When you have completed this chapter, you will be able to:

**Section 10.1**
- Describe the characteristics of corporate bonds.
- Identify the reasons corporations sell bonds.
- Explain why investors buy corporate bonds.
- Discuss the reasons governments issue bonds.
- Identify the types of government bonds.

**Section 10.2**
- Identify sources of information for selecting bond investments.

**Section 10.3**
- Identify types of mutual funds.

**Section 10.4**
- Discuss sources of information for selecting mutual funds.
- Describe the methods of buying and selling mutual funds.

To get the most out of your reading:

**Predict** what you will learn in this chapter.

**Relate** what you read to your own life.

**Question** what you are reading to be sure you understand.

**React** to what you have read.
In the Real World . . .

When Julie Schmidt read her sample ballot, she noticed several government bond measures for everything from hiring new firefighters to building an elementary school. She was particularly interested in a bond measure that would pay for building an athletic facility and field at her former high school. She did not know much about government bonds, so she asked her local banker about them. The banker said they are almost risk-free as investments. She also learned that there are corporate bonds, which carry more risk but may earn more profit. So Julie decided to vote for the measure and invest in bonds.

As You Read  Consider investment options such as bonds and mutual funds.

Mutual Funds

Q: I have about $50 a month to invest. What is a good investment choice for me?

A: Many mutual fund companies offer systematic investment programs in which you invest the same amount each month regardless of changes in the share price. As a result, your money buys more shares when prices are low and fewer shares when prices are high. Over time, this strategy can result in a lower average cost per share; however, it does not guarantee a profit or protect against a loss.

Ask Yourself  Why is it a good idea to invest even a small amount of money each month?

@  Go to finance07.glencoe.com to complete the Standard & Poor’s Financial Focus activity.
Corporate and Government Bonds

Corporate Bonds

**What is a corporate bond?**

When you buy a corporate bond, you are basically loaning money to a corporation. As discussed in Chapter 8, a corporate bond is a corporation’s written pledge to repay a bondholder (the person who bought the bond) a specified amount of money with interest. Figure 10.1 on page 313 shows an example of a typical corporate bond. The bond’s interest rate, maturity date, and face value are stated on the bond. The **maturity date** is the date when a bond will be repaid. The **face value** is the dollar amount that the bondholder will receive at the bond’s maturity. Typically, the face value of a corporate bond is $1,000. However, corporate bonds can have face values as high as $50,000.

Between the date when you buy a bond and the maturity date, the corporation pays you annual interest at the rate stated on the bond. Interest is usually paid semiannually (twice a year). By multiplying the face value by the interest rate, you can calculate how much interest you would earn each year.

At the maturity date, you cash in the bond and receive a check in the amount of the bond’s face value. Maturities for bonds can range from 1 to 30 years. Maturities for corporate bonds are classified as short term (less than 5 years), intermediate term (5 to 15 years), and long term (more than 15 years).

**Types of Corporate Bonds**

There are several types of corporate bonds. These types include debentures, mortgage bonds, subordinated debentures, and convertible bonds.

**Debentures** Most corporate bonds are debentures. A **debenture** is a bond that is backed only by the reputation of the issuing corporation, rather than by its assets. Investors buy this type of bond because they believe that the company, or corporation, that issues them is on solid financial ground. Investors expect the company to repay the face value of the bond and make interest payments until the bond matures.
Mortgage Bonds  A bond issue occurs when a company makes available a quantity of bonds at one time. To make these bonds more appealing to conservative investors, a corporation may also issue mortgage bonds. A mortgage bond, sometimes referred to as a secured bond, is a bond that is backed by assets of a corporation. A mortgage bond is a safer investment than a debenture because it is backed by corporate assets. These assets, such as real estate or equipment, can be sold to repay the mortgage bondholders if the corporation fails to make good on its bonds. Though safer, mortgage bonds usually earn less interest than debentures because their risk to the investor is lower.

Subordinated Debentures  A subordinated debenture is a type of unsecured bond that gives bondholders a claim to interest payments and assets of the corporation only after all other bondholders have been paid. Because subordinated debentures are more risky than other bonds, investors who buy them usually receive higher interest rates than other bondholders.

Convertible Bonds  A convertible bond is a bond that an investor can trade for shares of the corporation’s common stock. Because of the unique flexibility that it offers investors, the interest rate on a convertible bond is often 1 to 2 percent lower than interest rates on other types of corporate bonds.

Many bondholders choose not to convert their bonds into stock even when stock values are high. The reason for this is simple: As the market value of a company’s common stock increases, the market value of the company’s convertible bonds also increases. Bondholders benefit from this increase in value while keeping the relative safety of a bond and its interest income.

Before You Read

What do you think government bonds are?
Methods Corporations Use to Repay Bonds

Today most corporate bonds are “callable,” which means they have a call feature that allows a corporation to buy back bonds from bondholders before the maturity date. Corporations may get the money to call a bond by selling stock, by using profits, or by selling new bonds at a lower interest rate.

For example, suppose that Mobil Corporation issued bonds at 8.5 percent, but later, interest rates on comparable bonds dropped to 4.5 percent. Mobil Corporation might decide to call the bonds it had issued at 8.5 percent. By buying back those bonds early, Mobil would not have to pay bondholders interest at that high rate.

**Premiums** Usually, companies agree not to call their bonds for the first five to ten years after the bonds are issued. When they do call their bonds, they may have to pay bondholders a premium. A premium is an additional amount above the face value of the bond. The amount of the premium is stated in a bond indenture, which details all the conditions pertaining to a particular bond issue.

**Sinking Funds** A corporation may use one of two methods to make sure that it has enough funds to pay off a bond issue. First, the corporation may set up a sinking fund. A *sinking fund* is a fund to which a corporation makes deposits for the purpose of paying back a bond issue. If the bond indenture states that the corporation will deposit money in a sinking fund, the company will be able to repay its bonds.
**Serial Bonds** Second, a corporation may issue serial bonds. **Serial bonds** are bonds issued at the same time but which mature on different dates. For example, Seaside Productions issued $100 million of serial bonds for a 20-year period. None of the bonds matured during the first ten years. Therefore, during that time the company did not have to pay anything but the interest owed on the outstanding bonds. Instead, Seaside Productions used the funds raised by selling the bonds to grow its business. After that, only 10 percent of the bonds matured each year until all the bonds were retired at the end of 20 years. That allowed Seaside Productions to repay its bonds a few at a time instead of having to repay all $100 million at once.

**Why Corporations Sell Bonds**

**What are a corporation’s responsibilities to its stockholders and to its bondholders?**

Corporations sell bonds to raise money when it is difficult or impossible to sell stock. Companies also often use bonds simply to finance regular business activities. Selling bonds can also reduce the amount of tax a corporation must pay because the interest paid to bondholders is tax-deductible.

A corporation may sell both bonds and stocks to help pay for its activities. However, the corporation’s responsibility to investors is different for bonds and for stocks. Bondholders must be repaid at a future date for their investments. Stockholders do not have to be repaid. Companies are required to pay interest on bonds. They can choose whether to pay dividends to their stockholders. Finally, if a corporation files for bankruptcy, bondholders’ claims to assets are paid before the claims of stockholders.

**As You Read**

Do you think that investing in corporate bonds would be a good way to reach your financial goals? Why?

**Secure Footing**

Mortgage bonds may be backed by a company’s real estate, stock, or machinery and equipment. **Why would an investor want to buy a mortgage bond?**
Why Investors Buy Corporate Bonds

Why are bonds considered safe investments?

Historically, stocks have resulted in greater profits than bonds. Why, then, should you consider investing in bonds? Many corporate and government bonds are safe investments. Some investors use corporate and government bonds to diversify their investment portfolios (all the securities held by an investor). Bonds offer you three other benefits:

- Most bonds provide interest income.
- Bonds may increase in value, depending on the bond market, overall interest rates in the economy, and the reputation and assets of the issuer.
- The face value of a bond is repaid when it reaches maturity.

Interest Income

Bondholders usually receive interest payments every six months. The dollar amount of annual interest is determined by multiplying the interest rate by the face value of the bond. The method used by a company to pay you interest depends on the type of corporate bond you purchase:

- Registered bond
- Coupon bond
- Bearer bond
- Zero-coupon bond

Registered Bonds  A registered bond is a bond registered in the owner’s name by the company that issues the bond. This ensures that only the owner can collect money from the bond. Interest checks for registered bonds are mailed directly to the bondholder.

Coupon Bonds  A registered coupon bond is a bond that is registered in the owner’s name for only the face value and not for interest. This type of bond comes with detachable coupons. Because the face value of the bond is registered, only the bond’s owner can collect the face value. However, anyone who holds the coupons can collect the interest. To collect an interest payment on a registered coupon bond, you simply present one of the detachable coupons to the issuing corporation or to the appropriate bank or broker.

Bearer Bonds  A bearer bond is a bond that is not registered in the investor’s name. As with registered coupon bonds, the owner of a bearer bond must present coupons in order to collect interest payments. Anyone who has physical possession of the bonds or their coupons can collect on them. A few bearer bonds are still in circulation, but they are no longer issued by corporations.

Savings Mind-Set

It is exciting when you get a raise or finally pay off a loan. You know you have more money available. Be a smart saver—stick to your current budget and stash that newfound money in your savings or investment account.

If you received a $30 per week raise in net pay and were paid four times per month, how much “extra” money would you have in ten months from February to November? Would you save or invest that money? Why or why not?
**Zero-Coupon Bond** A zero-coupon bond is a bond that does not produce interest payments. It is sold at a price far below its face value, but it is redeemed for its full face value at maturity. Because you buy it for less than its face value, you automatically make a profit when your zero-coupon bond is repaid.

**Market Value of a Bond**

Many beginning investors think that a $1,000 bond is always worth $1,000. Actually, the market value of a corporate bond may fluctuate before its maturity date. Usually, shifts in bond prices result from changes in overall interest rates in the economy.

For example, suppose that Vanessa has a bond with a 7.5 percent interest rate. If overall interest rates fall below 7.5 percent, Vanessa’s bond will go up in market value because it earns more interest than bonds issued at the new lower rate. If overall interest rates rise above 7.5 percent, the market value of Vanessa’s bond will fall because it earns less interest than bonds issued at the new, higher rate.

When a bond is selling for less than its face value, it is said to be selling at a discount. When a bond is selling for more than its face value, it is said to be selling at a premium. You can calculate a bond’s approximate market value by using a formula that compares the bond’s interest rate to that of similar new corporate bonds. (See Go Figure on page 312.)

Find the dollar amount of the bond’s annual interest by multiplying the face value by the annual interest rate. Then, compute the bond’s approximate market value by dividing the dollar amount of annual interest by the interest rate of comparable new corporate bonds.

The market value of a bond may also be affected by the financial condition of the company that issues it. In addition, the law of supply and demand changes in the economy and can affect a bond’s value.

---

**As You Read**

**QUESTION**

What type of investor would be interested in a zero-coupon bond?
**Repayment at Maturity**

Corporate bonds are repaid at maturity. After you purchase a bond, you have two choices. You can keep the bond until its maturity date and then cash it in. You can also sell the bond at any time to another investor. In either case, the value of the bond is closely tied to the corporation’s ability to repay it. Other investors will pay more money to get a quality bond that has solid prospects of repayment.

### A Typical Bond Transaction

**Where can you purchase corporate bonds?**

Most bonds are sold through full-service brokerage firms, discount brokerage firms, or online. If you use a full-service brokerage firm, your account executive should provide information and advice about bond investments. If you use a discount brokerage firm or buy bonds online, you must do your own research and make your own decisions. However, you will probably pay a lower commission.

You can also buy corporate bonds directly from account executives or brokerage firms. If you buy or sell a bond through an account executive or brokerage firm, you should expect to pay a commission.
Purchasing in Primary and Secondary Markets

Bonds are purchased in the same way as stocks. Corporate bonds may be purchased in the primary or secondary markets. In the primary market, you purchase financial securities from an investment banker representing the corporation or government agency that issued them. In the secondary market, you trade financial securities with other investors. Corporate bonds issued by large companies are traded on the New York Bond Exchange and American Bond Exchange.

Sample Bond Transaction

Figure 10.1 shows an example of a bond transaction—Ms. Mansfield’s Borden bond transaction. On October 8, 1995, Ms. Mansfield purchased an 8.375 percent corporate bond issued by Borden, Inc. She paid $680 for the bond plus a $10 commission ($680 + $10 = $690). On October 8, 2006, she sold it at its current market value of $1,030 minus a $10 commission ($1,030 – $10 = $1,020).

After paying commissions for buying and selling her Borden bond, Ms. Mansfield had a capital gain of $330 ($1,020 – $690 = $330). The market value of the bond increased because overall interest rates in the economy declined during the time she owned the bond. Borden also established a good business reputation during this period, making the bond more secure and, therefore, more valuable.

<table>
<thead>
<tr>
<th>Costs when purchased</th>
<th>Transaction summary</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 bond @ $680</td>
<td>Dollar return</td>
</tr>
<tr>
<td>Plus commission</td>
<td>$1,020.00</td>
</tr>
<tr>
<td>Total investment</td>
<td>Minus total investment</td>
</tr>
<tr>
<td>Return when sold</td>
<td>Profit from bond sale</td>
</tr>
<tr>
<td>1 bond @ $1,030</td>
<td>$330.00</td>
</tr>
<tr>
<td>Minus commission</td>
<td>Plus interest ($83.75 for 11 years)</td>
</tr>
<tr>
<td>Dollar return</td>
<td>921.25</td>
</tr>
</tbody>
</table>

Ms. Mansfield paid a commission fee when she bought her bond and again when she sold it.

How did these fees affect the cost of her investment and the profit she made from selling the bond?
Ms. Mansfield also made money on her Borden bond by collecting interest payments. For each of the 11 years she owned the bond, Borden paid her $83.75 ($1,000 \times 8.375\% = $83.75) in interest. By the time she sold the bond, she had received interest payments totaling $921.25. These earnings, together with her $330 capital gain, added up to a total return of $1,251.25.

**Government Bonds and Securities**

*Why does the government issue bonds and securities?*

Like private corporations, the federal government as well as state and local governments issue bonds to help raise the money they need to operate.

The federal government sells bonds and other securities to help fund its regular activities and services, and to finance the national debt. U.S. government securities are considered to be almost risk-free. They are backed by the full faith and credit of the United States government. However, because they have a low risk of default, which means failure to pay debts, government bonds offer lower interest rates than corporate bonds.

**Treasury Bills, Notes, and Bonds**

The U.S. Department of the Treasury issues three basic types of securities: Treasury bills (T-bills), Treasury notes, and U.S. government savings bonds. Treasury bonds, another type of security, were sold by the Treasury Department until October 2001.

You can buy Treasury bills and Treasury notes online through Treasury Direct, which is a Web site operated by the Department of the Treasury. When you buy through Treasury Direct, you do not have to pay a commission. You can also buy these securities through banks or brokers, which charge a commission for their services. U.S. government savings bonds can also be purchased through Treasury Direct, commercial banks, savings and loan associations, or other financial institutions.

You can hold U.S. government securities until maturity or cash before the maturity date. You must pay federal income tax on interest you receive from these investments. However, state and local governments do not tax this income.

**Treasury Bills**  Treasury bills are sold in units of $1,000. They may reach maturity in 4 weeks, 13 weeks, 26 weeks, or 52 weeks. T-bills are discounted securities. That means that the actual purchase price you pay when you buy a T-bill is less than the face value of the T-bill. On the maturity date, you receive the full face value of the T-bill. A T-bill held until maturity can be reinvested in another bill or can be paid to the owner.
To figure out the dollar amount of return on a T-bill, just subtract the purchase price of the T-bill from the face value. After you have determined the dollar amount of return on your T-bill, you can calculate the rate of return by dividing the dollar amount of return by the purchase price. (See Go Figure on page 316.)

**Treasury Notes** Treasury notes are issued in $1,000 units with a maturity of between one and ten years. Interest rates for Treasury notes are slightly higher than those for Treasury bills because investors must wait longer to get their money back.

**Treasury Bonds** As mentioned earlier, the Treasury Department no longer issues Treasury bonds. However, many are still in existence and may be purchased in the secondary market through a broker or other financial institution.

Treasury bonds were issued in minimum units of $1,000 with maturities that ranged from 10 to 30 years. The most common maturity is 30 years. Because of the length of time to maturity, interest rates for Treasury bonds are usually higher than those for Treasury bills or Treasury notes.

**Series EE Savings Bonds** As you learned in Chapter 5, the federal government also offers savings bonds called Series EE Savings Bonds. The purchase price for a Series EE bond is one-half of its face value. For example, a $100 bond costs $50. You can redeem a savings bond anytime from 6 months to 30 years after you purchase it. You receive the amount that you paid for it plus interest. Series EE bonds can accumulate interest for up to 30 years. The interest on Series EE bonds is not taxed by state or local governments. You do not pay federal taxes on the interest until you cash in the bond.
The federal government offers other types of savings bonds, too. The most popular bonds, Series I bonds, are inflation-indexed. This means that Series I bonds pay a fixed interest rate that is lower than the rate of traditional savings bonds, but they also pay a variable rate that increases with inflation. The inflation rate is measured by the Consumer Price Index, which measures the change in cost of a fixed group of products and services such as gasoline, food, and automobiles. The inflation rate for Series I bonds is recalculated twice a year. Series I bonds pay interest for up to 30 years. If you redeem the bond less than five years from the date purchased, there is a penalty of three months of earnings.

**Bonds Issued by Federal Agencies**

**What are agency bonds?**

In addition to the securities issued by the Department of the Treasury, bonds are issued by other federal agencies as well. Agency bonds, such as the participation certificates issued by the Federal National Mortgage Association (sometimes referred to as *Fannie Mae*) and the Government National Mortgage Association (sometimes referred to as *GinnieMae*), are almost completely risk-free. However, they offer a slightly higher interest rate than securities issued by the treasury department and have an average maturity of about 12 years. Generally, their minimum denomination is $25,000. Securities issued by federal agencies have maturities ranging from 1 year to 30 years, with an average life of about 12 years. You will learn more about these types of investments in Chapter 11, which discusses real estate and other investments.
State and local governments often finance major projects, such as schools, airports, and highways, by selling municipal bonds. Where can you buy municipal bonds?

Bonds Issued by State and Local Governments

What are the two classifications of municipal bonds?

A municipal bond, sometimes called a muni, is a security issued by a state or local government (town, city, or county) to pay for its ongoing activities. These bonds may also pay for major projects, such as the building of airports, schools, and highways. You can buy municipal bonds directly from the government that issues them or through an account executive.

State and local government securities are classified as either general obligation bonds or revenue bonds. A general obligation bond is a bond that is backed by the full faith and credit of the government that issued it. A revenue bond is a bond that is repaid from the income generated by the project it is designed to finance. For example, a municipal sports arena would generate profits that would repay the investors who bought the bond to build the arena.

Although these bonds are relatively safe, on rare occasions, governments have defaulted, or failed to repay, their bonds. If a government defaults, investors could lose millions of dollars.
Insured Municipal Bonds

If the risk of default worries you, you might consider buying insured municipal bonds. Some states offer to guarantee payments on these selected securities. Also, three large private insurers guarantee such bonds: MBIA, Inc.; the Financial Security Assurance Corporation; and the American Municipal Bond Assurance Corporation. Because of the reduced risk of default, insured municipal securities usually carry a slightly lower interest rate than uninsured bonds.

The interest on municipal bonds may be exempt from federal taxes. Tax-exempt status depends on how the funds generated by the bonds are used. Before you invest in a particular municipal bond, find out whether the interest that you will receive from it is taxable.

Like a corporate bond, a municipal bond may be callable by the government that issued it. In most cases, the municipality that issues the bond agrees not to call it for the first ten years. If your municipal bond is not called, you can hold the bond until the maturity date or sell it to another investor.

Section 10.1 Assessment

QUICK CHECK
1. What are three characteristics of bonds?
2. Why might the government or a company decide to issue bonds?
3. What are reasons investors buy bonds?

THINK CRITICALLY
4. Discuss ways in which securities issued by state and local governments are similar to corporate bonds.

USE COMMUNICATION SKILLS
5. Comparing Bonds You have decided to diversify your investment portfolio. To research, compare a type of corporate bond with a type of government security.

Write About It Write one or two paragraphs making a case for both bonds. Then write a one-paragraph summary describing which investment you think would be best for diversifying your portfolio.

SOLVE MONEY PROBLEMS
6. Personal and Financial Goals The county in which Marie Kilbane lives is selling bonds to finance a new storm sewer system. Marie knows that the storm sewers need replacing because her street was flooded last week. At the same time, she knows that her county is not very stable financially. She is not sure that the bonds are a good investment.

Analyze Use what you have learned about personal satisfaction and financial goals in previous chapters to help Marie decide what to do. Should she buy the bonds to help improve her community and her own personal living conditions, or should she invest her money in another way that has a better chance of helping her meet her financial goals? Explain your reasoning.
Investing in Bonds

Determining Investment Value

How do you determine the investment value of a bond?

Before you make a decision to include bonds in your investment portfolio, you must learn how to accurately determine the investment value of a bond. By understanding bond price quotations, researching various sources of information on bonds, checking bond ratings, and calculating the yield of your bond investment, you will be able to determine whether a bond is a good investment.

Bond Price Quotations

Before you buy or sell bonds, you should become familiar with bond price quotations. Not all local newspapers contain bond price quotations, but many metropolitan newspapers publish complete information on the subject. Two other valuable sources for bond information are The Wall Street Journal and Barron’s.

In a bond price quotation, the price of a bond is given as a percentage of its face value. Remember that a bond’s face value is usually $1,000. To find the current market value, or price, for a bond, you must multiply the face value ($1,000) by the price quotation given in the newspaper. For example, a price quoted as “84” means that the current market value is 84 percent of the face value. Therefore, the selling price is $840 ($1,000 \times 84\% = 840\% = 840). Purchases and sales of bonds are reported in tables. (See Figure 10.2 on page 320.)

For government bonds, most financial publications include two price quotations: the bid price and the asked price. The bid price is the amount a seller could receive for the bond. The asked price represents the amount a buyer could pay to purchase the bond. Newspaper bond sections also provide information about interest rates, maturity dates, and yields.

Sources of Information on Bonds

As a bondholder, you should always be aware of the financial stability of the issuer of your bonds. The most important questions are:

• Will the bond be repaid at maturity?
• Will you receive interest payments until maturity?

To help answer these questions, annual reports, the Internet, business magazines, and government reports are good resources.
Annual Reports

Annual reports provide detailed financial information about a company and its products, services, activities, goals, and future plans. You will also find news about the company’s position in its industry and the industry’s major trends. A typical annual report contains the following sections:

- Letter to stockholders from the chief executive officer
- Company highlights for the year
- Detailed company review for the year
- Financial statements
- Notes to financial statements
- Independent auditors’ report
- List of directors and officers
- Investor information
To receive an annual report, call, e-mail, or write to the corporation’s headquarters and request one. Many large companies have toll-free telephone numbers for customers. You may also find annual reports for major corporations on the Internet or in the reference section of some large libraries.

As you read an annual report, look for signs of financial strength or weakness and ask:

- Is the firm profitable?
- Are sales increasing?
- Are long-term liabilities increasing?
- How might the company’s current activities and future plans affect its ability to repay bonds?

The Internet  You can access a wealth of information about bond investments on the Internet. You will find answers to many of your questions on corporate Web sites, which typically offer information about the particular company’s financial performance. Some sites even include financial information from past years, which allows you to compare one year’s performance with another’s.

Other sites are devoted to general information about bonds. However, some bond Web sites charge a fee for their research and recommendations.

When investing in bonds, you can use the Internet to obtain price information on specific bond issues to track investments. If you live in a small town or rural area without access to newspapers that provide bond coverage, the Internet can be a good source of current bond prices. You also might visit Web sites operated by Standard & Poor’s or Moody’s to obtain detailed information about both corporate and government bonds.

Once your research is completed, you can even use the Internet to purchase bonds, to monitor the value of your bonds, and to manage your investments. If you trade bonds online, you might pay lower commissions than you would if you used a full-service or discount brokerage firm.

Business Magazines  Another way to research possible bond investments is by reading business magazines. They provide information about the overall economy and give detailed financial data about companies that issue bonds.

Government Reports and Research  You can also consult reports and research published by the government to track the nation’s economy. This information is available in printed form and on the Internet. If you want to buy U.S. Treasury bills or notes, or U.S. savings bonds, check Web sites run by the Federal Reserve System. In addition, you can review information from the Securities and Exchange Commission by accessing its Web site. State and local governments will also give you information about specific municipal bond issues upon request.

As You Read

What section of an annual report would be most important for you to read? Why?

Government

Federal, state, and local governments issue bonds to help raise money for various activities and to relieve debt. It is the job of the Bureau of the Public Debt, a division of the U.S. Department of the Treasury, to promote the sale of U.S. Savings Bonds. Research the Bureau of the Public Debt and write a paragraph about its origins and duties.
Before you invest in a particular corporate or municipal bond, you should check its rating. This rating will give you a good idea of the quality and risk associated with that bond. Bond issues are rated or evaluated by independent rating companies. These companies assign to each bond a rating based on the financial stability of its issuer.

Two of the best-known sources of bond ratings are *Moody’s Bond Survey*, published by Moody’s Investors Service, Inc., and *Standard & Poor’s Stock and Bond Guide*, published by Standard & Poor’s. Investors rely on this information when making investment decisions. You can also find bond ratings on the Internet, in financial magazines, and at your public library.
As you can see in Figure 10.3, bond ratings are generally categorized from AAA (the highest—the best) to D (the lowest—the worst). The top four categories (Moody’s Aaa, Aa, A, and Baa and Standard & Poor’s AAA, AA, A, and BBB) include investment-grade bonds. **Investment-grade bonds** are bonds that are issued by financially stable companies or municipalities. They are considered safe investments that will provide a predictable source of income.

Bonds in the next two categories (Moody’s Ba and B and Standard & Poor’s BB and B) are considered riskier, or speculative. Bonds in the C and D categories may be in default or cannot continue interest payments to bondholders.

U.S. government securities are usually not rated because they are basically risk-free. Long-term municipal bonds are rated in much the same way as corporate bonds. However, short-term municipal bonds are rated differently. Standard & Poor’s rates municipal bonds that have maturity dates of three years or less with the following system:

- **SP-1**: Strong ability to pay face value and interest (Bonds with very safe characteristics get a plus (+) sign.)
- **SP-2**: Satisfactory ability to pay face value and interest
- **SP-3**: Doubtful ability to pay face value and interest

**Yield of a Bond Investment**

To determine the return that a particular bond may produce, investors calculate and track its yield. The **yield** is the rate of return, usually stated as a percentage, earned by an investor who holds a bond for a certain period of time.

**CURRENT YIELD OF A BOND INVESTMENT**

**Synopsis:** Yield is the rate of return an investor earns. By calculating the current yield of a bond, you can determine the return on a bond.

**Example:** Suppose that you own a $1,000 AT&T corporate bond that pays 7.5 percent interest per year. This means that each year you will receive $75 in interest ($1,000 × 7.5% = $75). Assume that the current market value of the AT&T bond is $960. What is the current yield of your bond investment?

**Formula:**

\[
\text{Current Yield of a Bond} = \frac{\text{Dollar Amount of Annual Interest Income}}{\text{Current Market Value}}
\]

**Solution:**

\[
\frac{75}{960} = 0.078 \text{ or } 7.8\%
\]

The current yield is 7.8 percent.

**YOU FIGURE**

You receive $120 in interest each year on your $2,000 corporate bond. What is the current yield of your bond?
Learn to identify and understand the standard financial documents you will use in the real world.

Investigate: A Mutual Fund Account Statement

A mutual fund account statement contains the following information:
- Name of the fund
- Account number
- Beginning and ending share balance
- Activity since the last statement

Your Motive: When you invest in a mutual fund, you need to monitor how effectively your investment is growing. Periodically, you may find it necessary to sell a mutual fund and place your money in another mutual fund that has a potential to grow faster.

President's Group
P.O. Box 605, Springfield, NY 12345

Tanya Sawyer
5744 Pioneer Trail, Harrison, UT 54321

Account number: 6875430001

Account statement: DECEMBER 31, 2005

JEFFERSON MUTUAL INVESTORS FUND

<table>
<thead>
<tr>
<th>Trade Date</th>
<th>Description</th>
<th>Dollar Amount</th>
<th>Share Price</th>
<th>Shares This Transaction</th>
<th>Share Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>10/1/05</td>
<td>Beginning share balance</td>
<td>$34.20</td>
<td></td>
<td></td>
<td>721.273</td>
</tr>
<tr>
<td>10/19/05</td>
<td>Income dividend</td>
<td>$104.58</td>
<td>$34.20</td>
<td>3.058</td>
<td>724.331</td>
</tr>
<tr>
<td>11/11/05</td>
<td>Income dividend</td>
<td>$105.03</td>
<td>$33.45</td>
<td>3.140</td>
<td>727.471</td>
</tr>
<tr>
<td>11/28/05</td>
<td>Direct investment</td>
<td>$1,000.00</td>
<td>$34.70</td>
<td>28.818</td>
<td>756.289</td>
</tr>
<tr>
<td>12/05/05</td>
<td>Direct investment</td>
<td>$700.00</td>
<td>$32.26</td>
<td>21.699</td>
<td>777.988</td>
</tr>
<tr>
<td>Ending share balance</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>777.988</td>
</tr>
</tbody>
</table>

Ending value as of 12/31/05 was $25,097.89

Key Points: An account statement for a mutual fund will list your contributions and any dividends your account has earned. It will also tell you how many shares of the mutual fund you own and what the value of each is on a given day.

Find the Solutions

1. How many shares did Tanya have at the beginning of the period?
2. How is the Shares This Transaction amount calculated?
3. Why is the share price different for each transaction?
4. How is the ending value calculated?
5. Did the value of Tanya’s account grow or decline during this time period?
The simplest way to measure a bond’s yield is to calculate its current yield. To find the current yield of a bond, divide the dollar amount of annual interest income by its current market value. (See Go Figure on page 323 for an example.)

This calculation lets you compare the yield on a bond investment with the yields of other investment alternatives such as savings accounts, certificates of deposit, common stocks, preferred stocks, and mutual funds. If the current market value is higher than the bond’s face value, the current yield decreases. If the current market value is less than the bond’s face value, the current yield increases. The higher the current yield, the better the return is for the investor.

Investors may also consider the yield to maturity of a bond. This calculation takes into account the relationship between a bond’s maturity value, the time to maturity, the current price, and the dollar amount of interest. Like the current yield, the yield to maturity allows you to compare returns on a bond investment with other investments, which is another strategy to track and evaluate your investment finances.

**Section 10.2 Assessment**

**QUICK CHECK**

1. What are three pieces of information about corporate bonds that you could find in the bond section of a newspaper?
2. What information in a company’s annual report would be important to an investor who is interested in its corporate bonds?
3. How could you use the Internet to help you learn about investing in bonds?

**THINK CRITICALLY**

4. Identify two sources for bond ratings, and explain what a bond rating tells you about a bond.

**USE MATH SKILLS**

5. **Bond Quotations** Every day Elise looks at the bond section of The Wall Street Journal to see if she can get a good deal on a $1,000 bond and add it to her portfolio. This morning a price quotation of 98 for TechnoWiz, a telecommunications firm, caught her interest.

**SOLVE MONEY PROBLEMS**

6. **Calculating Bond Yields** Tom and Rika Nagata plan to retire in ten years. In 2004, they purchased three bonds:
   - Two 20-year AT&T corporate bonds, each with a face value of $1,000 and 7 percent annual interest. The purchase price was $830 each. The current market value is $910 each.
   - A 30-year Coca-Cola corporate bond, with a face value of $1,000 and 8.5 percent annual interest. The purchase price was $1,050. The current market value is $1,020.

   Calculate To plan ahead, Tom and Rika need to know the current yield on their bonds. Use the formula in this section to calculate the current yield on their bond investments.
Mutual Funds

Defining Mutual Funds

What are mutual funds?

Mutual funds are an excellent choice for many investors. A mutual fund is an investment alternative in which investors pool their money to buy stocks, bonds, and other securities based on the selections of professional managers who work for an investment company. By buying shares in a mutual fund, even an investor with limited resources can own part of an entire portfolio of diverse securities. These funds can also be used for retirement accounts, such as 401(k) and 403(b) plans, individual retirement accounts (IRAs), and Roth IRAs, which are discussed in Chapter 15.

Why Investors Buy Mutual Funds

What is a key benefit of purchasing a mutual fund?

One major reason for purchasing a mutual fund is professional management. Investment companies employ professional fund managers who try to pick the best securities for their mutual fund portfolios. However, this can lead some investors to become careless. Many mutual fund investors assume that their investments will increase in value. They might not research and evaluate funds carefully before they buy. They may also neglect to keep track of the performance of the funds they own. Even the best portfolio managers make mistakes. Therefore, wise investors should monitor and review their mutual funds regularly.

Another key reason for buying a mutual fund is diversification. Mutual funds include a variety of securities, which reduces the shareholders’ risk. An occasional loss from one investment in a mutual fund is usually offset by gains from other investments in the same fund. Researching and tracking the right mutual fund can provide great results with less effort than it would take to maintain such a diverse portfolio on your own.

Because of these advantages, mutual funds have become extremely popular investments. In 1970, there were 361 mutual funds. By 2003, there were more than 8,300 mutual funds, and the combined assets owned by mutual funds in the United States were worth more than $6 trillion. In the month of April 2003 alone, investors poured more than $16.1 billion into mutual fund investments. Read the material in this section to see if mutual funds are right for you.
Types of Mutual Funds

What is the difference between a closed-end and an open-end fund?

An investment company is a firm that invests the pooled funds of many investors in various securities. The firm receives fee for this service. Mutual funds managed by investment companies are classified as either closed-end funds or open-end funds.

Closed-End Funds

About 6 percent of all mutual funds are closed-end funds offered by investment companies. A closed-end fund is a mutual fund with a fixed number of shares that are issued by an investment company when the fund is first organized. After all the original shares have been sold, an investor can buy shares only from another investor. Shares of closed-end funds are traded (bought and sold) on the floors of stock exchanges or in the over-the-counter market. A special section of The Wall Street Journal provides information about closed-end funds.

Open-End Funds

Most mutual funds are open-end funds. An open-end fund is a mutual fund with an unlimited number of shares that are issued and redeemed by an investment company at the investors’ request. Shares of open-end funds are bought and sold on any business day by contacting the investment company that manages the mutual fund.

GREAT TIP Mutual funds can be wise investments for people who have limited time and limited funds to invest. Why might a mutual fund be a good choice for such an investor?
**Net Asset Value**  Investors are free to buy and sell shares at the net asset value. The net asset value (NAV) is the amount that one share of a mutual fund is worth. To calculate the net asset value of a mutual fund, subtract the fund’s liabilities from the value of the fund’s portfolio, and divide the result by the number of shares outstanding. Shares outstanding are the number of shares held by all the investors.

**Services**  If you buy shares of an open-end fund from an investment company, you gain access to a wide variety of services. These services include payroll deduction programs, automatic reinvestment programs, and automatic withdrawal programs.

**Load Funds**  
Before investing in any mutual fund, compare its cost or fees with the cost of other types of investments. Mutual funds are classified as either load funds or no-load funds. A load fund (sometimes referred to as an “A” fund) is a mutual fund for which you pay a commission every time you buy or sell shares. The commission, or sales charge, can be as high as 8.5 percent. The average load charge for mutual funds is between 3 and 5 percent. The supposed advantage of a load fund is that the fund’s representatives, such as account executives and financial planners, will offer advice and guidance about when shares of the fund should be bought or sold.
No-Load Funds

A **no-load fund** is a mutual fund that has no commission fee. No-load funds do not charge commissions when you buy shares because they have no salespeople. No-load funds offer the same investment opportunities as load funds. If you have a choice between a load fund and a no-load fund, and both offer the same investment opportunities, choose the no-load fund.

Management Fees and Other Charges

The investment companies that sponsor mutual funds also charge management fees. This fee is a fixed percentage of the fund’s asset value. The fees generally range from 0.5 to 1.25 percent of the fund’s assets.

Instead of charging investors a fee when they purchase shares, some mutual funds charge a back-end load, which is a fee that is charged for withdrawing money from the fund. Fees range from 1 to 5 percent and are based on how long you own shares of the mutual fund. A back-end load is designed to discourage early withdrawals. A 12b-1 fee is a fee that an investment company charges to help pay for the marketing and advertising of a mutual fund. It is approximately 1 percent of a fund’s assets per year.

Careers in Finance

**CERTIFIED FINANCIAL PLANNER**

Matt Tucker

*Self-Employed*

Matt enjoys helping people reach their goals in life. He advises individuals and companies about managing their money wisely and effectively. He interviews his clients to determine their assets, liabilities, cash flow, insurance coverage, tax status, and financial objectives. Then he identifies and analyzes their income, spending, and investment patterns to develop a customized financial plan. Plans may include investment strategies, securities, insurance, pension plans, real estate, and tax strategies. Matt is self-employed, but certified financial planners may work for credit unions, banks, and other companies.

**SKILLS:** Communication, math, economic, financial, and customer-service skills

**PERSONAL TRAITS:** Good listener, people-oriented, detail-oriented, trustworthy, discreet, honest, and tactful

**EDUCATION:** Bachelor’s degree; Certified Financial Planner (CFP) or Chartered Financial Consultant (ChFC) designation

**ANALYZE** What sort of company might need help from a certified financial planner?

@ To learn more about career paths for certified financial planners, visit finance07.glencoe.com.
Categories of Mutual Funds

What are the three main groups of mutual funds?

The managers of mutual funds match their investment portfolios to the investment objectives of their customers. Usually a fund’s objectives are clearly explained in its prospectus—a report that provides potential investors with detailed information about a company and its products, such as a particular mutual fund. It can be helpful to sort mutual funds into three main groups: stock mutual funds, bond mutual funds, and mixed mutual funds. Within each group, mutual funds may fall into one of many categories. Note that different sources of investment information may use different categories for the same mutual fund.
Stock Mutual Funds

Most mutual funds are part of the stock mutual funds group. Stock mutual funds are made up of stocks. These funds fall into 14 categories, which describe the fund objectives and types of stock.

**Aggressive Growth Funds**  Aggressive growth funds (sometimes called *capital appreciation funds*) seek to grow money rapidly by investing in stocks whose prices will increase greatly in a short period of time. Because the stocks are often risky, the market value of shares in this type of fund frequently swings between low and high.

**Equity Income Funds**  Equity income funds include stocks issued by companies with a long history of paying dividends. The major objective of these funds is to provide steady income. These funds are investment choices for conservative or retired investors.

**Global Stock Funds**  Global stock funds invest in stocks of companies throughout the world, including the United States. The managers of global funds are not restricted by national boundaries.

**Growth Funds**  Growth funds buy shares of companies expecting higher-than-average revenue and earnings growth. Growth funds tend to invest in larger, less risky companies that may pay some dividends. As a result, the market value of shares in a growth fund is more stable when compared to aggressive growth funds.

**Growth and Income Funds**  Growth and income funds purchase stocks that provide both a steady source of dividend income and the potential for growth. These funds are considered conservative because they invest in large, established companies.

**Index Funds**  Index funds include stocks of companies that are listed in an index such as Standard & Poor’s 500 Stock Index. Fund managers select stocks issued by the companies that are included in the index. Thus, an index fund should provide about the same performance as the index. Index funds may have lower management fees.

**International Funds**  International funds include foreign stocks that are sold in securities markets throughout the world. That way, if the economy in one region or nation is in a decline, profits can still be earned in others. Such funds invest outside of the United States.

**Large-Cap Funds**  Large-cap funds generally invest in companies with market values greater than $8 billion. For most investors, a large-cap fund is a long-term holding used for retirement savings.

**Mid-Cap Funds**  Mid-cap funds include stocks of companies with total assets of at least $500 million. Mid-cap funds offer more security than small-cap funds and more growth potential.

**Small-Cap Funds**  Small-cap funds include shares of small, innovative companies with total assets of less than $500 million. They offer high growth potential but are riskier.
**Micro-Cap Funds**  As the name suggests, micro-cap funds invest in the smallest companies. Micro-cap funds buy shares of companies with market values below $250 million. These funds tend to include start-up companies, takeover companies, or companies about to exploit new growing markets. With stocks this small, the risk is always extremely high, but the growth potential is exceptional.

**Regional Funds**  Regional funds include stocks that are traded within one region of the world. Examples include the European region, the Latin American region, and the Pacific region.

**Sector Funds**  Sector funds invest in companies within the same industry. Examples of sectors include health and biotechnology, science and technology, computers, and natural resources.

**Utility Funds**  Utility funds include stocks of companies that provide utility services to their customers. Because these funds are generally safe and stable investments, they are often chosen by conservative investors, such as retired people.

**Bond Mutual Funds**

Mutual funds in the bond mutual funds group invest only in bonds. The bond fund categories are based on the type of bond the mutual funds purchase.

**High-Yield (Junk) Bond Funds**  High-yield (junk) bond funds invest in high-yield, high-risk corporate bonds.

**Insured Municipal Bond Funds**  Insured municipal bond funds include municipal bonds that provide tax-exempt income. An outside company insures them against the risk of default, or nonpayment.

**Intermediate Corporate Bond Funds**  Intermediate corporate bond funds invest in investment-grade corporate bonds that have maturities between five and ten years.

**Intermediate U.S. Bond Funds**  Intermediate U.S. bond funds include U.S. Treasury notes that have maturities between five and ten years.

**Long-Term Corporate Bond Funds**  Long-term corporate bond funds buy investment-grade corporate bonds that have maturities of more than ten years.

**Long-Term U.S. Bond Funds**  Long-term U.S. bond funds include U.S. Treasury bonds and zero-coupon bonds that have maturities of longer than ten years.

**Municipal Bond Funds**  Municipal bond funds invest in municipal bonds that provide investors with tax-exempt interest income.

**Short-Term Corporate Bond Funds**  Short-term corporate bond funds include investment-grade corporate bond issues that have maturities of between one and five years.
Short-Term U.S. Bond Funds  
Short-term U.S. bond funds invest in U.S. Treasury bills and some Treasury notes that have maturities of between one and five years.

Mixed Mutual Funds

Other mutual funds are part of a third group—mixed mutual funds. These funds invest in a mix of stocks and bonds or in various other types of securities. The funds fall into three categories: balanced funds, money-market funds, and stock/bond blend funds.

Global Financial Landscape

BRAZIL

Latin America is “Hot, hot, hot!” but it is not due to the climate. This enthusiastic description refers to the region’s financial markets. Although stocks in a number of Latin countries have been riding high, Brazil has been the “darling of the investing public.” Since the Brazilian president made a number of economic reforms in 2003, the stock market has soared. The easy money—over 100 percent return—may have been made already. Some stocks, however, still show promise. Brazil’s Petrobras, a state-run oil giant, is a favorite, especially with the increasing cost of fuel. AmBev, the country’s only Pepsi distributor, is another popular stock. For the more conservative investors, advisors suggest mutual funds as the safest way to go.

Think Globally

What type of mutual fund would include stocks from Brazilian companies? Would that fund be a good investment choice? Why or why not?
Balanced Funds  Balanced funds include both stocks and bonds to provide income while avoiding excessive risk. Often the percentage of stocks and bonds is stated in the fund’s prospectus.

Money-Market Funds  Money-market funds invest in certificates of deposit, government securities, and other safe investments. It is relatively easy to withdraw money from a money-market fund.

Stock/Bond Blend Funds  Stock/bond blend funds invest in both stocks and bonds, enabling investors to diversify their holdings with a single fund.

Variety of Funds  A variety of mutual funds managed by one investment company is called a family of funds. Each mutual fund within the family has a different financial objective. For instance, one fund may be a short-term U.S. bond fund and a growth stock fund. Most investment companies make it easy for shareholders to switch among the mutual funds within a family. This allows investors to adjust their investments conveniently to suit their changing needs or to maximize their profits over time.

As You Read

QUESTION

Which of these investments, stock, bond, or mixed mutual funds, do you think would be a good investment? Why?

Section 10.3 Assessment

QUICK CHECK

1. What are the characteristics of closed-end mutual funds?
2. What is an open-end mutual fund?
3. What are three categories of funds that fall under the bond mutual fund group?

THINK CRITICALLY

4. Choose three categories of stock or bond funds in which you think you might like to invest. Explain why you think they are good investments.

USE MATH SKILLS

5. Load Fund  Noah is thinking about investing $1,000 in a global mutual fund. However, the fund is a load fund, which charges a commission of 8.5 percent. The investment company would deduct this fee from Noah’s $1,000 before his money is invested in the fund.

Calculate and Advise  What is the dollar amount of the commission that Noah must pay the investment company to invest in this fund? Should he look for a no-load fund? Why or why not?

SOLVE MONEY PROBLEMS

6. Fund Objectives  Hilda wants to invest her savings in a mutual fund, but she is concerned about the risk of investing. She wants a fund that is stable and safe. Her friend Ana recommends that she consider utility funds and money-market funds. Her friend Jack says she should explore aggressive growth funds and high-yield (junk) bond funds.

Write About It  Review the characteristics of utility funds, money-market funds, aggressive growth funds, and high-yield (junk) bond funds. Write down a list of the objectives for these funds. Whose advice is best? Why?
Investing in Mutual Funds

Making an Informed Decision

What steps can you take to decide on mutual fund investments?

Which mutual funds are best for you? When should you buy or sell your shares? You will have to answer these questions for yourself. However, by considering your financial goals and consulting various sources of information on mutual funds, you will be able to determine the best approach for investing in mutual funds.

Considering Your Financial Goals

You can consider several questions when you are in the process of identifying your investment goals:

- How old are you?
- What is your family situation?
- How much risk do you want to take?
- How much money do you make now?
- How much money are you likely to make in the future?

After you have considered these factors and answered these questions, you can set your investment goals. Once you know your goals, find a mutual fund with investment objectives that match your own.

Information on Mutual Funds

You will find a great deal of information that can guide you through the decision-making process of buying or selling shares in a mutual fund. The main sources of information on mutual funds include:

- Newspapers
- Quotations
- Prospectuses
- Annual reports
- Financial publications
- Professional advice
- Internet

Newspapers Metropolitan newspapers and financial newspapers, such as The Wall Street Journal and Barron’s, provide a wealth of information.
How to Read the Monthly Performance Tables

Performance tables are provided by Lipper, Inc. These tables include all primary funds listed by NASDAQ. Bond performance numbers are preliminary. Though verified, the data cannot be guaranteed by Lipper or its data sources. Double-check with funds before investing.

Performance calculations assume reinvestment of all distributions and are after subtracting annual expenses. But figures do not reflect sales charges (“loads”) or redemption fees.

**TOTAL RETURN**
Change in net asset value with reinvestment of all distributions, including dividends, for the period, in percent. Percentages are annualized for periods longer than one year. Calculations are based on latest data from fund.

**MAXIMUM INITIAL SALES COMMISSION**
In percent. Based on prospectus.

**ANNUAL EXPENSES**
Shown as a percentage, based on fund annual report. Covers all asset based charges including distribution (12b-1) fee.

**RANKING**
Compares performance among funds with same investment objectives and then ranked for time periods listed.

- A = top 20%; B = next 20%; C = middle 20%; D = next 20%; E = bottom 20%

**FUND OBJECTIVE**
Compare performance among funds with same investment objectives and then ranked for time periods listed.

- A = top 20%; B = next 20%; C = middle 20%; D = next 20%; E = bottom 20%

---

**Quotations**
As shown in Figure 10.4, mutual fund quotations contain information about a fund’s net asset value, objective, performance, and cost. When you read mutual fund quotations, remember to note any letters beside the name of a specific fund. Then look up their meanings in the quotation footnotes.
**Mutual Fund Prospectuses**  After you have narrowed your search, check out the prospectuses of the mutual funds that most interest you. To get a copy of a prospectus, call, write, or e-mail the investment company that manages the mutual fund. Many investment companies have toll-free telephone numbers that you can find by calling the toll-free information number (1-800-555-1212). An investment company sponsoring a mutual fund must give a potential investor a prospectus when requested.

Read the prospectus completely before you invest. The prospectus summarizes the fund and lists any fees you will have to pay. The prospectus usually provides the following information:

- A description of the fund’s objective
- The risk factor associated with the fund
- A fee table
- A description of the fund’s past performance
- A description of the type of investments contained in the fund’s portfolio
- Information about dividends, distributions, and taxes
- Information about the fund’s management
- Information on limitations or requirements the fund must honor when choosing investments
- The process by which investors can buy or sell shares of the mutual fund
- A description of services provided to investors
- Fees for services
- Information about how often the fund’s investment portfolio changes (sometimes referred to as *turnover ratio*)
- Information about how to open a mutual fund account

**Mutual Fund Annual Reports**  If you are a potential investor, you may request an annual report by mail, telephone, or e-mail. When you become a shareholder, the investment company will automatically send you an annual report. Annual reports may also be posted on a company’s Web site. A fund’s annual report contains a letter from the president of the investment company, the fund manager, or both.

Do not forget the role of the fund manager in determining a fund’s success. If a fund’s present manager has been doing a good job for five years or longer, chances are that he or she will continue to perform well in the future.

The annual report contains detailed financial information about the fund’s assets and liabilities. It also includes a statement of operations that describes expenses and day-to-day operating costs of the fund, a statement of changes in net assets, and a schedule of investments.

Finally, most annual reports include a letter from the fund’s independent auditors. This letter backs up the accuracy of the information contained in the report.
**Mutual Fund Scoreboard**

**Equity Funds**

**How to use the tables**

**BUSINESSWEEK RATINGS** Overall ratings are based on five-year, risk-adjusted returns. They are calculated by subtracting a fund’s risk-of-loss factor (see RISK) from pretax total return. Category ratings are based on risk-adjusted returns of the funds in that category. The ratings:

- **A SUPERIOR**
- **B+ VERY GOOD**
- **B ABOVE AVERAGE**
- **C BELOW AVERAGE**
- **D POOR**
- **F VERY POOR**

**S&P 500 COMPARISON** The pretax total returns for the Standard & Poor’s 500-stock index are as follows: 2004, 10.9%; three-year average (2002-2004), 3.6%; five-year average (2000-2004), –2.3%; 10-year average (1995-2004), 12.1%.

**CATEGORY** U.S. diversified funds are classified by market capitalization of the stocks in the portfolio and by the nature of those stocks.

<table>
<thead>
<tr>
<th>Fund/Symbol</th>
<th>Overall Rating</th>
<th>Size</th>
<th>Fees</th>
<th>2004 Returns (%$)</th>
</tr>
</thead>
<tbody>
<tr>
<td>ABN AMRO MID CAP N CHTTX</td>
<td>B+ Mid-cap Blend</td>
<td>A</td>
<td>423.9 130</td>
<td>No load</td>
</tr>
<tr>
<td>ABN AMRO REAL ESTATE N ARFX</td>
<td>A Real Estate</td>
<td>C</td>
<td>76.6 51</td>
<td>No load</td>
</tr>
<tr>
<td>ABA FIVE STAR LARGE CAP INSTITUTIONAL AFEX</td>
<td>Large-cap Growth</td>
<td>A</td>
<td>20.3 –1</td>
<td>No load</td>
</tr>
<tr>
<td>AFRE FIVE STAR USA GLOBAL INSTITUTIONAL AFQLX</td>
<td>Large-cap Growth</td>
<td>A</td>
<td>40.0</td>
<td>No load</td>
</tr>
<tr>
<td>AIM ENERGY INV. FTEX (A)</td>
<td>Natural Resources</td>
<td>B</td>
<td>311.1 52</td>
<td>No load</td>
</tr>
<tr>
<td>AIM GOLD &amp; PRECIOUS METALS INV. FGLDX (b)</td>
<td>Precious Metals</td>
<td>A</td>
<td>117.8 –1</td>
<td>No load</td>
</tr>
<tr>
<td>AIM REAL ESTATE A IARAX</td>
<td>A Real Estate</td>
<td>B+</td>
<td>625.3 147</td>
<td>4.75</td>
</tr>
<tr>
<td>AEGIS VALUE AVALX</td>
<td>Small-cap Value</td>
<td>B+</td>
<td>815.2 92</td>
<td>No load</td>
</tr>
<tr>
<td>AL FRANK VALUX</td>
<td>Mid-cap Value</td>
<td>B+</td>
<td>244.0 103</td>
<td>0.00*</td>
</tr>
<tr>
<td>ALLIANCE BERNSTEIN REAL ESTATE INV. ADV. ARSYX</td>
<td>A Real Estate</td>
<td>B</td>
<td>159.3 56</td>
<td>No load</td>
</tr>
</tbody>
</table>

**SALES CHARGE** Many funds take this “load” out of the initial investment, and for ratings purposes, returns are reduced by these charges. Loads may be levied on withdrawals.

**EXPENSE RATIO** This counts expenses as a percentage of average net assets. Footnotes indicate a 12(b)-1 plan, which uses shareholder money for marketing. The average is 1.38%.

**PRETAX TOTAL RETURN** A fund’s net gain to investors, including reinvestment of dividends and capital gains at month-end prices.

**AFTER TAX TOTAL RETURN** Returns adjusted for U.S. taxes; treats all capital gains and long-term.

**YIELD** Income as a percent of net asset value.

**Source:** Reprinted from the January 24, 2005, issue of BusinessWeek by permission. © 2005 McGraw-Hill Companies, Inc.

**Fund Scores**

Every year BusinessWeek magazine publishes and rates equity funds based on performance and risk.

Besides ratings, what other types of information does this survey provide?

**Financial Publications** Financial magazines such as BusinessWeek, Forbes, Kiplinger’s Personal Finance, and Money are sources of information about mutual funds. These publications provide annual surveys and rankings of mutual funds, such as the example from BusinessWeek magazine shown in Figure 10.5.

In addition to annual surveys, a number of mutual fund guidebooks are available at bookstores or your local public library.
This report shows the type of information that Morningstar.com provides to an investor who is interested in the T. Rowe Price Equity Income Fund.

**Online Information**

What can you learn by reading the section titled “Performance” at the top of the Web page?
**Professional Advice** Professional advisory services also provide detailed information on mutual funds (see Figure 10.6). Popular sources include Standard & Poor’s, Lipper Analytical Services, Morningstar, Inc., Value Line, and Wiesenberger Investment Companies. In addition, various mutual fund newsletters provide financial information to subscribers for a fee. These publications are expensive, but you may be able to obtain copies of them from brokerage firms or public libraries.

Professional advisory services, such as Morningstar, also offer online research reports for mutual funds. Many investors find that the research reports provided by such companies are worth the fees they charge. The information is basically the same as that in the printed reports. However, the ability to obtain the information quickly can be a real advantage.

**Internet** Many investors research mutual fund investments on the Internet. You may access this information online by one of several methods. If you know the name or the four- or five-letter symbol for a fund, you may obtain current market values by using Web sites such as Yahoo! Finance. You can also get a price history and a profile.

Most investment companies that sponsor mutual funds have Web sites. These sites are another source of useful information. To obtain information, use a search engine, such as Google, and type in the name of the fund. You will find information regarding statistics about individual funds, procedures for opening an account, promotional literature, and investor services. However, investment companies want you to become a shareholder, and therefore, their Web-site material may read like a sales pitch. Look at the facts before you invest your money.

**Go Figure**

**FINANCIAL MATH**

**CAPITAL GAIN**

**Synopsis:** Capital gain is the amount by which a share’s selling price exceeds its purchase price. Determining the capital gain that you will receive when you sell the shares of your mutual fund will tell you how much the return on your investment will be.

**Example:** Sani purchased shares in the Fidelity Stock Selector Fund at $17 per share. Two years later, Sani sold the shares at $19.50 per share. What was the capital gain per share on Sani’s mutual fund?

**Formula:**

\[
\text{Capital Gain per Share} = \frac{\text{Sales Price}}{\text{Purchase Price}} - 1
\]

**Solution:**

\[
\frac{19.50}{17.00} - 1 = 2.50
\]

The capital gain per share on Sani’s mutual fund was $2.50.

**YOU FIGURE**

If you purchased mutual fund shares at $8.50 each and sold them for $11 per share, what would be your capital gain?
Return on Investment
What is the difference between a capital gain distribution and a capital gain?

Whether you choose a closed-end fund or an open-end fund, the purpose of investing in a mutual fund is to receive income. As a mutual fund shareholder, you may gain income in one of three ways.

First, you may receive income dividends. Income dividends are the earnings a fund pays to shareholders. Second, you may earn capital gain distributions. Capital gain distributions are payments made to shareholders that result from the sale of securities in the fund’s portfolio. Third, you may make a good return by buying shares at a low price and then selling them after the price increases.

When you sell shares in a mutual fund, the profit that results from an increase in value is referred to as a capital gain. As discussed in Chapter 8, a capital gain is the profit from the sale of an asset such as stocks, bonds, or real estate. Of course, if the price of a fund’s shares goes down between the time of purchase and the time of sale, you lose money. Note the difference between a capital gain distribution and a capital gain. A capital gain distribution occurs when the fund sells securities within the fund’s portfolio and distributes profits to shareholders. A capital gain occurs when the shareholder sells some of his or her shares in the mutual fund.

Taxes and Mutual Funds
How are mutual fund earnings taxed?

Income dividends, capital gain distributions, and capital gains are all taxable earnings. At the end of every year, investment companies and brokerage firms send each shareholder a statement detailing the income dividends and capital gain distributions he or she received. Usually, this information is provided on the IRS Form 1099DIV. However, the investor is responsible for maintaining clear and accurate records of the purchase and sale prices. The following are some general guidelines on how mutual fund transactions are taxed:

- Income dividends are reported along with all other dividend amounts you have received. They are taxed as regular income.
- Capital gain distributions are reported on your federal income tax return.
- Capital gains or losses that result from your selling shares in a mutual fund are reported on your federal income tax return.

You should be aware of two factors when you pay taxes on your mutual funds. First, almost all investment companies allow you to reinvest the capital gains distributions and income dividends you earn instead of receiving cash. These distributions are taxable and must be reported on your income tax return. Second, you decide when to sell your stocks or bonds.
Thus, you can pick the tax year when you pay tax or deduct losses on these investments. Mutual funds, on the other hand, buy and sell securities on a regular basis during any 12-month period. Unlike investments that you manage, you have no control over when the mutual fund sells securities. Therefore, you have no control over when you are taxed on capital gain distributions.

**Buying and Selling Mutual Funds**

*How do you buy and sell mutual funds to help you meet your financial goals?*

The main reason for investing is the opportunity to make money on your investment. Mutual funds can provide investors with income dividends, capital gain distributions, and profits that result from their decision to sell their shares. Various purchase options and withdrawal options allow you to manage your mutual fund investments and profits to help you meet your financial goals.
Purchase Options

Before you buy shares in a fund, you will need to consider several different purchase options. As discussed earlier in this chapter, different types of funds are sold by different means. Closed-end funds are traded through stock exchanges, such as the New York Stock Exchange or in the over-the-counter market. You can purchase shares of an open-end fund from a brokerage firm or by contacting the investment company that sponsors the fund.

A wide variety of both no-load and load funds can also be bought from mutual fund supermarkets that are available through brokerage firms such as Charles Schwab and E*Trade. Mutual fund supermarkets offer at least two advantages. First, instead of dealing with several investment companies, you can make one toll-free phone call to buy or sell a large number of mutual funds. Second, you receive one statement from the brokerage firm instead of receiving a statement from each investment company. This statement provides the information that you need to monitor all of your investments in one place and in the same format.

When you buy shares in an open-end mutual fund from an investment company, you have several purchase options. You can choose a regular account transaction, a voluntary savings plan, a payroll deduction plan, a contractual savings plan, or a reinvestment plan.

Regular Account Transactions A regular account transaction is the most popular and least complicated way to buy shares. With this method you decide how much money to invest and when to invest it. Then you simply buy as many shares as possible.

Voluntary Savings Plans A voluntary savings plan lets you make smaller purchases than the minimum required by the regular account transaction. However, when you make your first purchase, you also must commit to making regular minimum purchases of the fund’s shares. Such small monthly investments can be a great way to save for long-term objectives. For most voluntary savings plans, the minimum purchase ranges from $25 to $100.

Payroll Deduction Plans Most voluntary savings plans also offer payroll deduction plans. This means that with your approval, the investment company will deduct a certain amount from your paycheck each month and invest it in your mutual fund. Mutual fund savings plans can also be used to invest money that is contributed to tax-deferred 401(k) and 403(b) retirement plans or individual retirement accounts (IRAs).

Contractual Savings Plans Contractual savings plans require you to make regular purchases of shares over a specific period of time, usually 10 to 20 years. You will pay penalty fees if you do not make the required purchases. Financial experts and government agencies disapprove of contractual savings plans because many investors lose money with these plans.
Reinvestment Plans  You can also buy shares in an open-end fund by using the fund’s reinvestment plan. With a reinvestment plan, your income dividends and capital gain distributions are automatically reinvested to buy additional shares of the fund. Most reinvestment plans allow shareholders to reinvest without having to pay additional sales charges or commissions. Reinvestment is a great way to add to your portfolio.

Withdrawal Options

If you choose to invest in mutual funds, you will also need to know how you can take your money out of a fund. You can sell shares of closed-end funds to another investor anytime you want on the stock exchange or in the over-the-counter market. Shares in an open-end fund can be sold to the investment company that sponsors the fund. In this case, provide proper notification, and the fund will send you a check for the net asset value of your shares. With some funds, you can write checks to withdraw money. If you have at least $5,000 worth of shares in a mutual fund, most funds will offer you four additional ways of withdrawing money.

Investment Period Withdrawal  First, you may withdraw a certain amount each investment period until your fund has been exhausted. Typically, an investment period is three months, and most funds require investors to withdraw a minimum amount, usually $50, if the investor chooses to withdraw funds.

GO FIGURE  FINANCIAL MATH

PERCENTAGE OF ASSET GROWTH WITHDRAWAL

Synopsis: Most mutual funds will allow an investor to withdraw a prearranged percentage of his or her investment’s asset growth—or the amount that the investment has grown during a period.

Example: Marco invested $1,500 in a green energy mutual fund. This first period, his investment was reported to be worth $1,800. He is allowed to withdraw 60 percent of the asset growth per period. How much can he withdraw?

Formula: Current Portfolio Value – Original Portfolio Value = Asset Growth

Solution: $1,800 – $1,500 = $300

$300 × 60% or .60 = $180

Marco can withdraw $180.

YOU FIGURE

You invested $1,000 in a mutual fund specializing in cell-phone technology. During the first period, your portfolio has a value of $1,235. Your prearranged withdrawal percentage is 40 percent of net asset growth. How much can you withdraw?
Investment Period Liquidation A second option is to liquidate or “sell off” a certain number of shares each investment period. Of course the net asset value of shares in a fund varies from one period to the next. Therefore, the amount of money you receive will also vary.

Asset Growth Withdrawal A third choice lets you withdraw a prearranged percentage of your investment’s asset growth, which is the amount by which your portfolio has increased in value. For example, suppose that you arrange to receive 60 percent of the asset growth of your portfolio. The asset growth of your portfolio was $800 in a particular investment period. For that period you will receive a check for $480 ($800 \times 60\% = $480). If the value of your portfolio does not increase, you receive no payment. Under this option, your principal (the amount of your original investment) remains untouched.

Dividend and Distribution Withdrawal A final option allows you to withdraw all income that results from income dividends and capital gains distributions earned during an investment period. Under this option, too, your principal remains untouched.

Section 10.4 Assessment

QUICK CHECK

1. What type of information does a mutual fund quotation provide to help you evaluate a fund?

2. What are three ways in which you can receive income from your mutual fund investments?

3. What are the withdrawal options that are available when selling shares in a mutual fund?

THINK CRITICALLY

4. Newspaper mutual fund quotations, financial magazines, and the Internet are three sources you might use to research a mutual fund that matches your financial goals. Decide which source you would use first, and explain why.

USE COMMUNICATION SKILLS

5. Sales Pitch Imagine that you are the professional manager of a large mutual fund. You are looking for investors to buy shares in your fund.

Present Prepare a flyer that will convince people to invest in your fund. Name your fund, and give as many reasons as possible why it would be a solid investment. Make your flyer appealing by using exciting language and by including pictures, charts, and graphs.

SOLVE MONEY PROBLEMS

6. Purchase Options Malia has invested in a mutual fund. She wants to add to her investment on a regular basis and is trying to decide which purchase option to use. Her mutual fund offers a voluntary savings plan, a contractual savings plan, and a reinvestment plan.

Analyze Analyze the advantages and disadvantages of the three purchase options available to Malia. Which purchase option would you suggest to her? Why?
Communicating Key Terms

You meet with employees who will retire in five years to discuss adding bonds to their 401(k) plans. Explain the benefits of bond investments, using as many of these key terms as possible.

- maturity date
- face value
- debenture
- mortgage bond
- convertible bond
- sinking fund
- serial bonds
- registered bond
- coupon bond
- bearer bond
- zero-coupon bond
- municipal bond
- investment-grade bonds
- yield
- closed-end fund
- open-end fund
- net asset value (NAV)
- load fund
- no-load fund
- income dividends

Reviewing Key Concepts

1. Explain the advantages of the call feature on bonds to corporations and to investors.
2. Explain why corporations may prefer to issue bonds to raise funds for their operations.
3. Explain how the market value of a bond is determined.
4. List three examples of reasons state and local governments might issue bonds.
5. Describe the characteristics of a municipal bond, including tax factors.
6. Explain the meaning of bond ratings and their impact on buying decisions.
7. Describe the characteristics of a closed-end, open-end, load, and no-load mutual fund.
8. Describe a mutual fund prospectus.
9. Compare the three ways you can purchase mutual funds.
**Bond Market Value**  You own 12 20-year General Electric Capital Services corporate bonds with face values of $1,000. Their coupon rate is 7.5%. Their current yield is 5.2%.

1. **Calculate** (a) What is the current market value of one of these bonds? (b) Of the total investment? (c) If you do not have an immediate need for the cash, what would be your best course of action, sell and reinvest in some other security or hold?

2. **Compute** by using spreadsheet software to make and present these calculations.

**Connect with Economics**  You just inherited $4,000. You need to decide whether to invest this money in a mutual fund, pay down your credit card debt, or simply hold the money in an interest-bearing checking account to pay upcoming bills.

1. **Think Critically**  What is your current financial situation, and do you foresee a legitimate need for extra funds in the short term?

2. **Analyze**  What is the “health” of your emergency fund?

**Mutual Fund Prospectus**  The prospectus of a mutual fund is where you find out about the structure, fees, and “rules” of investing in the fund.

**Log On**  Use an Internet search engine and find Web sites of mutual fund companies, such as Fidelity and T. Rowe. Review at least one mutual fund’s prospectus. Answer the following questions:

1. What are the investment orientation, risk tolerance, and goals of the managers of this fund?

2. Would you recommend this fund? Why or why not?

**Newsclip: Reliable Bonds?**  A bond fund is a mutual fund comprised mainly of bonds. These types of funds are usually safe investments with greater opportunity for returns.

**Log On**  Go to finance07.glencoe.com and open Chapter 10. Learn more about the different types of bond funds. Write a list of points you have learned about bond funds. Would you invest in a bond fund? Why or why not?
WHAT’S YOUR INVESTING IQ?

The more you know about investing, the greater your chance for higher returns. Before you read this chapter, answer the questions below on a separate sheet of paper. After you have studied the chapter in class, take the quiz again to see how much you have learned.

1. Liquidity is the ability to __________.
   a. easily convert your financial resources into cash without a loss in value
   b. invest in any liquid substance
   c. transfer funds electronically

2. The least speculative investment listed below is __________.
   a. municipal bonds
   b. treasury bonds
   c. zero-coupon bonds

3. A mutual fund prospectus is __________.
   a. a possible date for Saturday night
   b. a report that provides potential investors with information about the fund
   c. a statement of your earnings

4. Federally tax-exempt interest can be earned on __________.
   a. an annuity
   b. a convertible bond
   c. a municipal bond

5. Investors buy junk bond funds because __________.
   a. of the possibility of a high yield
   b. municipalities always need to remove junk
   c. they usually resist fluctuations in the stock market

6. Mutual funds are popular because __________.
   a. they generally receive the highest (AAA) rating
   b. investors can choose which stocks are in their portfolio
   c. investors can acquire a diversified portfolio
Evaluating Mutual Funds

Eric is looking at a mutual fund because it might earn a greater return than a CD. He used the following checklist as a way to evaluate the Pacific Sun Growth Fund, a stock mutual fund.

After evaluating Pacific Sun Growth Fund, Eric has decided that he likes the potential for a high return. He may go with the fund, even though he needs $1,000 to make his initial investment.

<table>
<thead>
<tr>
<th>Pacific Sun Growth Fund</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Name of mutual fund</td>
</tr>
<tr>
<td>2. Mutual fund group and category</td>
</tr>
<tr>
<td>3. Mutual fund’s objective</td>
</tr>
<tr>
<td>(Aggressive growth, moderate growth, income and safety, and income)</td>
</tr>
<tr>
<td>4. Yield in the last twelve months</td>
</tr>
<tr>
<td>5. Average return or yield for last five years</td>
</tr>
<tr>
<td>6. Average return or yield for last ten years</td>
</tr>
<tr>
<td>7. Load fees or redemption fees</td>
</tr>
<tr>
<td>8. What is the minimum investment?</td>
</tr>
<tr>
<td>9. Is the fund closed to new investors?</td>
</tr>
<tr>
<td>10. Morningstar rating (in stars and risk)</td>
</tr>
<tr>
<td>1. Pacific Sun Growth Fund</td>
</tr>
<tr>
<td>2. Stock mutual fund/aggressive growth</td>
</tr>
<tr>
<td>3. Aggressive growth of capital</td>
</tr>
<tr>
<td>4. 15%</td>
</tr>
<tr>
<td>5. 11%</td>
</tr>
<tr>
<td>6. 18%</td>
</tr>
<tr>
<td>7. no fees</td>
</tr>
<tr>
<td>8. $1,000</td>
</tr>
<tr>
<td>9. No</td>
</tr>
<tr>
<td>10. Three-star rating and moderate risk</td>
</tr>
</tbody>
</table>

Research

Call an investment company for a prospectus of a mutual fund. You can also visit your local library and look in Morningstar Mutual Funds or the Weisenberger Investment Companies Yearbook. On a separate sheet of paper, fill in the information on the checklist to evaluate the fund.