How Mutual Funds Work

A mutual fund is both an investment and an actual company. This dual nature may seem strange, but it is no different from how a share of RIL is a representation of Reliance Ltd. When an investor buys RIL stock, he is buying partial ownership of the company and its assets. Similarly, a mutual fund investor is buying partial ownership of the mutual fund company and its assets. The difference is that Reliance is in the business of manufacturing essential goods, while a mutual fund company is in the business of making investments.

Investors typically earn a return from a mutual fund in three ways:

1. Income is earned from dividends on stocks and interest on bonds held in the fund's portfolio. A fund pays out nearly all of the income it receives over the year to fund owners in the form of a distribution. Funds often give investors a choice either to receive a check for distributions or to reinvest the earnings and get more shares.
2. If the fund sells securities that have increased in price, the fund has a capital gain. Most funds also pass on these gains to investors in a distribution.
3. If fund holdings increase in price but are not sold by the fund manager, the fund's shares increase in price. You can then sell your mutual fund shares for a profit in the market.

Disadvantages of Mutual Funds:

Liquidity, diversification, and professional management all make mutual funds attractive options for younger and other individual investors who don't want to actively manage their money. However, no asset is perfect, and mutual funds have drawbacks too.

1. Fluctuating Returns

Like many other investments without a guaranteed return, there is always the possibility that the value of your mutual fund will depreciate. Equity mutual funds experience price fluctuations, along with the stocks that make up the fund. Of course, almost every investment carries risk. It is especially important for investors in money market funds to know that their funds are not insured.

2. Cash Drag

Mutual funds pool money from thousands of investors, so every day people are putting money into the fund as well as withdrawing it. To maintain the capacity to accommodate withdrawals, funds typically have to keep a large portion of their portfolios in cash. Having ample cash is excellent for liquidity, but money that is sitting around as cash and not working for you is not very advantageous. Mutual funds require a significant amount of their portfolios to be held in cash in order to satisfy share redemptions each day. To maintain liquidity and the capacity to accommodate withdrawals, funds typically have to keep a larger portion of their portfolio as cash than a typical investor might. Because cash earns no return, it is often referred to as a "cash drag."

3. High Costs

Mutual funds provide investors with professional management, but it comes at a cost. The fees of the various parties involved reduce the fund's overall payout, and they're assessed to mutual fund investors regardless of the performance of the fund. In years when the fund doesn't make money, these fees only magnify losses. Creating, distributing, and running a mutual fund is an expensive undertaking. Everything from the portfolio manager's salary to the investors' quarterly statements cost money. Those expenses are passed on to the investors. Since fees vary widely from fund to fund, failing to pay attention to the fees can have negative long-term consequences. Actively managed funds incur transaction costs that accumulate over each year.

4. "Diversification" and Dilution

"An investment or portfolio strategy that implies too much complexity can lead to worse results. Many mutual fund investors tend to overcomplicate matters. That is, they acquire too many funds that are highly related and, as a result, don't get the risk-reducing benefits of diversification. These investors may have made their portfolio more exposed. At the other extreme, just because you own mutual funds doesn't mean you are automatically diversified. For example, a fund that invests only in a particular industry sector or region is still relatively risky. Dilution is also the result of a successful fund growing too big. When new money pours into funds that have had strong track records, the manager often has trouble finding suitable investments for all the new capital to be put to good use.

5. Active Fund Management

Many investors debate whether or not the professionals are any better at picking stocks. Management is by no means infallible, and even if the fund loses money, the manager still gets paid. Actively managed funds incur higher fees, but increasingly passive index funds have gained popularity. These funds track an index such as the S&P 500 and are much less costly to hold. Actively managed funds over several time periods have failed to outperform their benchmark indices, especially after accounting for taxes and fees.

6. Lack of Liquidity

A mutual fund allows you to request that your shares be converted into cash at any time, however, unlike stock that trades throughout the day, many mutual fund redemptions take place only at the end of each trading day.

7. Taxes

When a fund manager sells a security, a capital-gains tax is triggered. Investors who are concerned about the impact of taxes need to keep those concerns in mind when investing in mutual funds.