

AN INTRODUCTION

TO MUTUAL FUNDS



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An Introduction to Mutual Funds

A Mutual Fund Checklist

- ✓ Mutual funds are not guaranteed or insured by any bank or government agency. Even if you buy through a bank and the fund carries the bank's name, there is no guarantee. You can lose money.
- ✓ Mutual funds always carry investment risks. Some types carry more risk than others.
- ✓ Understand that a higher rate of return typically involves a higher risk of loss.
- ✓ Past performance is not a reliable indicator of future performance.
- ✓ Beware of dazzling performance claims.
- ✓ All mutual funds have costs that lower your investment returns
- ✓ You can buy some mutual funds by contacting them directly. Others are sold mainly through brokers, banks, financial planners, or insurance agents. If you buy through these financial professionals, you generally will pay an extra sales charge for the benefit of their advice.
- ✓ Shop around. Compare a mutual fund with others of the same type before you buy.

WHY MUTUAL FUNDS?

Mutual funds can be a good way for people to invest in stocks, bonds and other securities. Why?

- Mutual funds are managed by professional money managers.
- By owning shares in a mutual fund instead of buying individual stocks or bonds directly, your investment risk is spread out.
- Because your mutual fund buys and sells large amounts of securities at a time, its costs are often lower than what you would pay on your own.

This document explains the basics of mutual fund investing -- how a mutual fund works, what factors to consider before investing, and how to avoid common pitfalls.

There are sources of information that you should consult before you invest in mutual funds. The most important of these is the prospectus of any fund you are considering. The prospectus is the fund's selling document and contains information about costs, risks, past performance, and the fund's investment goals. Request a prospectus from a fund, or from a financial professional if you are using one. Read the prospectus before you invest.

Before you buy a mutual fund, make sure it is right for you.

HOW MUTUAL FUNDS WORK

A mutual fund is a company that brings together money from many people and invest it in stocks, bonds, or other securities (The combined holdings of stocks, bonds, or other securities and assets the fund owns are known as its portfolio.) Each investor owns shares, which represent a part of the holdings.

How to Buy and Sell Shares

You can buy some mutual funds by contacting them directly.

Others are sold mainly through brokers, banks, financial planners, or insurance agents. All mutual funds will redeem (buy back) your shares on any business day and must send you the payment within seven days.

You can find out the value of your shares in the financial pages of major newspapers: After the fund's name, look for the column marked "NAV".

Terms to Know:

Net Asset Value per share (NAV): NAV is the value of one share in a fund. When you buy shares, you pay the current NAV per share, plus any sales charge (also call a sales load). When you sell your shares, the fund will pay you NAV less any other sales load. A fund's NAV goes up or down daily as its holdings change in value.

Example: You invest \$1,000 in a mutual fund with an NAV of \$10.00. You will therefore own 100 shares of the fund. If the NAV drops to \$9.00 (because the value of the fund's portfolio has dropped), you will still own 100 shares, but your investment is now worth \$900. If the NAV goes up to \$11.00, your investment is worth \$1,100. (This example assumes no sales charge.)

HOW FUNDS CAN EARN YOU MONEY

You can earn money from your investment in three ways.

First, a fund may receive income in the form of dividends and interest on the securities it owns. A fund will pay its shareholders nearly all of the income it has earned in the form of dividends.

Second, the price of the securities a fund owns may increase. When a fund sells a security that has increased in price, the fund has a capital gain. At the end of the year, most funds distribute these capital gains (minus any capital losses) to investors.

Third, if a fund does not sell but holds on to securities that have increased in prices, the value of its shares (NAV) increases. The higher NAV reflects the higher value of your investment. If you sell your shares, you make a profit (this also is a capital gain).

Usually funds will give you a choice: the fund can send you payment for distributions and dividends, or you can have them reinvested in the fund to buy more shares, often without paying an additional sales load.

Taxes

You will owe taxes on any distributions and dividends in the year you receive them (or reinvest them). You will also owe taxes on any capital gains you receive when you sell your shares. Keep your account statements in order to figure out your taxes at the end of the year.

If you invest in a tax-exempt fund (such as a municipal bond fund), some or all of your dividends will be exempt from federal (and sometimes state and local) income tax. You will, however, owe taxes on any capital gains.

KINDS OF MUTUAL FUNDS

You take risks when you invest in any mutual fund. You may lose some or all of the money you invest (your principal), because the securities held by a fund go up and down in value. What you earn on your investment also may go up or down.

Each kind of mutual fund has different risks and rewards. Generally, the higher the potential return, the higher the risk of loss.

Before you invest, decide whether the goals and risks of any fund you are considering are a good fit for you. To make this decision you may need the help of a financial adviser. There are also investment books and services to guide you.

The three main categories of mutual funds are money market funds, bond funds, and stock funds. There are a variety of types within each category.

1. Money Market Funds have relatively low risks, compared to other mutual funds. They are limited by law to certain high-quality, short-term investments. Money market funds try to keep their value (NAV) at a stable \$1.00 per share, but NAV may fall below \$1.00 if their investments perform poorly. Investor losses have been rare, but they are possible.

A Word About Banks and Mutual Funds

Banks now sell mutual funds, some of which carry the bank's name. But mutual funds sold in banks, including money market funds, are not bank deposits. Don't confuse a "money market fund" with a "money market deposit account." The names are similar, but they are completely different:

- A money market fund is a type of mutual fund. It is not guaranteed, and comes with a prospectus.
- A money market deposit account is a bank deposit. It is guaranteed, and comes with a Truth in Savings form.

2. Bond Funds, (also called **Fixed Income Funds**) have higher risks than money market funds, but seek to pay higher yields. Unlike money market funds, bond funds are not restricted to high-quality or short-term investments. Because there are many different types of bonds, bond funds can vary dramatically in their risks and rewards.

Most bond funds have credit risk, which is the risk that companies or other issuers whose bonds are owned by the fund may fail to pay their debts (including the debt owed to holders of their bonds). Some funds have little credit risk, such as those that invest in insured bonds or U.S. Treasury bonds. But be careful: Nearly all bond funds have interest rate risk, which means that the market value of the bonds they hold will go down when interest rates go up. Because of this, you can lose money in any bond fund, including those that invest only in insured bonds or Treasury bonds.

Long-term bond funds invest in bonds with longer maturities (length of time until the final payout). The values (NAVs) of long-term bond funds can go up or down more rapidly than those of shorter-term bond funds.

3. Stock Funds (also called **Equity Funds**) generally involve more risk than money market or bond funds, but they also can offer the highest returns. A stock fund's value (NAV) can rise and fall quickly over the short term, but historically stocks have performed better over the long term than other types of investments.

Not all stock funds are the same. For example, growth funds focus on stocks that may not pay a regular dividend but have the potential for large capital gains. Others specialize in a particular industry segment such as technology stocks.

A Word About Derivatives

- Some funds may face special risks if they invest in derivatives. Derivatives are financial instruments whose performance is derived, at least in part, from the performance of an underlying asset, security or index. Their value can be affected dramatically by even small market movements, sometimes in unpredictable ways.
- There are many types of derivatives with many different uses. They do not necessarily increase risk, and may in fact reduce risk. A fund's prospectus will disclose how it may use derivatives. You may also want to call a fund and ask how it uses these instruments.

COMPARING DIFFERENT FUNDS

Once you identify the types of funds that interest you, it is time to look at particular funds in those categories.

Viewing Past Performance

A fund's past performance is not as important as you might think. Advertisements, rankings, and ratings tell you how well a fund has performed in the past. But studies show that the future is often different. This year's "number one" fund can easily become next year's below average fund. (Note: Although past performance is not a reliable indicator of future performance, volatility of past returns is a good indicator of a fund's future volatility.)

Tips for Comparing Performance

- Check the fund's total return. You will find it in the Financial Highlights, near the front of the prospectus. Total return measures increases and decreases in the value of your investment over time, after subtracting costs.
- See how total return has varied over the years. The Financial Highlights in the prospectus show yearly total return for the most recent 10-year period. An impressive 10-year total return may be based on one spectacular year followed by many average years. Looking at year-to-year changes in total return is a good way to see how stable the fund's returns have been.

Comparing Costs

Costs are important because they lower your returns. A fund that has a sales load and high expenses will have to perform better than a low-cost fund, just to stay even with the low-cost fund.

Find the fee table near the front of the fund's prospectus, where the fund's costs are laid out. You can use the fee table to compare the costs of different funds.

The fee table breaks costs into two main categories:

1. Sales loads and transaction fees (paid when you buy, sell, or exchange your shares), and
2. Ongoing expenses (paid while you remain invested in the fund).

Sales Loads

The first part of the fee table will tell you if the fund charges any sales loads.

No-load funds do not charge sales loads. When you buy no-load funds, you make your own choices, without the assistance of a financial professional. There are no-load funds in every major fund category. Even no-load funds have ongoing expenses, however, such as management fees.

When a mutual fund charges a sales load, it usually pays for commissions to people who sell the fund's shares to you, as well as other marketing costs. Sales loads buy you a broker's services and advice; they do not assure superior performance.

In fact, funds that charge sales loads have not performed better on average (ignoring the loads) than those that do not charge sales loads.

Terms to Know

Front-end load: A front-end load is a sales charge you pay when you buy shares. This type of load, which by law cannot be higher than 8.5% of your investment, reduces the amount of your investment in the fund.

Example: If you have \$1,000 to invest in a mutual fund with a 5% front-end load, \$50 will go to pay the sales charge, and \$950 will be invested in the fund.

Back-end load: A back-end load (also called a deferred load) is a sales charge you pay when you sell your shares. It usually starts out 5% or 6% for the first year and gets smaller each year after that until it reaches zero (say, in year six or seven of your investment).

Example: You invest \$1,000 in a mutual fund with a 6% back-end load that decreases to zero in the seventh year. Let's assume for the purpose of this example that the value of your investment remains at \$1,000 for seven years. If you sell your shares during the first year, you only will get back \$940 (ignoring any gains or losses). \$60 will go to pay the sales charge. If you sell your shares during the seventh year, you will get back \$1,000.

Ongoing Expenses

The second part of the fee table tells you the kinds of ongoing expenses you will pay while you remain invested in the fund. The table shows expenses as a percentage of the fund's assets generally for the most recent fiscal year. Here, the table will tell you the management fee (which pays for managing the fund's portfolio), along with any other fees and expenses.

High expenses do not assure superior performance. Higher expense funds do not, on average, perform better than lower expense funds. But there may be circumstances in which you decide it is appropriate for you to pay higher expenses. For example, you can expect to pay higher expenses for certain types of funds that require extra work by its managers, such as international stock funds, which require sophisticated research. You may also pay higher expenses for funds that provide special services, like toll-free telephone numbers, check-writing and automatic investment programs.

A difference in expenses that may look small to you can make a big difference in the value of your investment over time.

Example: Say you invest \$1,000 in a fund. Let's assume for the purpose of this example that you receive a flat rate of return of 5% before expenses. If the fund has expenses of 1.5%, after 20 years you would end up with roughly \$1,990. If the fund has expense of 0.5%, you would end up with more than \$2,410. This is a 22% difference.

Terms to Know

Rule 12b-1 fee: One type of ongoing fee that is taken out of fund assets has come to be known as a rule 12b-1 fee. It most often is used to pay commissions to brokers and other salespersons, and occasionally to pay for the advertising and other costs of promoting the fund to investors. It usually is between 0.25% and 1.00% of assets annually.

Funds with back-end loads usually have higher rule 12b-1 fees. If you are considering whether to pay a front-end load or a back-end load, think about how long you plan to stay in a fund. If you plan to stay in for six years or more, a front-end load may cost less than a back-end load. Even if your back-end load has fallen to zero, over time you could pay more in rule 12b-1 fees than if you paid a front-end load.

Tips for Comparing Costs

- Beware of a salesperson who tells you, “This is just like a no-load fund.” Even if there is no front-end load, check the fee table in the prospectus to see what other loads or fees you may have to pay.
- Check the fee table to see if any part of a fund’s fees or expenses has been waived. If so, the fees and expenses may increase suddenly when the waiver ends (the part of the prospectus after the fee table will tell you by how much).
- Many funds allow you to exchange your share for shares of another fund managed by the same adviser. The first part of the fee table will tell you if there is any exchange fee.

Shop wisely. Compare fees and expenses before you invest.

Reduced Sales Charges

Mutual funds often offer discounts on front-end sales charges or loads for larger investments. The investment levels at which the discounts become available are called “breakpoints.” For example, a mutual fund might charge you a front-end sales load of 5.75% for all purchases of less than \$50,000, but reduce the load to 4.50% for investments between \$50,000 and \$99,999, and further reduce or eliminate the sales load for even larger investments.

Mutual Fund Breakpoints

When your dollar amount of mutual fund purchases reaches a specified level, called a breakpoint, you are entitled to pay a smaller sales load. For example, a purchase of \$49,500 in mutual fund shares may be charged a front-end sales load of 5.75% or

\$2,846.25, while a purchase of \$50,000 in fund shares might be charged a sales load of 4.50% or \$2,250. In this example, by choosing to invest \$500 more in funds, you would have \$596.25 more invested in fund assets. Typically, there are several breakpoints, and if you invest more and reach each of these thresholds, the greater the reduction in the sales load.

You may be entitled to a lower front-end sales load based on a single mutual fund transaction if the dollar size of the transaction exceeds one or more breakpoints. In addition, you may become entitled to receive a breakpoint discount based on rights of accumulation or by using letters of intent.

Sample Breakpoint Schedule

Class A Shares (Front-end Sales Load)

| Investment Amount | Sales Load |
|-------------------------------------|------------|
| Less than \$25,000 | 5.0% |
| \$25,000 but less than \$50,000 | 4.25% |
| \$50,000 but less than \$100,000 | 3.75% |
| \$100,000 but less than \$250,000 | 3.25% |
| \$250,000 but less than \$500,000 | 2.75% |
| \$500,000 but less than \$1 million | 2.0% |
| \$1 million or more | 0.0% |

Rights of Accumulation

A right of accumulation (ROA) typically gives you a discount on your current mutual fund purchases by combining both your current and previous fund transactions to reach a breakpoint. For example, if you are investing \$10,000 in a fund today, but previously had invested \$40,000, those amounts can be combined to reach a \$50,000 breakpoint, which will entitle you to a lower sales load on your \$10,000 purchase.

Letter of Intent

What if you can’t immediately invest the minimum amount necessary to trigger a breakpoint discount? If you are planning to make additional investments over the coming months, you might still be able to obtain a reduced sales charge by means of a letter of intent (LOI). An LOI is a statement you sign that expresses your intent to invest an amount over the breakpoint within a given period of time specified by

the fund. Many fund companies permit you to include purchases completed within 90 days before the LOI is signed and within 13 months after the LOI is signed in reaching the dollar amount of the breakpoint threshold. If you expect to invest regularly in a fund with a front-end sales load, it's worth finding out if a LOI can help you qualify for a reduced charge.

Caution! If you fail to invest the amount stated in your LOI, the fund can retroactively collect the higher fee.

Family Discounts

In the case of either ROAs or LOIs, you usually may credit mutual fund transactions in other related accounts, in different mutual fund classes, or in different mutual funds that are part of the same fund family, toward your discounts. For example, a fund may allow you to get a breakpoint discount by combining your fund purchases with those of your spouse or children. You also may be able to credit mutual fund transactions in retirement accounts, educational savings accounts, or in accounts at other brokerage firms.

Each mutual fund and family of funds set their own breakpoints and the conditions through which discounts are available. These terms and conditions differ from one fund to another, and they also can change. You can find information on breakpoints in the mutual fund prospectuses or Statements of Additional Information and on many mutual fund company websites.

Protecting Yourself

There are a number of steps you can take to make sure you are paying the lowest possible price for a fund that charges a front-end sales load:

Understand how breakpoints work. Read the mutual fund prospectus or Statement of Additional Information, check a mutual fund company's website, or ask a financial professional for information on the terms and conditions of any available breakpoints. You can use the NASD's [mutual fund expense analyzer](#), located on the NASD Regulation website, www.nasdr.com, to calculate the impact of breakpoint discounts on your investment.

Review your mutual fund holdings. Before making a mutual fund purchase, review your account statements and those of your family to find amounts of investments in a particular mutual fund or family of funds to see if these transactions can be combined to obtain a breakpoint discount. Don't limit your review to accounts at a single brokerage firm. You may have related mutual fund holdings in accounts at other brokerage firms or with the mutual fund company itself that can help you reach a breakpoint discount.

Keep your broker informed. Be sure that you tell your broker about your mutual fund holdings and those of your family, **including holdings at other brokers** or with the mutual fund itself. Also tell your broker about any plans you may have for making any additional purchases. With this information, your broker can make sure you get all available breakpoint discounts.

OTHER SOURCES OF INFORMATION

Read the sections of the prospectus that discuss the risks, investment goals, and investment policies of any fund that you are considering. Funds of the same type can have significantly different risks, objectives and policies.

All mutual funds must prepare a Statement of Additional Information (SAI, also called Part B of the prospectus). It explains a fund's operations in greater detail than the prospectus. If you ask, the fund must send you an SAI.

You can get a clearer picture of a fund's investment goals and policies by reading its annual and semiannual reports to shareholders. If you ask, the fund will send you these reports.

You can also research funds at most libraries. Helpful resources include fund investment books, investor magazines and newspapers. The fund companies themselves can also provide information.

Remember: There are no guarantees in mutual fund investing. Inform yourself and exercise your judgement carefully before you invest.

Resource: Securities and Exchange Commission website; <http://www.sec.gov>