select a wide variety of securities for your portfolio to minimize investment risks. Experts suggest that diversification can reduce the total risk of investing by more than half. Investing in several assets will produce a return based on the average of your various investment returns, rather than relying completely upon the return of one investment.
Evaluate Your Investment Plan	Evaluate your investment plan annually or at times of significant life events. If necessary, rebalance your portfolio to ensure your mix of investments aligns with your goals, risk tolerance and the time horizon.

RESOURCES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