What is a mutual fund?

A mutual fund is a bucket of stocks, bonds and/or both. The average mutual fund invests in over 500 different stocks, or companies. Some mutual funds invest in thousands of different stocks. By spreading the investment over many different stocks, mutual funds provide diversification which reduces the risk of loss experienced by any one stock.

There are two basic types of mutual funds: (a) actively managed; and (b) passive funds.

Actively managed funds are managed by a person and a team of analysts who are responsible to study and research the stocks the fund invests in. They buy and sell the stock in the mutual fund. Their analysis includes examining the books, meeting with management, visiting operations and attending board meetings.

Passive funds, also known as index funds, invest in an index. An index is a group of stocks used to measure and benchmark specific areas or sectors of the market. For example, an S&P 500 index fund invests in all of the stocks in the S&P 500. Index funds are not managed. The funds are linked directly to a computer program that executes all of the buys and sells based on composition of the index.

It is important to note, that while a mutual fund is much more diversified than one stock, one mutual fund alone does not provide investors enough diversification. In order to be properly diversified, investors should invest in several different mutual funds. Please see the article on "asset allocation".