

How Do Mutual Funds Compensate Investors?

As you probably know, a mutual fund may contain many different types of investments, such as stocks, bonds and government securities. But as an investor, you need to pay attention to not only what goes into your mutual fund, but also what comes out of it — namely, the three ways in which a fund can compensate you.

Let's take a look at these three avenues:

- *Dividends and interest* — A mutual fund earns income from dividends on stocks and interest on bonds. The fund pays out nearly all the income it receives over the year, in the form of a distribution, to you and the other fund owners. Usually, you have the choice of taking the distribution check or reinvesting the earnings to purchase more shares. If you don't actually need the income to boost your cash flow, you'll certainly want to consider the reinvestment option, because it's an easy and cost-efficient way of building your share of ownership. Keep in mind, though, that whether you take the distribution as a check or reinvest it, you will still owe income tax on the dividends.

- *Capital gains distributions* — You will receive your share of any net profits the fund makes from selling investments. Mutual funds usually make these capital gains distributions annually or semiannually. You can choose to automatically reinvest these distributions into your fund, thereby purchasing more shares. Even if you reinvest the proceeds, you'll incur taxes, but as long as the gains are long-term, you'll pay only the capital gains rate, which will likely be 15 percent.

- *Increased share value* — Generally speaking, you invest in a mutual fund because you are hoping its price will rise over time. When its price per share — its net asset value — does

rise, you can sell your shares for a profit. As long as you've held them for more than a year, you'll pay the capital gains rate rather than your normal income tax rate.

Of course, there are no guarantees when it comes to earning a profit from mutual funds; some funds decline in value and never recover. So when choosing a mutual fund, you'll need to carefully evaluate a number of factors, including these: *What are the fund's overall objectives? Has its management team been in place for long? Does it have a good track record?* While past performance can't guarantee future results, you can get a sense of how a fund has performed in different economic environments by looking at its history over five or 10 years.

To sum up: You'll need *discipline* and *patience* when investing in mutual funds. You'll need the discipline to continually reinvest your dividends and capital gains distributions so that you can accumulate more and more shares. And you'll need patience to wait for an increase in share value, which is not guaranteed and may take years to develop.

But if you have this patience and discipline, you may find that mutual funds can help you make progress toward your financial goals. So look for quality funds that are appropriate for your situation and risk tolerance. Your search may well be worth the effort.

This article was written by Edward Jones for use by your local Edward Jones Financial Advisor.

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