What are mutual funds?

A mutual fund is a company that offers investors an interest in a portfolio of professionally managed investment assets. Mutual funds are “open-ended” in the sense that they maintain a continuous market and a constantly changing number of outstanding shares. The term “mutual fund” is sometimes used (incorrectly) to refer to closed-end investment companies, which have a fixed number of outstanding shares and are actively traded on the secondary market.

Mutual funds are managed, in the sense that the underlying portfolio is changing as assets are bought and sold. Funds are generally designed to accomplish some primary investment objective, such as growth, income, capital appreciation, tax-exempt interest, international investing, etc., and therefore emphasize investments they consider appropriate to this purpose. Many funds (e.g., asset allocation funds, balanced funds, equity-income funds, hybrid funds) combine two or more investment objectives in an effort to maintain a more diversified portfolio. “Tax-managed” funds (i.e., tax-sensitive, tax-efficient funds) employ investment strategies designed to minimize current income taxes by keeping taxable gains and income as low as possible and emphasizing long-term growth. Although the specific methods vary from one fund to another, they generally include: (1) keeping turnover low; (2) offsetting capital gains with capital losses; and (3) keeping dividends and interest at a minimum. “Life cycle” funds (or “target date” funds) invest in stocks, bonds, and cash in a ratio considered appropriate for investors with a particular age and risk tolerance.[[1]](#footnote-1)

The Securities and Exchange Commission (SEC) requires mutual fund companies to disclose standardized after-tax returns for 1-, 5-, and 10-year periods to help investors understand the magnitude of tax costs and compare the impact of taxes on the performance of different funds. After-tax returns must accompany before-tax returns in a fund’s prospectus and must be presented in two ways: (1) returns after taxes on fund distributions only; and (2) returns after taxes on fund distributions and redemption of fund shares. The SEC also requires that funds include standardized after-tax returns in certain advertisements and other sales material.[[2]](#footnote-2)

*Portfolio investment programs* provide investors with the opportunity to use a sponsoring broker-dealer’s web site to “create and manage portfolios of securities (‘baskets’) based on each investor’s individual needs and objectives.” (Portfolio investment programs are frequently referred to as “folios,” the name of the initial

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sponsor’s product). However, unlike a mutual fund, “the investor does not hold an undivided interest in a pool of securities; rather the investor is the direct beneficial owner of each of the securities included in the portfolio. Each investor has all of the rights of ownership with respect to such securities.”[[3]](#footnote-3) The SEC denied a request from the Investment Company Institute (ICI) to adopt a rule that would deem portfolio investment programs to be regulated as mutual funds.[[4]](#footnote-4)

Because investors in investment portfolio programs own the stocks directly, they are taxed on distributions and the sale of their shares in the same manner as stockholders.

1. See United States Securities and Exchange Commission, Frequently Asked Questions about Rule 35d-1 (Investment Company Names), at [www.sec.gov/divisions/investment/guidance/rule35d-1faq.htm](http://www.sec.gov/divisions/investment/guidance/rule35d-1faq.htm). [↑](#footnote-ref-1)
2. See 17 CFR Parts 230, 239, and 270. [↑](#footnote-ref-2)
3. U.S. Securities and Exchange Commission, Letter in Response to Petition for Rulemaking from Investment Company Institute, (August 23, 2001); Speech by Paul F. Roye (Director of Investment Management, U.S. Securities and Exchange Commission) to the American Law Institute - American Bar Association Conference on Investment Management Regulation, (October 11, 2001). [↑](#footnote-ref-3)
4. See Letter in Response to Petition for Rulemaking from Investment Company Institute, above. [↑](#footnote-ref-4)