A Guide to

Understanding Mutual Funds

INVESTMENT COMPANY INSTITUTE®

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INVESTMENT COMPANY INSTITUTE®

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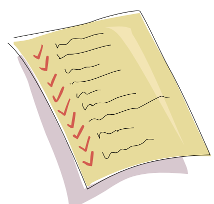

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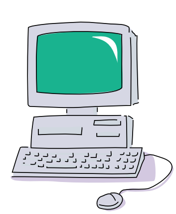

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To The Reader

The Investment Company Institute is pleased to bring you A Guide to Understanding Mutual Funds. *This guide, one of several in the Institute's Investor Awareness Series, is intended to explain mutual funds and the basic principles of investing.*

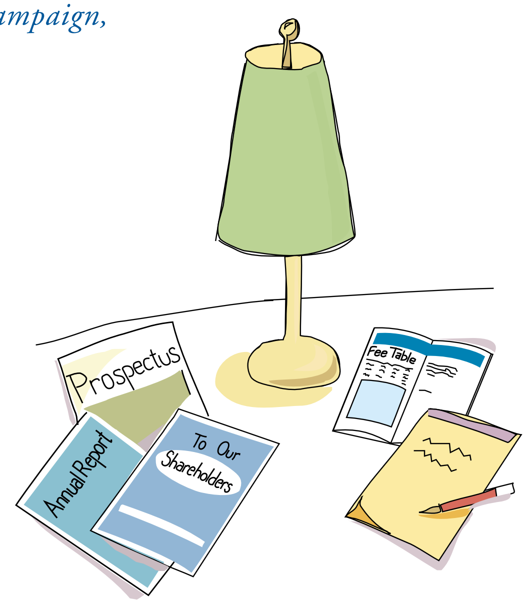
During the past decade, interest in—and information about—investing has increased dramatically. Technological advances have ushered in a vast supply of new services that allow you to invest with ease. Mutual fund shareholders have benefited from these technological advances, as funds have continually offered improved services to meet changing investor needs.

Still, the most important advantages mutual funds offer over other types of investments remain unchanged since the first fund was offered in 1924: professional management—the security of knowing your money is managed by a team of professionals devoted to reaching your investment objectives—and diversification—the ability to invest affordably in a wide range of securities and reap market rewards while diminishing accompanying risks.

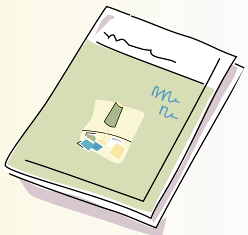
This guide is designed to increase your awareness of the benefits of funds and investing, and help you set realistic goals and expectations. If you would like to learn more, please visit our website at www.ici.org or write for a catalogue of additional investor awareness materials at ICI Investor Awareness Campaign, P.O. Box 27849, Washington, DC 20038-7850.

Matthew P. Fink

President, Investment Company Institute



Introduction



Establishing realistic financial goals is an essential first step toward successful investing. Understanding the investments best suited to helping you achieve your goals is equally important.

Most Americans invest to meet long-term goals, such as ensuring a secure retirement or paying for a child's college education, but many also have more immediate goals, like making a down payment on a home or automobile.

Mutual funds can fit well into either your long- or short-term investment strategy, but the success of your plan depends on the type of fund you choose. Because all funds invest in securities markets, it is crucial to maintain realistic expectations about the performance of those markets and choose funds best suited to your needs.

Keeping Recent Investment Returns in Perspective

Successful investors base their performance expectations on historic average returns, and keep short-term market movements in perspective.

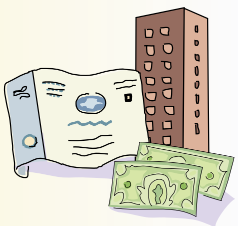
Although many investors have enjoyed strong returns on their investments in recent years—as the stock market has returned an average of nearly 18 percent annually over the past decade—the historic average returns since 1926 are about 11 percent. Experts remind us that the unprecedented returns of the 1990s are not likely to continue.

If your investment expectations are too high, and the market reverts to historic levels, you may fail to reach your financial goals. To achieve your goals, it helps to follow a few basic rules of investing:

1. Diversify your investments;
2. Understand the relationship between risk and reward;
3. Maintain realistic expectations about investment performance;
4. Keep short-term market movements in perspective;
5. Consider the impact that fees and taxes will have on your investment return; and
6. Remember that an investment's past performance is not necessarily indicative of its future results.

This three-part booklet explores these and other investment concepts in greater detail, explaining essential information about fund investing; helping you determine how funds can fit into a well-formulated plan; and offering additional resources that can help you build on your knowledge of funds and investing.

About Mutual Funds



What Is a Mutual Fund?

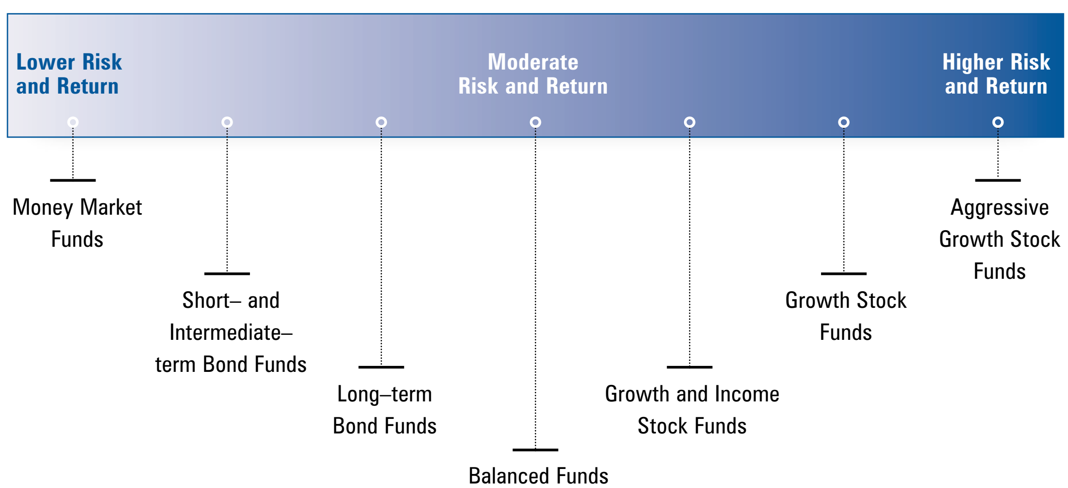
A mutual fund is a company that invests in a diversified portfolio of securities. People who buy shares of a mutual fund are its owners or shareholders. Their investments provide the money for a mutual fund to buy securities such as stocks and bonds. A mutual fund can make money from its securities in two ways: a security can pay dividends or interest to the fund, or a security can rise in value. A fund can also lose money and drop in value.

Different Funds, Different Features

There are three basic types of mutual funds—stock (also called equity), bond, and money market. **Stock mutual funds** invest primarily in shares of stock issued by U.S. or foreign companies. **Bond mutual funds** invest primarily in bonds. **Money market mutual funds** invest mainly in short-term securities issued by the U.S. government and its agencies, U.S. corporations, and state and local governments.

Risk and Reward Potential for Types of Funds

Generally, risk and reward go hand in hand with mutual fund investments.



Why Invest in a Mutual Fund?

Mutual funds make saving and investing simple, accessible, and affordable. The advantages of mutual funds include professional management, diversification, variety, liquidity, affordability, convenience, and ease of recordkeeping—as well as strict government regulation and full disclosure.

Professional Management Even under the best of market conditions, it takes an astute, experienced investor to choose investments correctly, and a further commitment of time to continually monitor those investments.

With mutual funds, experienced professionals manage a portfolio of securities for you full-time, and decide which securities to buy and sell based on extensive research. A fund is usually managed by an individual or a team choosing investments that best match the fund's objectives. As economic conditions change, the managers often adjust the mix of the fund's investments to ensure it continues to meet the fund's objectives.

Diversification Successful investors know that diversifying their investments can help reduce the adverse impact of a single investment. Mutual funds introduce diversification to your investment portfolio automatically by holding a wide variety of securities. Moreover, since you pool your assets with those of other investors, a mutual fund allows you to obtain a more diversified portfolio than you would probably be able to comfortably manage on your own—and at a fraction of the cost.

In short, funds allow you the opportunity to invest in many markets and sectors. That's the key benefit of diversification.

Variety Within the broad categories of stock, bond, and money market funds, you can choose among a variety of investment approaches. Today, there are about 8,200 mutual funds available in the U.S., with goals and styles to fit most objectives and circumstances.

Low Costs Mutual funds usually hold dozens or even hundreds of securities like stocks and bonds. The primary way you pay for this service is through a fee that is based on the total value of your account. Because the fund industry consists of hundreds of competing firms and thousands of funds, the actual level of fees can vary. But for most investors, mutual funds provide professional management and diversification at a fraction of the cost of making such investments independently.

Liquidity Liquidity is the ability to readily access your money in an investment. Mutual fund shares are liquid investments that can be sold on any business day. Mutual funds are required by law to buy, or redeem, shares each business day. The price per share at which you can redeem shares is known as the fund's **net asset value (NAV)**. NAV is the current market value of all the fund's assets, minus liabilities, divided by the total number of outstanding shares.

How a Fund Determines Its Share Price

Market Value in Dollars of a Fund's Assets
(including income and other earnings)
($6,000,000)

—

Fund's Liabilities
(including fees and expenses)
($60,000)

÷

Number of Investor Shares Outstanding
(500,000)

=

Fund Share Price or Net Asset Value (NAV)
$11.88

Fund share prices appear in the financial pages of most major newspapers. Actual calculations of a fund's share price can be found in its semiannual and annual reports.

Convenience You can purchase or sell fund shares directly from a fund or through a broker, financial planner, bank or insurance agent, by mail, over the telephone, and increasingly by personal computer. You can also arrange for automatic reinvestment or periodic distribution of the dividends and capital gains paid by the fund. Funds may offer a wide variety of other services, including monthly or quarterly account statements, tax information, and 24-hour phone and computer access to fund and account information.

Protecting Investors Not only are mutual funds subject to exacting internal standards, they are also highly regulated by the federal government through the U.S. Securities and Exchange Commission (SEC). As part of this government regulation, all funds must meet certain operating standards, observe strict antifraud rules, and disclose complete information to current and potential investors. These laws are strictly enforced and designed to protect investors from fraud and abuse. But these laws obviously cannot help you pick the fund that is right for you or prevent a fund from losing money. You can still lose money by investing in a mutual fund. A mutual fund is not guaranteed or insured by the FDIC or SIPC, even if fund shares are purchased through a bank. For more information about how funds are regulated and supervised, see page 37.

Stock Funds

Stock funds invest primarily in stocks. A share of stock represents a unit of ownership in a company. If a company is successful, shareholders can profit in two ways: the stock may increase in value, or the company can pass its profits to shareholders in the form of dividends. If a company fails, a shareholder can lose the entire value of his or her shares; however, a shareholder is not liable for the debts of the company.

When you buy shares of a stock mutual fund, you essentially become a part owner of each of the securities in your fund's portfolio. Stock investments have historically been a great source for increasing individual wealth, even though the stocks of the most successful companies may experience periodic declines in value. Over time, stocks historically have performed better than other investments in securities, such as bonds and money market instruments. Of course, there is no guarantee that this historical trend will be true in the future. That's why stock funds are best used as long-term investments.

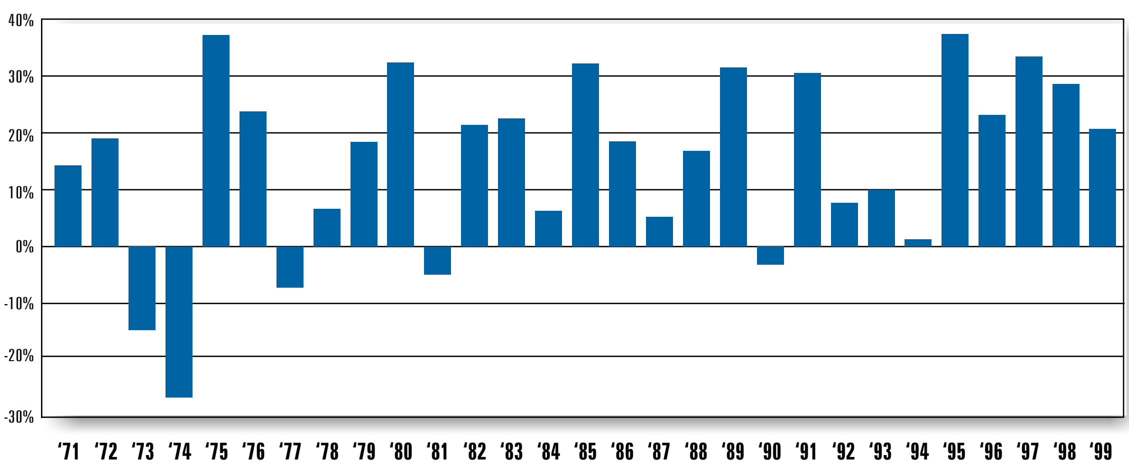
Stock Market Returns

The upswings and downturns of the stock market affect stock funds. Despite a history of outperforming other types of securities, stocks sometimes lose money (see chart below). Sometimes these losses can be substantial and last for long periods. The recent S&P 500 annual returns of 20 and 30 percent are unprecedented, and cannot be counted on to continue in the future. The average rate of annual return from 1926 to 1999 is about 11 percent. Most experts expect stock market returns to revert to their historical range.

Stock prices move up and down for a variety of reasons—some of them affecting the entire market, others limited to particular industries or companies.

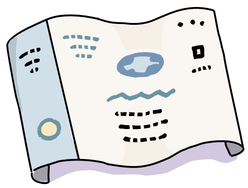
Volatility: Stock Market Returns Fluctuate from Year to Year

S&P 500 Total Return



Source: Stocks, Bonds, Bills and Inflation® 2000 Yearbook, *© Ibbotson Associates, Inc. Based on copyrighted works by Ibbotson and Sinquefield. All rights reserved. Used with permission.*

Bond Funds



Bond funds invest primarily in securities known as bonds. A bond is a type of security that resembles a loan. When a bond is purchased, money is lent to the company, municipality, or government agency that issued the bond. In exchange for the use of this money, the issuer promises to repay the amount loaned (the **principal**; also known as the **face value** of the bond) on a specific maturity date. In addition, the issuer typically promises to make periodic interest payments over the life of the loan.

A bond fund share represents ownership in a pool of bonds and other securities comprising the fund's portfolio. Although there have been past exceptions, bond funds tend to be less volatile than stock funds and often produce regular income. For these reasons, investors often use bond funds to diversify, provide a stream of income, or invest for intermediate-term goals. Like stock funds, bond funds have risks and can make or lose money.

Types of Risk

After a bond is first issued, it may be traded. If a bond is traded before it matures, it may be worth more or less than the price paid for it. The price at which a bond trades can be affected by several types of risk.

Interest Rate Risk Think of the relationship between bond prices and interest rates as opposite ends of a seesaw. When interest rates fall, a bond's value usually rises. When interest rates rise, a bond's value usually falls. The longer a bond's maturity, the more its price tends to fluctuate as market interest rates change. However, while longer-term bonds tend to fluctuate in value more than shorter-term bonds, they also tend to have higher yields (see page 24) to compensate for this risk.

Unlike a bond, a bond mutual fund does not have a fixed maturity. It does, however, have an **average portfolio maturity**—the average of all the maturity dates of the bonds in the fund's portfolio. In general, the longer a fund's average portfolio maturity, the more sensitive the fund's share price will be to changes in interest rates and the more the fund's shares will fluctuate in value.

Credit Risk Credit risk refers to the "credit-worthiness" of the bond issuer and its expected ability to pay interest and to repay its debt. If a bond issuer is unable to repay principal or interest on time, the bond is said to be in default. A decline in an issuer's credit rating, or creditworthiness, can cause a bond's price to decline. Bond funds holding the bond could then experience a decline in their net asset value.

Prepayment Risk Prepayment risk is the possibility that a bond owner will receive his or her principal investment back from the issuer prior to the bond's maturity date. This can happen when interest rates fall, giving the issuer an opportunity to borrow money at a lower interest rate than the one currently being paid. (For example, a homeowner who refinances a home mortgage to take advantage of decreasing interest rates has prepaid the mortgage.) As a consequence, the bond's owner will not receive any more interest payments from the investment. This also forces any reinvestment to be made in a market where prevailing interest rates are lower than when the initial investment was made. If a bond fund held a bond that has been prepaid, the fund may have to reinvest the money in a bond that will have a lower yield.

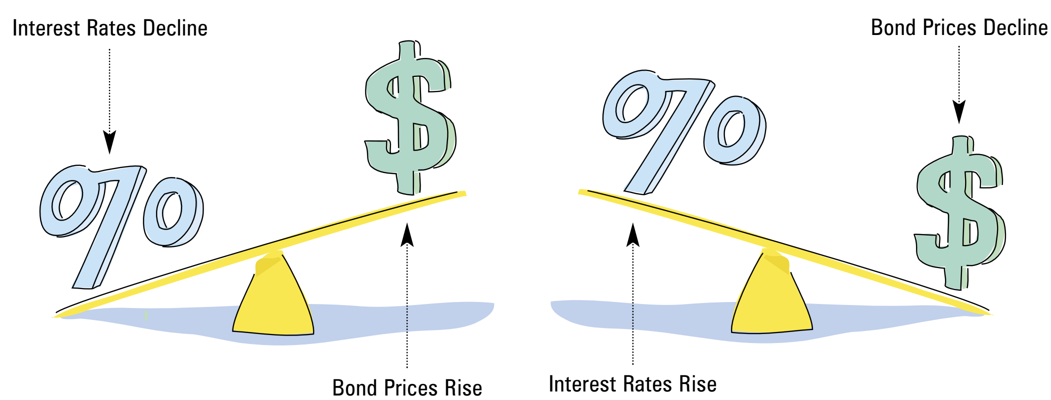
Are Tax-free Bond Funds Right for You?

With most bond funds, the income you receive is taxable as ordinary income. However, some funds invest in bonds whose

continued

How Interest Rates Affect Bond Prices

General interest rates are constantly changing, but the rate of interest on many bonds is fixed. Instead, their market prices change when general interest rates go up or down.



Bond credit ratings represent the opinion of independent agencies on the likelihood that a bond's issuer will be able to make periodic interest payments and repay principal.

interest payments are free from federal income tax, while other funds invest in bonds that are free from both federal and state income tax. Tax-exempt funds may be subject to capital gains taxes (see page 27).

The income tax benefit typically means that the income from these funds is lower than that of comparable taxable funds. But if you compare the yields after taxes, a tax-free fund may be a better choice, depending on your tax bracket. The chart at right shows how taxable and tax-free yields compare after taxes for investors in different tax brackets.

If you live in an area where there are state or local income taxes, you may be able to find a fund whose interest payments are free from these taxes as well as federal taxes.

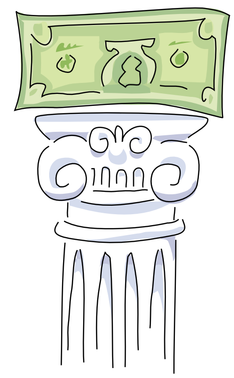
Tax Comparison

A Hypothetical Tax-free Yield of:	**4.0%**	**5.0%**	**6.0%**	**7.0%**
Equals a Taxable Yield in the 28% Tax Bracket of:	5.56%	6.94%	8.33%	9.72%
Equals a Taxable Yield in the 31% Tax Bracket of:	5.80%	7.25%	8.70%	10.14%
Equals a Taxable Yield in the 36% Tax Bracket of:	6.25%	7.81%	9.38%	10.94%
Equals a Taxable Yield in the 39.6% Tax Bracket of:	6.62%	8.28%	9.93%	11.59%

Money Market Funds

A money market fund invests in a pool of short-term, interest-bearing securities. A money market instrument is a short-term IOU issued by the U.S. government, U.S. corporations, and state and local governments. Money market instruments have maturity dates of less than 13 months. These instruments are relatively stable because of their short maturities and high quality.

Money market funds are most appropriate for short-term investment and savings goals or in situations where you seek to preserve the value of your investment while still earning income. In general, money market funds are useful as part of a diversified personal financial program that includes long-term investments.



Maintaining a stable $1 share price is a goal of most money market funds. However, there is no guarantee that you will receive $1 per share when you redeem your shares.

Money Market Fund Risks

The short-term nature of money market investments makes money market funds less volatile than any other type of fund. Money market funds seek to maintain a $1-per-share price to preserve your investment principal while generating dividend income.

To help preserve the value of your principal investment, money market funds must meet stringent credit quality, maturity, and diversification standards. Most money market funds are required to invest at least 95 percent of their assets in U.S. Treasury issues and privately issued securities carrying the highest credit rating by at least two of the five major credit rating agencies. A money market fund generally cannot invest in any security with a maturity greater than 397 days, nor can its average maturity exceed 90 days. All of these factors help minimize risk. However, money market funds do not guarantee that you will receive all your money back. Money market funds are not insured by the U.S. government.

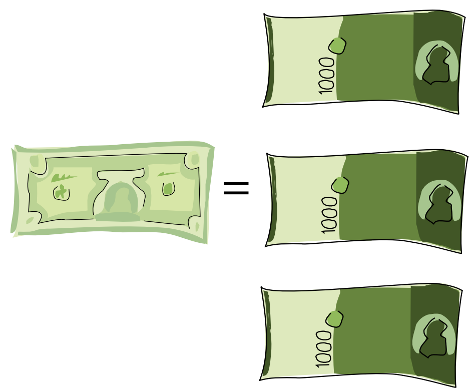
"Inflation risk"—that is, the risk your investment return fails to keep pace with the inflation rate—is another concern if you choose to invest in money market funds or any other short-term investments. See page 25 for a broader discussion of inflation risk.

Investing Internationally

International stock and bond mutual funds provide a convenient, low-cost way for you to invest in foreign securities markets compared with investing in these markets directly. Investing internationally offers diversification and the opportunity for higher returns. But these investments also have risks that are usually not present with investments in U.S. stocks and bonds.

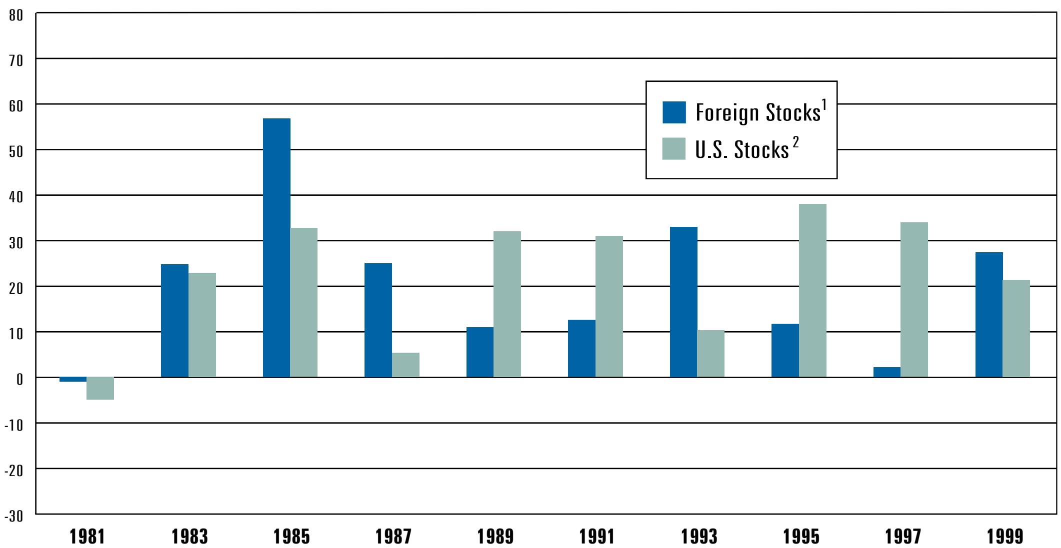
For example, U.S. investors usually buy foreign securities in the other country's currency, making the investments subject to changes in the currency exchange rate. Fluctuations in currency exchange rates can have a significant effect on an investor's return. If your fund's investment in a Malaysian stock increased by 10 percent during a six-month period while the value of the Malaysian ringgit declined 10 percent during the same period, you would break even on the investment. Some international funds try to offset this effect by performing "hedging transactions."

Investing in foreign markets may involve additional costs due to the unique operational requirements of an overseas fund, and may also involve volatile political and economic situations—especially in emerging markets.



Thinking of Investing Internationally?

From year to year, investments overseas rarely perform the same as investments in U.S. markets. The chart below illustrates that point with a comparison of the performance of U.S. and international stocks over the past 20 years. Notice the times when each type of investment outperformed the other. The key point is that a diversified investment strategy that incorporates both domestic and foreign securities can help improve your potential return and offset the risks of downturns in either market.



[1] Morgan Stanley Capital International EAFE Index (Europe, Australasia, and Far East Developed Market Index)

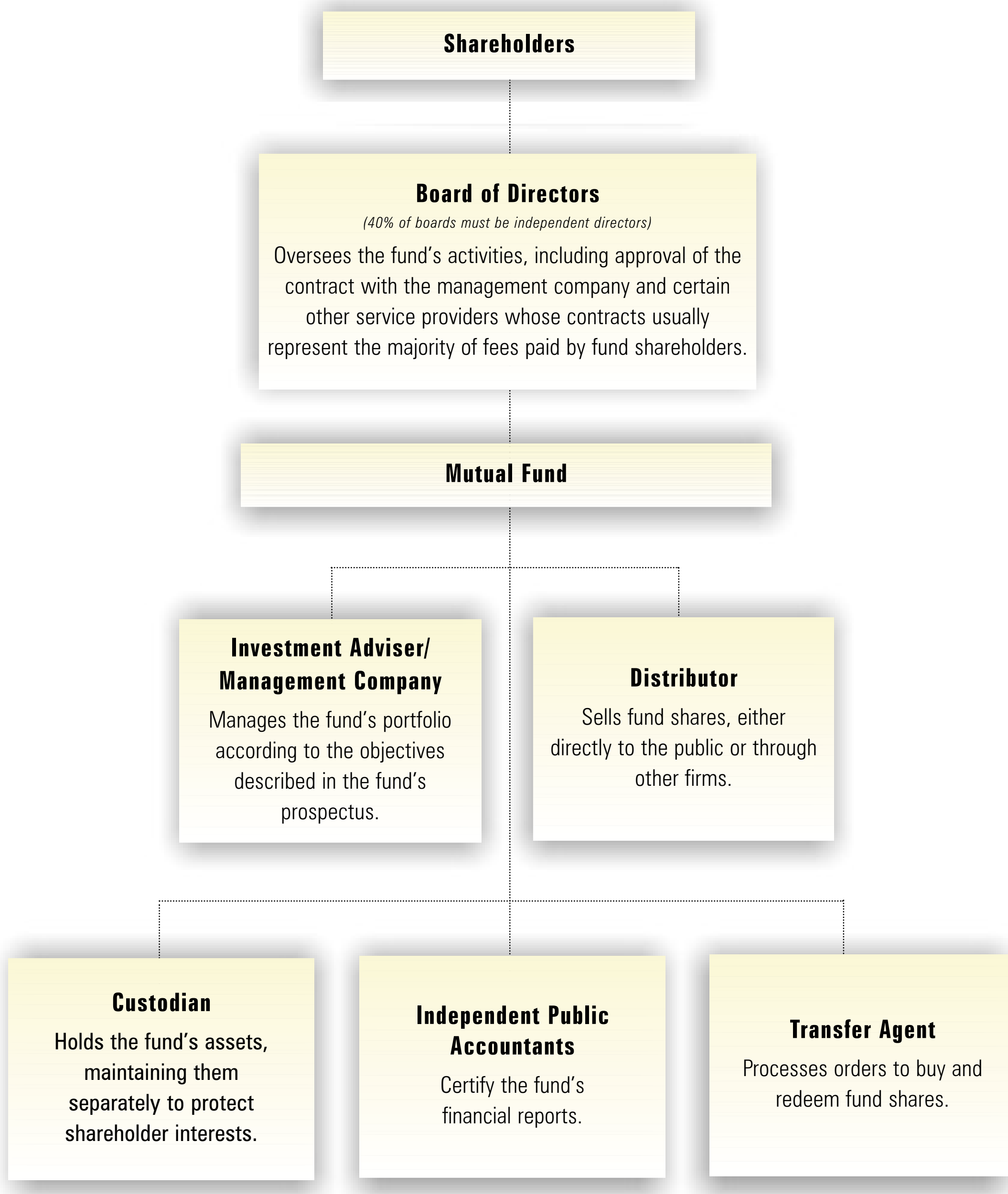
[2] S&P 500 Index

How Mutual Funds Are Structured

A mutual fund is usually either a corporation or a business trust (which is like a corporation). Like any corporation, a mutual fund is owned by its shareholders. Virtually all mutual funds are externally managed; they do not have employees of their own. Instead, their operations are conducted by affiliated organizations and independent contractors.

The Structure of a Mutual Fund

The illustration below shows the business structure of a typical mutual fund.



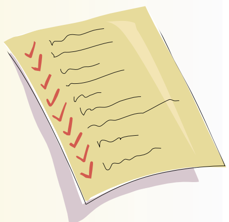
Other Types of Investment Companies

Mutual funds are one of three types of investment companies; the other two are closed-end funds and unit investment trusts.

A **closed-end fund** is an investment company whose shares are publicly traded like stocks. As a result, the price of a closed-end fund share fluctuates based on supply and demand. If the share price is more than the value of its assets, then the fund is trading at a premium; if the share price is less, then it is trading at a discount. The assets of a closed-end fund are managed by a professional or a group of professionals choosing investments such as stocks and bonds to match the fund's objectives.

A **unit investment trust** (UIT) is an investment company that buys a fixed portfolio of stocks or bonds. A UIT holds its securities until the trust's termination date. When a trust is dissolved, proceeds from the securities are paid to shareholders. UITs have a fixed number of shares or "units" that are sold to investors in an initial public offering. If some shareholders redeem units, the UIT or its sponsor may purchase them and reoffer them to the public.

Establishing an Investment Plan



Establishing Goals and Realistic Expectations

Determining your financial goals is the first step to successful investing. You may have immediate goals, such as making a down payment on a home, paying for a wedding, or creating an emergency fund. You may also have long-term goals, like paying for college or retirement. Establishing goals will help assess how much money you need to invest, how much your investments must earn, and when you will need the money.

The next step is to make a realistic investment plan designed to meet your goals. Setting realistic expectations about your investments and about market performance is an important part of your investment plan. Securities don't always rise in value, and when they fall, the downturns can sometimes be lengthy. A well-conceived, diversified personal investment plan can help you weather these downturns, and give you a measure of comfort when market volatility occurs.

Remember, also, that your plan should paint a broad picture of your personal financial situation now and where you want it to be in the future. In addition to goals, your plan should reflect your time horizon, financial situation, and personal feelings about risk. Establish your goals and create an investment plan now—the sooner you begin investing, the longer your money has to work for you.

Goals and Time Horizon

Generally, your goals will dictate how much time you have to invest. For example, if you are 35 years old and investing for retirement at age 65, then you have a time horizon of 30 years before you plan to begin withdrawing money. Identifying your time horizon is important because it influences how you invest your assets. Typically, a shorter time frame necessitates conservative investments, while a longer period allows you to handle more risk.

Start Investing Now to Take Advantage of Compounding

Compounding is the earnings on an investment's earnings. For example, if you invest $1,000 at a rate of 5 percent per year, your initial investment is worth $1,050 after one year. During the second year, assuming the same rate of return, earnings are based not on the original $1,000 investment, but also on the $50 in first-year earnings. Over time, compounding can produce significant growth in the value of an investment. So, the earlier you start investing, the faster your investments can grow in value.

Risk/Reward Tradeoff

All mutual funds involve investment risk, including the possible loss of principal. Making an informed decision to assume some risk also creates the opportunity for greater potential reward. This fundamental principle of investing is known as the risk/reward tradeoff. When forming a plan, examine your personal attitude toward investment risk. Is stability more important than higher returns, or can you tolerate short-term losses for potential long-term gains?

Remember, investments that increase in value in a short period can just as quickly decrease in value. But if you've considered the risk/reward tradeoff, you know that investment volatility is a characteristic of a successful long-term plan.

Three Common Investment Goals

Goals of Mutual Fund Investors*

84%

Supplement retirement income

26%

Pay for education expenses

9%

Supplement current living expenses

7%

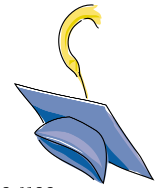
Buy home or other real estate

**Multiple responses included*

Goal No. 1: Retirement

Most individuals buy mutual funds for long-term goals, especially retirement. It is estimated that retirees will need 70 to 80 percent of their final, pre-tax income to maintain a comfortable lifestyle in retirement. If you plan to retire at age 65, retirement savings should last for at least 17 years, since the average life expectancy for a 65-year-old is 82, and continues to rise. Ideally, individuals use a combination of sources to fund retirement, such as Social Security benefits, employer-sponsored retirement plans-like 401(k) plans—and personal savings, including Individual Retirement Accounts (IRAs).

Goal No. 2: Education



Many parents and grandparents use mutual funds to invest for children's college educations. Your time horizon is an essential consideration when investing for education: if you start when the child is born, you have 18 years to invest. However, if a child or grandchild is in your future, the time horizon can be lengthened by investing now.

Goal No. 3: Emergency Reserves and Other Short-term Goals

Emergency reserves are assets you may need unexpectedly on short notice. Many investors use money market funds for their reserves. Money market funds alone, or in combination with short-term bond funds, can also be appropriate investments for other short-term goals.

Investment Advice

Professionals such as stockbrokers, financial planners, bank representatives, or insurance agents can help you analyze your financial needs and objectives and recommend appropriate funds. In addition, fund organizations may maintain their own sales forces to help potential investors, or they may sell shares through outside professionals.

If you prefer to do it yourself, researching mutual funds and buying shares can be done through the telephone, mail, or personal computer. Many funds can be contacted directly to purchase their shares.

Figuring Out Your Retirement Needs

There are many paper- and computer-based worksheets that can help you estimate your retirement needs. Here's an example from the American Savings Education Council.

BALLPARK ESTIMATE®

Planning for retirement is not a one-size-fits-all exercise. The purpose of *Ballpark* is to give you a basic idea of the savings you'll need when you retire. If you are married, you and your spouse should each fill out your own *Ballpark Estimate®* taking your marital status into account when entering your Social Security benefit in number 2 below. Let's play ball!

1. How much annual income will you want in retirement? (Figure 70% of your current annual income just to maintain your current standard of living. Really.) $ ______

2. Subtract the income you expect to receive annually from:

A. Social Security – If you make:
- ▸less than $25,000, enter $8,000;
- ▸between $25,000 - $40,000, enter $12,000;
- ▸more than $40,000, enter $14,500

(Married couples: enter the lower-earning spouse's benefit or 50% of the higher-earning spouse's benefit, whichever is higher.) -$ ______

B. Traditional Employer Pension – a plan that pays a set dollar amount for life, where the dollar amount depends on salary and years of service (in today's dollars) -$ ______

C. Part-time income -$ ______

D. Other -$ ______

This is how much you need to make up for each retirement year: =$ ______

Now you want a ballpark estimate of how much money you'll need the day you retire. The accountants devised a simple formula. For the record, they figure you'll realize a constant real rate of return of 3% after inflation, you'll live to age 87, and you'll begin to receive income from Social Security at age 65.

3. To determine the amount you'll need to save, multiply the amount you need to make up by the factor below.

Age you expect to retire:	Your factor is:	$ ______
55	21.0	
60	18.9	
65	16.4	
70	13.6	

4. If you expect to retire before age 65, multiply your Social Security benefit from line 2 by the factor below.

Age you expect to retire:	Your factor is:	+$ ______
55	8.8	
60	4.7	

5. Multiply your savings to date by the factor below (include money accumulated in a 401(k), IRA, or similar retirement plan):

If you want to retire in:	Your factor is:	-$ ______
10 years	1.3	
15 years	1.6	
20 years	1.8	
25 years	2.1	
30 years	2.4	
35 years	2.8	
40 years	3.3	

Total additional savings needed at retirement: =$ ______

DON'T PANIC. Those same accountants devised another formula to show you how much to save each year in order to reach your goal. This formula factors in compounding. That's where your money not only makes interest, your interest starts making interest as well, creating a snowball effect.

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6. To determine the ANNUAL amount you'll need to save, multiply the total amount by the factor below.

If you want to retire in:	Your factor is:	=$ ______
10 years	.085	
15 years	.052	
20 years	.036	
25 years	.027	
30 years	.020	
35 years	.016	
40 years	.013	

SEE? It's not impossible or even particularly painful. It just takes planning. And the sooner you start, the better off you'll be.

Note: This worksheet simplifies several retirement planning issues such as projected Social Security benefits and earnings assumptions on savings. It also reflects today's dollars; therefore you will need to re-calculate your retirement needs annually and as your salary and circumstances change. You may want to consider doing further analysis, either yourself using a more detailed worksheet or computer software or with the assistance of a financial professional.

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Dollar-cost Averaging

A systematic approach to long-term investing is called dollar-cost averaging. This refers to the practice of investing the same amount of money in the same investment at regular intervals (like once a month), regardless of market conditions. If you choose the dollar-cost averaging approach, the amount you invest is always the same. Thus, you automatically buy more shares when the price is low, and fewer when the price is high.

Setting up a regular investment schedule can make it easier to invest and can help you take advantage of the potential benefits of dollar-cost averaging.

Your natural instinct might be to stop investing if the price starts to drop—but history suggests that the best time to invest may be when you are getting good value. Dollar-cost averaging can be an effective strategy with funds or stocks that can have sharp ups and downs, because it gives you more opportunities to purchase shares less expensively.

The benefit of this approach is that, over time, you may reduce the risk of having bought shares when their cost was highest. Instead, as the example below demonstrates, the average cost of your shares will be lower.

Dollar-cost averaging does not assure a profit, however, and it does not protect against investment losses in declining markets.

Saying No to Market Timing

"Buy low, sell high" may seem like good advice, but even the most experienced investors find it impossible to pinpoint market lows and highs with any degree of accuracy and consistency. That's why experts advise putting a fixed amount of money into a stock or bond fund on a regular schedule rather than "timing the market." However, you should keep in mind that dollar-cost averaging can't guarantee a profit or protect against a loss in a declining market. So choose an amount you feel comfortable investing under all market conditions.

It's easy to use the dollar-cost averaging method. In fact, you can do it using automatic investment services available from most mutual funds.

An Example of Dollar-cost Averaging

Let's say, for example, that an investor puts $100 a month into the same mutual fund for six months in a row. The share price is up in some months, down other months. The table below shows how this hypothetical investor might have made out.

Month	Investment	Share price	Shares bought
1	$100	$10	10
2	$100	$ 8	12.5
3	$100	$ 5	20
4	$100	$10	10
5	$100	$16	6.25
6	$100	$10	10

Results:

Total amount invested:	$600
Number of shares owned:	68.75
Average cost per share: ($600 ÷ 68.75 shares)	$8.72
Current share price:	$10

Establishing Realistic Expectations About Performance

A fund investment can help you reach your financial goals, but mutual funds and the stock and bond markets are not an automatic route to financial security. That's why an important part of your investment plan is having realistic expectations about your funds and market performance.

Bull and Bear Markets

A **bull market** is a prolonged period of rising stock prices, and conversely, a **bear market** is a prolonged period of declining stock prices. The longest bull market in history has occurred during the 1980s and 1990s. However, bear markets are also a fact of life for most investors.

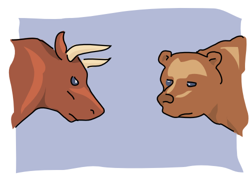
Experts remind investors that it is unrealistic to expect stock market annual returns of 15 and 20 percent or higher. The stock market's average annual return from 1926 to 1999 is 11 percent. The 1973-74 bear market caused a 41 percent drop in the S&P 500, a leading gauge of stock market performance.

It may be tempting to try to avoid market declines and bear markets by "timing the market"—that is, moving your money out of stocks or other securities when you think their prices will fall. However, you run the risk of missing out if the market goes up.

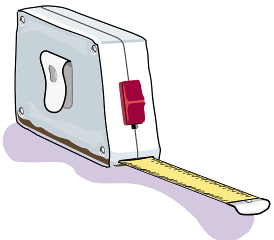
The Ten Worst Stock Market Declines Since 1926

Year	Decline in S&P 500 Index
1931	- 43.3%
1937	- 35.0%
1974	- 26.5%
1930	- 24.9%
1973	- 14.7%
1941	- 11.6%
1957	- 10.8%
1966	- 10.1%
1940	- 9.8%
1962	- 8.7%

Source: Stocks, Bonds, Bills and Inflation® 2000 Yearbook, *© Ibbotson Associates, Inc. Based on copyrighted works by Ibbotson and Sinquefield. All rights reserved. Used with permission.*



It's important to have realistic expectations about how an investment may perform—for risks as well as for returns.



Measurements of Performance

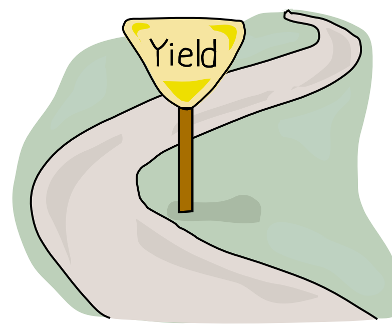
Total return is generally regarded as the best measure of fund performance because it is the most comprehensive. Total return includes dividend and capital gains distributions along with any changes in the fund's share price. A dividend distribution comes from the interest and dividends earned by the securities held by a fund; a capital gains distribution represents any net gains resulting from the sale of the securities held by a fund. Total return, expressed as a percentage of an initial investment in a fund, represents the change in that investment's value over a given period, assuming any distributions were reinvested in the fund.

Yield is the measure of net income (dividends and interest less expenses) earned by the securities in the fund's portfolio during a specified period. Yield is expressed as a percentage of the fund's NAV (including the highest applicable sales charge, if any). Yield does not include the change, if any, in the investment's value over a given period.

Key Considerations About Performance

Past performance cannot predict future results. This year's top-performing funds aren't necessarily going to be next year's winners.

Short-term returns may not tell the whole story. Looking at fund performance over a longer period, such as 10 years, can give you a better picture of how the fund has performed during market fluctuations, and how it compares to funds with similar objectives.



The Risk of Inflation

It may seem logical that the safest investment is one that seeks to preserve your money, like certificates of deposit (bank CDs) or money market funds. While these instruments may play an important role in your overall financial plan, you need to be aware that they may not protect your assets against an easy-to-overlook risk—inflation.

The Invisible Tax

Think of inflation as an invisible tax that erodes the purchasing power of any investment. For example, $1,000 in a deposit account earns 5 percent interest, but inflation is 2 percent per year. Although this money will earn $50 in interest after one year, inflation cuts the actual worth of this $50 down to $49. In addition, the initial $1,000 will also erode by 2 percent to $980. Therefore, after one year, the account has a balance of $1,050, but due to inflation, its purchasing power is only $1,029. This is the effect of inflation risk. To maintain an investment's purchasing power, its total return must keep pace with the inflation rate.

The Effect of Inflation

In 1999, the inflation rate was 2.2 percent. Even at this historically low rate, inflation will erode the value of $1,000 by more than one-quarter in 15 years:

In this many years...	$1000 will be worth...
5	897
10	804
15	722
20	647
25	580
30	521
35	467
40	419

assuming 2.2% annual inflation

When planning for future goals, it's important to allow for the likelihood that future expenses will be higher because of inflation

The Annual Review

At least once a year, it's a good idea to review your investment plan. Because different investments grow at different paces, your current distribution of money among stock, bond, and money market funds may no longer correspond with your original allocations. If this happens with your investments, you will probably want to consider whether to redistribute some money to bring your allocations back in line with your plan.

Changing Lifestyles

In addition to the annual review, whenever you make a major life change, it's time to reassess your overall financial situation. Some common examples of life changes:

- switching careers;
- retiring;
- getting married or divorced;
- having a child;
- buying a house;
- starting your own business; and
- entering college or paying tuition for a child.

Most of these events are likely to affect your ability to invest, your time horizon, and your overall financial picture, both short-term and long-term.

It's never easy to find the time to review your investment plan when you're in the midst of any of these life changes, but it's worth making the effort. You don't want to enter a new phase of your life with a plan that was designed for different circumstances.

By staying on course with your asset allocations, you will help ensure that your overall portfolio continues to work effectively toward achieving your investment goals.

Tax Considerations

Mutual funds make two basic types of taxable distributions to shareholders every year: ordinary dividends and capital gains distributions. These two types of distributions are reported differently on your income tax return. If you're investing in an IRA, 401(k), annuity, or other tax-advantaged retirement vehicle, tax issues are not generally a consideration.

Distributions

Dividend distributions come primarily from the interest and dividends earned by the securities in the fund's portfolio after expenses. These payments must be reported as dividends on your tax return.

Capital gains distributions represent the fund's net gains from the sale of securities held in its portfolio for more than one year. When gains from these sales exceed losses, they are distributed to shareholders.

continued

How to Read Form 1099-DIV

Once a year a fund sends a Form 1099-DIV to any shareholder receiving $10 or more taxable income. This form contains much of the tax reporting information a shareholder needs. Any taxpayer who receives a capital gains distribution from a mutual fund and has no other capital gains is generally not required to complete Schedule D (for capital gains and losses) as part of year-end tax filing.

Ordinary dividends—the amount to report on Form 1040 as dividend income. These include any short-term capital gains distributions (assets held less than 12 months).

Total capital gains distributions—the amount to report as capital gains distributions. Amounts reported in box 2a include amounts reported in boxes 2b, 2c, and 2d.

28% rate gain—capital gains distributions subject to the 28 percent maximum tax rate. These include gains on certain "collectibles," such as gold bullion.

Unrecaptured sec. 1250 gain—the portion, if any, of capital gains distributions attributable to certain real estate investments.

Nontaxable distributions—distributions that represent a return of capital; these are not taxable, but do reduce the basis of fund shares.

Foreign tax paid and foreign country or U.S. possession—an amount entered here represents a shareholder's proportionate share of foreign income tax paid by the fund. An investor may be able to take a deduction or credit for this amount. An investor taking a foreign tax credit may be required to attach Form 1116 to Form 1040.

☐ CORRECTED (if checked)

PAYER'S name, street address, city, state, ZIP code, and telephone no. Mutual Fund XYZ 555 Investment Street San Francisco, CA 94104		1 Ordinary dividends $ 986.10 2a Total capital gain distr. $ 1,691.03	OMB No. 1545-0110 2000 Form 1099-DIV	Dividends and Distributions
PAYER'S Federal identification number 12-3456789	RECIPIENT'S identification number 234-56-7890	2b 28% rate gain $ 0	2c Unrecap. sec. 1250 gain $ 0.00	Copy B For Recipient
RECIPIENT'S name Jane D. Investor		2d Section 1202 gain $	3 Nontaxable distributions $ 0.00	This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this income is taxable and the IRS determines that it has not been reported.
Street address (including apt. no.) 345 Capitol Street		4 Federal income tax withheld $	5 Investment expenses $	
City, state, and ZIP code Washington, DC 20002		6 Foreign tax paid $ 0.00	7 Foreign country or U.S. possession	
Account number (optional)		8 Cash liquidation distr. $	9 Noncash liquidation distr. $	

Form 1099-DIV (Keep for your records.) Department of the Treasury - Internal Revenue Service

Note: Funds often send "substitute" forms that contain the required information shown above, but in a different layout.

Remember that taxes can affect the return of any investment you make.

At tax time, your mutual fund will send you a Form 1099-DIV that tells you what earnings to report on your income tax return. You report ordinary dividends as dividend income on your tax return and capital gains distributions as long-term capital gains regardless of how long you have owned your fund shares. Certain long-term capital gains are taxed at different rates.

Tax-exempt Funds

Fund dividends from municipal bond interest are generally exempt from federal income tax and, in some cases, state and local taxes as well. Tax-exempt money market funds, for example, invest in short-term municipal securities, and also pay tax-exempt dividends.

Even though income from these funds generally is tax-exempt, you must still report it. Your tax-exempt mutual fund provides this information in a year-end statement, and will explain how to handle tax-exempt dividends on a state-by-state basis.

For some taxpayers, portions of income earned by tax-exempt funds may be subject to the federal alternative minimum tax; your tax professional can advise you on this issue. Even though municipal bond dividends may be tax-free, an investor may realize taxable capital gains when redeeming shares.

Taxes Can Affect Your Investment Return

It is important to understand the impact that taxes can have on the return of any investment you choose. Taxes can especially affect the investment return generated in taxable or "non-retirement" accounts. The returns you earn in your company retirement plan are most likely tax-deferred—and you don't begin to pay taxes until you take money out, usually when you retire.

In taxable or "non-retirement" accounts, regardless of the underlying investment, you will be responsible for taxable income (such as interest or dividends) realized from that investment. Thus, you may want to consider the typical size and frequency of income distributions that are paid.

Another significant factor that affects whether you will be faced with a tax obligation is how often you sell any security, since each securities transaction is a "tax event."

Share Sales and Exchanges

When you sell mutual fund shares, you will have a capital gain or loss in the year the shares are sold. An exchange of shares from one fund to another in the same fund family is taxed the same as if you sold the shares and purchased new ones with the proceeds. You are liable for tax on any capital gain arising from the sale, just as you would be if you sold individual securities. Losses may be used to offset other gains in the current year and thereafter.

The amount of the gain or loss is determined by the difference between the "cost basis" of the shares (generally, the original purchase price) and the sale price. To figure the gain or loss on a sale of shares, it is essential to know the cost basis.

Recordkeeping

Recordkeeping is critical to calculating taxes due on mutual fund investments. To figure out gains and losses, you will need a complete record of your purchases and sales of fund shares. Fortunately, funds provide you with all the records that you need to compute cost basis, and you should keep these records. As a special service, some funds will provide cost basis information to their shareholders or compute gains and losses for shares sold.

Calculating Cost Basis

Assuming no sales charges, the cost basis of a mutual fund share is simply the purchase price. If there were fees or commissions paid at the time of purchase, they are included in the basis.

Let's say you bought 100 shares of Blue-Chip Plus Fund at $10 each and paid an up-front sales charge of 2 percent, or $20, on the purchase. The cost basis for each share would be $10.20 ($1,020 divided by 100).

If you later sell the 100 shares for $1,500, your capital gain will be $480 ($1,500 - $1,020).

When you reinvest dividends and capital gains distributions to buy more shares, do not forget to include the cost of those shares in the cost basis of your account.

Because every person's tax situation is unique, it's a good idea to ask a tax professional if you have questions about the tax status of any investment.

Becoming an Informed Investor

The Mutual Fund Prospectus and Shareholder Reports

To protect investors, all mutual funds are highly regulated by the federal government through the U.S. Securities and Exchange Commission (SEC). Federal law requires that all funds provide two types of documents to current and potential investors free of charge: a prospectus and a shareholder report.

A mutual fund's prospectus describes in plain English the fund's goals, fees and expenses, investment strategies and risks, as well as information on how to buy and sell shares. You can get a copy of a fund's current prospectus from the fund or your broker or financial planner. Many funds also make prospectuses available on their websites. The SEC requires a fund to provide a full prospectus either before you invest or together with the confirmation statement for your initial investment.

Annual and semiannual shareholder reports document the fund's recent performance and include other important information. By examining these reports, you can learn if a fund has been effective in meeting the goals and investment strategies described in the fund's prospectus.

What to Look for in a Shareholder Report

Shareholder reports typically include two main types of information:

- the fund's financial statements and performance; and
- a list of the securities the fund held in its portfolio at the end of the most recent accounting period.

A Streamlined Approach to Investment Decisionmaking: The Fund Profile

Some mutual funds offer a streamlined version of a fund prospectus called a fund profile. The fund profile contains the answers to key questions to consider before investing in a mutual fund. If you find you need more information, a fund stands ready to send you a prospectus, shareholder reports, and other helpful documents. Once you invest, the fund automatically sends you the prospectus.

The annual report discusses the factors and investment strategies that affected the fund's performance during the period covered by the report. Also included in a fund's annual report (with the exception of money market funds) is information comparing the fund's performance at the end of each of the past 10 years (or since the first year the fund was in operation) with one or more market indices, such as the S&P 500 Stock Index or the Lehman Brothers Corporate Bond Index. Charts and tables assume a $10,000 investment was made at the beginning of the first fiscal year. (The SEC requires that the performance discussion and chart be included in either the shareholder report or the prospectus; most funds include it in their shareholder reports.)

Evaluating Fund Performance

A fund's annual report or prospectus contains charts and tables, like the one below, allowing for an easy comparison of the fund's performance versus a similar market index. When comparing mutual fund performance with that of an index, remember that your fund's performance is calculated after fees and expenses have been deducted; the performance of the index does not reflect the costs associated with constructing and maintaining an identical portfolio.

	Past 1 Year	Past 5 Years*	Past 10 Years*
Equity Fund	8.39%	23.22%	18.96%
S&P 500 Index*	7.22%	23.77%	17.79%

**The S&P 500 is the Standard & Poor's Composite Index of 500 Stocks, a widely recognized, unmanaged index of common stock price.*

**Average annual return.*

Publications and Websites

In addition to fund prospectuses and shareholder reports, there are many other sources of mutual fund information available to you. However, none can substitute for reading the prospectus and shareholder reports.

Information found in newspapers, magazines, independent reports, websites, and other outside sources of information can be valuable because they provide third-party views and comparisons of different funds.

To learn how to obtain information from many of these sources, look at the *Other Resources* section in the back of this booklet (see pages 40-41).

Newspapers and Magazines

Many newspapers, business magazines, and financial publications cover mutual funds. They can be a source of information on industry trends, expense ratios, rankings, and profiles of various funds.

Newspapers can be a good way to track mutual fund performance. Most major dailies publish the latest mutual fund share prices and performance.

In some papers, the share price (NAV) is identified as the sell, or bid price, which is the amount per share you would receive if you sell a share (less any deferred sales charges or redemption fees). Also listed in the paper is the offering price, sometimes called the buy, or asked, price which is the price investors pay to purchase shares. The offering price is the share price plus any sales charges.

Online Information

Many fund companies have Internet websites. You can usually access fund information and download prospectuses and annual reports from these sites. Some companies use the Internet to provide educational material and to allow shareholder transactions. Fund information can also be found on the SEC's website.

How to Read a Mutual Fund Fee Table

You pay for the cost of owning a mutual fund when you buy and own fund shares. There can be two types of costs. Some funds charge shareholder fees, which are sales commissions based on the purchase and sale of fund shares. In addition, all funds have operating expenses, which represent the costs of running the fund. A mutual fund's fees and expenses are required by law to be clearly disclosed to investors in a fee table (see page 34) at the front of the fund's prospectus.

Mutual funds compete vigorously to keep costs low, since the performance figures reported by the fund, and the total value of your mutual fund account, are provided after all fees and expenses have been deducted. For example, the fund returns published in newspapers, advertisements, and official fund documents already are "net" of any fees the fund charges you. Thus, any time you consider a fund's past performance, your decision reflects the impact fees have had on the fund in the past.

Particularly important to your assessment of costs is the fund's expense ratio. The availability of this figure in all fund prospectuses allows you to easily compare how much more or less one fund costs versus another—an important part of making an informed investment decision.

The Statement of Additional Information

After reviewing the prospectus, if you want more information, ask the fund for its Statement of Additional Information (SAI), which the fund will send you free of charge. Most SAIs are lengthy and fairly technical but include many additional details about the fund, such as:

- more information about the fund's securities, risks, and policies;
- the fund's audited financial statements;
- the fund's portfolio securities as of the date of the SAI; and
- information about anyone who owns 5 percent or more of the fund's shares.

Mutual Fund Fee Table Required by Federal Law

(example is hypothetical)

Shareholder Fees are charged directly to an investor for a specific transaction, such as a purchase, redemption, or exchange.

Maximum Sales Charge (Load) Imposed on Purchases—The maximum "front-end load" or sales charge that may be attached to the purchase of mutual fund shares. This fee compensates a financial professional for his or her services. By law, this charge may not exceed 8.5 percent of the investment, although most fund families charge less than the maximum.

Maximum Deferred Sales Charge (Load)—The maximum "back-end load" or sales charge that a fund may impose when shares are redeemed or sold; an alternative way to compensate financial professionals for their services. A common type of deferred sales charge is a "contingent deferred sales charge," which typically applies for the first few years of ownership, declining until it disappears.

Maximum Sales Charge (Load) on Reinvested Dividends—The maximum fee charged by a fund when dividends are reinvested in the purchase of additional shares. Most funds do not charge a fee for this service. Beginning in April 2000, new funds were prohibited from charging this fee.

Redemption Fee—Like a contingent deferred sales charge, this fee is another type of back-end charge when an investor redeems shares. Unlike contingent deferred sales charges, this fee is paid to the fund. It covers costs, other than sales costs, involved with a redemption. The fee is expressed as a dollar amount or as a percentage of the redemption price.

Exchange Fee—This fee may be charged when an investor transfers money from one fund to another within the same fund family.

Account Maintenance Fee—This fee may be charged by some funds, for example, to maintain low-balance accounts.

Mutual Fund Fee Table

Shareholder Fees

Maximum Sales Charge (Load) Imposed on Purchases	**4.5%**
Maximum Deferred Sales Charge (Load)	**None**
Maximum Sales Charge (Load) on Reinvested Dividends	**None**
Redemption Fee	**None**
Exchange Fee	**None**
Annual Account Maintenance Fee	**None**

Annual Fund Operating Expenses reflect the normal costs of operating a fund. Unlike transaction fees, these expenses are not charged directly to an investor but are deducted from fund assets before earnings are distributed to shareholders.

Annual Fund Operating Expenses

Management Fees	**0.75%**
Distribution (12b-1) Fees	**None**
Other Expenses	**0.22%**
Total Annual Fund Operating Expenses (Expense Ratio)	**0.97%**

Example

This example is intended to help an investor compare the cost of investing in different funds. The example assumes a $10,000 investment in the fund for one, three, five, and ten years and then a redemption of all fund shares at the end of those periods. The example also assumes that an investment returns 5 percent each year and that the fund's operating expenses remain the same. Although actual costs may be higher or lower, based on these assumptions an investor's costs would be:

1 year	**$99**
3 years	**$309**
5 years	**$536**
10 years	**$1,190**

Management Fees—These are fees charged by a fund's investment adviser for managing the fund's portfolio of securities and providing related services.

Distribution (12b-1) Fees—These fees, if charged, are deducted from fund assets to pay marketing and advertising expenses or, more commonly, to compensate sales professionals. By law, 12b-1 fees cannot exceed 1 percent of a fund's average net assets per year. The 12b-1 fee may include a service fee of up to 0.25 percent of average net assets per year to compensate sales professionals for providing services or maintaining shareholder accounts.

Other Expenses—These expenses include, for example, fees paid to a fund's transfer agent for providing fund shareholder services, such as toll-free phone communications, computerized account services, website services, recordkeeping, printing, and mailing.

Total Annual Fund Operating Expenses (Expense Ratio)—This represents the sum of all a fund's annual operating costs, expressed as a percentage of average net assets. Total annual fund operating expenses are also known as the fund's expense ratio.

Example of the effect of expenses on a $10,000 investment—This is a hypothetical illustration required by the SEC to be included in every fund's fee table. It is presented in a standardized format and based on specified assumptions (five percent annual return, expenses unchanged) in order to make it easier for investors to compare different funds' fees.

Share Classes

A fund may offer different "classes" of shares for the same mutual fund. Multiple classes of shares—Class A, Class B, Class C, etc.—represent ownership in the same mutual fund, but charge different fees. This can allow you to choose the fee structure that best suits your needs.

For example, a mutual fund may offer Class A, B, and C shares. The Class A share charges a front-end sales commission (or "load"); the Class B share charges a back-end load; the Class C share charges a "level load" every year. A, B, and C shareholders own the same fund, but they have chosen different options for paying fund expenses.

Should Fund Fees Affect Your Decision?

If two funds were *identical*, except for the fees and expenses they charge, the lower-cost fund would be a better option.

But rarely, if ever, are funds identical. For example, stock funds typically cost more than bond and money market funds, but stock funds historically have provided a significantly higher return—even after expenses are deducted. Even different types of stock funds, U.S. or foreign, typically vary in cost.

In short, there are many factors that affect the fees and expenses a fund charges. Only after weighing all of the relative benefits of different funds, including an analysis of their costs, can you decide if owning a particular fund is acceptable to you. A fund with higher costs may make more money for you, even after accounting for the costs you pay, than a fund with a lower cost. The opposite may also be true.

How to Calculate the Annual Fund Fees You Pay

It's easy to compare the annual costs of two or more funds. Costs are displayed prominently at the front of each fund's prospectus in a standardized fee table, as shown in the illustration on pages 34–35. The fund fee table displays annual costs as a percentage of fund assets—the expense ratio. The expense ratio allows you to make simple but exact comparisons of annual fees. Finally—and equally important—the fee table includes a hypothetical example that tells you in dollars and cents what a $10,000 investment would cost based on a five percent return. This cost includes transactional charges, if any, and the fund's annual fees. Thus, in the hypothetical $10,000 investment example, a fund with a 0.75 operating expense ratio would cost a shareholder $6.25 a month.

You can also perform cost calculations and comparisons on your own based on your own investments. Some websites offer cost calculators, like the one found on the Securities and Exchange Commission website (at www.sec.gov/mfcc/mfcc-int.htm), that supply you with dollars-and-cents cost comparisons.

Protecting Investors—Who Oversees Mutual Funds?

Most experts agree that a primary reason for the mutual fund industry's popularity and success is its reputation for honesty, fairness, and integrity. That reputation is built on a system of fund regulation specifically designed to ensure that funds are operated in the best interests of fund shareholders. Funds are also governed by a board of directors, 40 percent of whom must be independent from the fund and who are required to act as shareholder advocates. In practice, many funds go beyond the legal requirement and maintain a majority of independent directors on their boards.

The System of Fund Regulation

Mutual funds must comply with an extensive set of strict federal laws and regulations. These laws are vigorously enforced and actively monitored by regulators to ensure compliance.

Securities and Exchange Commission

The U.S. Securities and Exchange Commission (SEC) is the main federal agency responsible for regulating mutual fund activities. The SEC monitors fund compliance with the chief federal statute governing mutual funds: the Investment Company Act of 1940. The 1940 Act imposes restrictions not only on mutual funds but also on the investment advisers, directors, principal underwriters, officers, and employees that carry out the business of the fund. The SEC also monitors how funds comply with other federal statutes, including the Investment Advisers Act, the Securities Exchange Act of 1934, and the Securities Act of 1933.

The SEC Division of Investment Management oversees and regulates funds specifically, and also considers changes to the securities laws affecting funds and other investment companies. Working within the guidelines of the 1940 Act, the SEC Division of Investment Management:

- works to prohibit conflicts of interest to ensure funds serve only the interests of their shareholders;
- enforces rules requiring independent custodians to ensure funds invest as they disclose in their prospectuses and other fund documents;
- maintains strict standards on leveraging so that funds do not take undue risks with fund assets;
- ensures that funds maintain an effective system of self-governance;
- requires understandable and full disclosure to investors and works to eliminate fraud and abuse;

continued

- interprets laws and regulations for the public and for SEC inspection and enforcement purposes;
- reviews funds' required filings with the SEC;
- reviews enforcement matters involving funds; and
- develops new rules and amendments to adapt regulation to new circumstances.

Office of Compliance Inspections and Examinations. The SEC Office of Compliance Inspections and Examinations (OCIE) administers a nationwide examination and inspection program for mutual funds and other investment companies. OCIE inspects funds to foster compliance with the 1940 Act and other securities laws, detects possible law violations, and keeps the SEC informed of developments in the fund industry.

Office of Investor Education and Assistance. The SEC Office of Investor Education and Assistance (OIEA) serves individual investors directly, ensuring that their problems and concerns are known throughout the SEC and considered when the agency takes action.

OIEA investor assistance specialists answer questions, analyze complaints, and seek informal resolutions. This office also publishes free brochures and other educational materials on numerous investing topics. These brochures and other resources are available by contacting the SEC (please see *Other Resources* on page 40).

Fund Directors

A mutual fund is governed by a board of directors, which works to ensure that the fund management executes its business affairs in the best interests of fund shareholders. Because mutual fund directors are, in essence, looking out for shareholders' money, the law holds directors to a very high legal standard.

Fund directors must exercise the care that a reasonably prudent person would take with his or her own money. They are expected to obtain adequate information, exercise sound business judgment, approve policies and procedures, and undertake oversight and review of the performance of the investment managers and other entities that perform services for the fund.

A provision of the 1940 Act requires that at least 40 percent of a fund's board of directors be independent of the fund's investment adviser or principal underwriter. Recognizing the importance of independent directors, most funds require a majority of independent directors. The bottom line is that independent fund directors serve as watchdogs for shareholder interests and oversee a fund's investment adviser and others closely affiliated with the fund.

Other Regulatory Agencies and Entities

Department of Labor

The Department of Labor's Pension and Welfare Benefits Administration (PWBA) protects the integrity of pension plans, including 401(k) and other plans to which mutual funds often provide services.

The PWBA assists workers in getting the information they need to protect their benefit rights and enforces the relevant provisions of federal pension laws.

NASD Regulation, Inc.

NASD Regulation, Inc. regulates the securities industry, including mutual funds, according to federal laws from the 1930s allowing the establishment of "self-regulatory" organizations under SEC oversight. As a result, mutual fund communications must comply with NASD rules and regulations.

Internal Revenue Service

The Internal Revenue Service (IRS) has no direct oversight of mutual funds, but IRS regulations and decisions affect how mutual funds conduct their business and can impact an individual's fund investments through its tax policies. For example, changes to tax laws are what led to the establishment of 401(k) plans and Individual Retirement Accounts.

Other Resources

Useful Addresses

Government Resources

Consumer Information Center
(federal publications on finance)
Dept. WWW
Pueblo, CO 81009
888/878-3256
www.pueblo.gsa.gov/money.htm

Federal Trade Commission
6th Street & Pennsylvania Avenue, NW
Washington, DC 20580
202/326-2000
www.ftc.gov

Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224
202/622-5000
www.irs.gov

Pension and Welfare Benefits Administration
U.S. Department of Labor
200 Constitution Avenue, NW
Washington, DC 20210
202/219-8776
www2.dol.gov/dol/pwba/

Securities and Exchange Commission
Office of Investor Education and Assistance
450 Fifth Street, NW
Washington, DC 20549
800/SEC-0330
www.sec.gov/oiea1.htm

Social Security Administration
6401 Security Boulevard
Baltimore, MD 21235
800/772-1213
www.ssa.gov

Investor Resources

Alliance for Investor Education
www.investoreducation.org/

American Association of Individual Investors
625 N. Michigan Avenue, Suite 1900
Chicago, IL 60611
800/428-2244
www.aaii.com

American Association of Retired Persons
601 E Street, NW
Washington, DC 20049
800/424-3410
www.aarp.org

American Savings Education Council
2121 K Street, NW
Suite 600
Washington, DC 20037
202/775-9130
www.asec.org

The Bond Market Association
40 Broad Street
New York, NY 10004
212/440-9400
www.psa.com

Coalition of Black Investors
P.O. Box 30553
Winston-Salem, NC 27130
888/411-2624
www.cobinvest.com

Consumer Federation of America
1424 16th Street, NW
Suite 604
Washington, DC 20036
202/387-6121
www.consumerfed.org

Employee Benefit Research Institute
2121 K Street, NW
Suite 600
Washington, DC 20037
202/659-0670
www.ebri.org

Forum for Investor Advice
7200 Wisconsin Avenue
Suite 709
Bethesda, MD 20814
301/656-7998
www.investoradvice.org

Futures Industry Institute
2001 Pennsylvania Avenue, NW
Suite 600
Washington, DC 20006
202/223-1528
www.fiafii.org

Financial Planning Association
3801 E. Florida Avenue
Suite 708
Denver, CO 80210
800/322-4237
www.fpanet.org

Investor Protection Trust
1901 North Fort Myer Drive
Suite 1012-1014
Arlington, VA 22209
703/276-1116
www.investorprotection.org

Mutual Fund Education Alliance
100 NW Englewood Road
Suite 130
Kansas City, MO 64118
816/454-9422
www.mfea.com

NASD Regulation, Inc.
1735 K Street, NW
Washington, DC 20006
202/728-8958
www.nasdr.com

National Association of Insurance Commissioners
Support and Services Offices
120 Twelfth Street
Suite 1100
Kansas City, MO 64105
816/842-3600
www.naic.org

National Association of Investors Corporation
711 West Thirteen Mile Road
Madison Heights, MI 48071
877/275-6242
www.better-investing.org

National Association of Personal
Financial Advisors
355 West Dundee Road
Suite 200
Buffalo Grove, IL 60089
888/333-6659
www.napfa.org

National Consumers League
1701 K Street, NW
12th Floor
Washington, DC 20006
202/835-3323
www.natlconsumersleague.org

National Endowment for Financial Education
5299 DTC Boulevard
Suite 1300
Englewood, CO 80111
303/741-6333
www.nefe.org

National Foundation for Consumer Credit
8611 Second Avenue
Suite 100
Silver Spring, MD 20910
301/589-5600
www.nfcc.org

National Institute for Consumer Education
559 Gary M. Owen Building
300 W. Michigan Avenue
Ypsilanti, MI 48197
734/487-2292
www.nice.emich.edu

National Urban League/ICI Education
Foundation Partnership
(Investing for Success Program)
1401 H Street, NW
Suite 1200
Washington, DC 20005
202/326-5800
www.ici.org/investing_for_success/index.html

Securities Industry Association
120 Broadway
35th Floor
New York, NY 10271
212/608-1500
www.sia.com

Securities Investor Protection Corporation
805 15th Street, NW
Suite 800
Washington, DC 20005
202/371-8300
www.sipc.org

Questions About Business Practices

If you believe you have been subject to improper business practices involving a mutual fund, broker, or brokerage firm, NASD Regulation, Inc. (NASDR) advises that you contact your fund, your broker, and the manager of your broker's office in writing. If you find the response unsatisfactory, you may choose to file a customer complaint. Complaints may be filed by sending a letter to the nearest NASD district office or online through the NASDR's website (www.nasdr.com). The NASDR main address is:

NASD Regulation, Inc.
1735 K Street, NW
Washington, DC 20006
202/728-8958
www.nasdr.com

For more information about filing a complaint or to learn whether a fund, broker, or brokerage firm has been involved in a disciplinary action, arbitration decision, civil judgment, criminal indictment, or has a formal disciplinary proceeding pending, call the NASD Public Disclosure Phone Center at 800/289-9999.

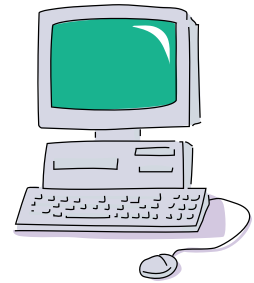
You may also wish to contact your state securities agency for information on a fund, a brokerage firm and its brokers, and whether there is a history of regulatory violations, disciplinary actions, or investor complaints. For a directory of securities agencies by state, call the North American Securities Administrators Association, Inc. (NASAA) at 202/737-0900, or visit their website at www.nasaa.org.

The Investment Company Institute

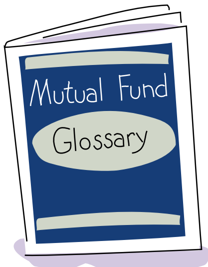
The Investment Company Institute is the national association of the investment company industry. The Institute's website, ICI Mutual Fund Connection, located at www.ici.org, provides educational and reference materials for individuals seeking information about mutual funds. If you would like to know more, please write for a list of additional investor awareness materials at ICI Investor Awareness Campaign, P.O. Box 27850, Washington, DC 20038-7850.

Mutual Fund Company Websites

Many mutual fund companies have websites that offer information about their funds and educational tools for investors. Many fund websites can be located using a major Internet search engine.



Glossary of Mutual Fund Terms



Annual and Semiannual Reports—Summaries that a mutual fund sends to its shareholders that discuss the fund's performance over a certain period and identify the securities in the fund's portfolio on a specific date.

Appreciation—An increase in an investment's value.

Asked or Offering Price—(As seen in some mutual fund newspaper listings, see p. 32.) The price at which a mutual fund's shares can be purchased. The asked or offering price includes the current net asset value per share plus any sales charge.

Assets—The current dollar value of the pool of money shareholders have invested in a fund.

Automatic Reinvestment—A fund service giving shareholders the option to purchase additional shares using dividends and capital gains distributions.

Average Portfolio Maturity—The average maturity of all the bonds in a bond fund's portfolio.

Bear Market—A period during which security prices in a particular market (such as the stock market) are generally falling.

Bid or Sell Price—The price at which a mutual fund's shares are redeemed, or bought back, by the fund. The bid or redemption price is usually the current net asset value per share.

Bond—A debt security, or IOU, issued by a company, municipality, or government agency. A bond investor lends money to the issuer and, in exchange, the issuer promises to repay the loan amount on a specified maturity date; the issuer usually pays the bondholder periodic interest payments over the life of the loan.

Broker/Dealer (or Dealer)—A firm that buys and sells mutual fund shares and other securities from and to investors.

Bull Market—A period during which security prices in a particular market (such as the stock market) are generally rising.

Capital Gains Distribution—Profits distributed to shareholders resulting from the sale of securities held in the fund's portfolio.

Closed-end Fund—A type of investment company that has a fixed number of shares which are publicly traded. The price of a closed-end fund share fluctuates based on investor supply and demand. Closed-end funds are not required to redeem shares and have managed portfolios.

Commission—A fee paid by an investor to a broker or other sales agent for investment advice and assistance.

Compounding—Earnings on an investment's earnings. Over time, compounding can produce significant growth in the value of an investment.

Contingent Deferred Sales Charge (CDSC)—A fee imposed when shares are redeemed (sold back to the fund) during the first few years of ownership.

Credit Risk—The possibility that a bond issuer may not be able to pay interest and repay its debt.

Custodian—An organization, usually a bank, that holds the securities and other assets of a mutual fund.

Depreciation—A decline in an investment's value.

Diversification—The practice of investing broadly across a number of securities to reduce risk.

Dollar-cost Averaging—The practice of investing a fixed amount of money at regular intervals, regardless of whether the securities markets are declining or rising.

Exchange Privilege—A fund option enabling shareholders to transfer their investments from one fund to another within the same fund family as their needs or objectives change. Typically, fund companies allow exchanges several times a year for a low or no fee.

Expense Ratio—A fund's cost of doing business—disclosed in the prospectus—expressed as a percent of its assets.

Face Value—The amount that a bond's issuer must repay at the maturity date.

Family of Funds—A group of mutual funds, each typically with its own investment objective, managed and distributed by the same company.

401(k) Plan—An employer-sponsored retirement plan that enables employees to make tax-deferred contributions from their salaries to the plan.

403(b) Plan—An employer-sponsored retirement plan that enables employees of universities, public schools, and non-profit organizations to make tax-deferred contributions from their salaries to the plan.

457 Plan—An employer-sponsored retirement plan that enables employees of state and local governments and other tax-exempt employers to make tax-deferred contributions from their salaries to the plan.

Hedge Fund—A private investment pool for wealthy investors that, unlike a mutual fund, is exempt from SEC regulation.

Income—Dividends, interest and/or short-term capital gains paid to a mutual fund's shareholders. Income is earned on a fund's investment portfolio after deducting operating expenses.

Individual Retirement Account (IRA)—An investor-established, tax-deferred account set up to hold and invest funds until retirement.

Inflation Risk—The risk that a portion of an investment's return may be eliminated by inflation.

Interest Rate Risk—The possibility that a bond's or bond mutual fund's value will decrease due to rising interest rates.

Investment Adviser—An organization employed by a mutual fund to give professional advice on the fund's investments and asset management practices.

Investment Company—A corporation, trust, or partnership that invests pooled shareholder dollars in securities appropriate to the organization's objective. Mutual funds, closed-end funds, and unit investment trusts are the three types of investment companies.

Investment Objective—The goal that an investor and mutual fund pursue together (e.g., current income, long-term capital growth, etc.).

Issuer—The company, municipality, or government agency that issues a security, such as a stock, bond, or money market security.

Large-cap Stocks—Stocks of large-capitalization companies, which are generally considered to be companies whose total outstanding shares are valued at $10 billion or more.

Liquidity—The ability to readily access invested money. Mutual funds are liquid because their shares can be redeemed for current value (which may be more or less than the original cost) on any business day.

Long-term Funds—A mutual fund industry designation for all funds other than money market funds. Long-term funds are broadly divided into equity (stock), bond, and hybrid funds.

Management Fee—The amount paid by a mutual fund to the investment adviser for its services.

Maturity—The date by which an issuer promises to repay the bond's face value.

Mutual Fund—An investment company that buys a portfolio of securities selected by a professional investment adviser to meet a specified financial goal. Mutual fund investors buy shares in the fund that represent ownership in all the fund's securities. A mutual fund stands ready to buy back its shares at their current net asset value, which is the total market value of the fund's investment portfolio, minus its liabilities, divided by the number of shares outstanding. Most mutual funds continuously offer new shares to investors.

National Association of Securities Dealers Regulation, Inc. (NASDR)—A self-regulatory organization with authority over firms that distribute mutual fund shares as well as other securities.

Net Asset Value (NAV)—The per-share value of a mutual fund, found by subtracting the fund's liabilities from its assets and dividing by the number of shares outstanding. Mutual funds calculate their NAVs at least once daily.

No-load Fund—A mutual fund whose shares are sold without a sales commission and without a 12b-1 fee of more than .25 percent per year.

Open-end Investment Company—The legal name for a mutual fund, indicating that it stands ready to redeem (buy back) its shares from investors on any business day.

Operating Expenses—Business costs paid from a fund's assets before earnings are distributed to shareholders. These include management fees and 12b-1 fees and other expenses.

Portfolio—A collection of securities owned by an individual or an institution (such as a mutual fund) that may include stocks, bonds, and money market securities.

Portfolio Manager—A specialist employed by a mutual fund's adviser to invest the fund's assets in accordance with predetermined investment objectives.

Portfolio Turnover—A measure of the trading activity in a fund's investment portfolio—how often securities are bought and sold by a fund.

Prepayment Risk—The possibility that a bond owner will receive his or her principal investment back from the issuer prior to the bond's maturity date.

Principal—see Face Value.

Prospectus—The official document that describes a mutual fund to prospective investors. The prospectus contains information required by the SEC, such as investment objectives and policies, risks, services, and fees.

Quality—The creditworthiness of a bond issuer, which indicates the likelihood that it will be able to repay its debt.

Redeem—To cash in mutual fund shares by selling them back to the fund. Mutual fund shares may be redeemed on any business day. You will receive the current share price, called net asset value, minus any deferred sales charge or redemption fee.

Reinvestment Privilege—An option whereby mutual fund dividends and capital gains distributions automatically buy new fund shares.

Risk/Reward Tradeoff—The investment principle that an investment must offer higher potential returns as compensation for the likelihood of increased volatility.

Rollover—The shifting of an investor's assets from one qualified retirement plan to another—due to changing jobs, for instance—without a tax penalty.

Sales Charge or Load—An amount charged for the sale of some fund shares, usually those sold by brokers or other sales professionals. By regulation, a mutual fund sales charge may not exceed 8.5 percent of an investment purchase. The charge may vary depending on the amount invested and the fund chosen. A sales charge or load is reflected in the asked or offering price (see Asked Price).

Securities and Exchange Commission (SEC)—The primary U.S. government agency responsible for the regulation of the day-to-day operations and disclosure obligations of mutual funds.

Series Fund—A group of different mutual funds, each with its own investment objective and policies, that is structured as a single corporation or business trust.

Share Classes (e.g., Class A, Class B, etc.)—Represent ownership in the same fund, but charge different fees. This can enable shareholders to choose the type of fee structure that best suits their particular needs.

Shareholder—An investor who owns shares of a mutual fund or other company.

Short-term Funds—Another term for money market funds.

Small-cap Stocks—Stock of small-capitalization companies, which are generally considered to be companies whose total outstanding shares are valued at less than $1.6 billion.

Spread—The difference between what you pay for a stock or bond and what the security dealer pays for it.

Statement of Additional Information (SAI)—The supplementary document to a prospectus that contains more detailed information about a mutual fund; also known as "Part B" of the prospectus.

Stock—A share of ownership or equity in a corporation.

Total Return—A measure of a fund's performance that encompasses all elements of return: dividends, capital gains distributions, and changes in net asset value. Total return is the change in value of an investment over a given period, assuming reinvestment of any dividends and capital gains distributions, expressed as a percentage of the initial investment.

Transfer Agent—The organization employed by a mutual fund to prepare and maintain records relating to shareholder accounts.

12b-1 Fee—A mutual fund fee, named for the SEC rule that permits it, used to pay for broker-dealer compensation and other distribution costs. If a fund has a 12b-1 fee, it will be disclosed in the fee table of a fund's prospectus.

Underwriter—The organization that sells a mutual fund's shares to broker/dealers and investors.

Unit Investment Trust (UIT)—An investment company that buys and holds a fixed number of shares until the trust's termination date. When the trust is dissolved, proceeds are paid to shareholders. A UIT has an unmanaged portfolio. Like a mutual fund, shares of a UIT can be redeemed on any business day.

Withdrawal Plan—A fund service allowing shareholders to receive income or principal payments from their fund account at regular intervals.

Yield—A measure of net income (dividends and interest) earned by the securities in the fund's portfolio less fund expenses during a specified period. A fund's yield is expressed as a percentage of the maximum offering price per share on a specified date.

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