Understanding mutual funds

Canadian Securities Administrators
Securities regulators from each province and territory have teamed up to form the Canadian Securities Administrators, or CSA for short. The CSA is primarily responsible for developing a harmonized approach to securities regulation across the country.

www.securities-administrators.ca

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Thinking about investing in mutual funds? They can be an effective way to save for important goals like retirement or your child's education. But like all investments, they have their risks. There are also costs involved in owning mutual funds.

The **Canadian Securities Administrators (CSA)** have put together this guide to help you learn more. Our members include the 13 securities regulators of Canada's provinces and territories. If you have questions or want more information, contact your local securities regulator listed on page 12.

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What is a mutual fund?

A mutual fund is a type of investment fund. An investment fund is a collection of investments, such as stocks, bonds or other funds. Unlike most other types of investment funds, mutual funds are "open-ended," which means as more people invest, the fund issues new units or shares.

A mutual fund typically focuses on specific types of investments. For example, a fund may invest mainly in government bonds, stocks from large companies or stocks from certain countries. Some funds may invest in a mix of stocks and bonds, or other mutual funds.

Why invest in mutual funds?

When you buy a mutual fund, you're pooling your money with many other investors. This lets you invest in a variety of investments for a relatively low cost. Another advantage is that a professional manager makes the decisions about specific investments.

Also, mutual funds are widely available through banks, financial planning firms, brokerage firms, credit unions, trust companies and other investment firms. You can buy or sell funds at any time.

Other things to consider

Like all investments, mutual funds have risk—you could lose money on your investment. The value of most mutual funds will change as the value of their investments goes up and down. Depending on the fund, the value could change frequently and by a lot.

Also, there are fees that will affect the return you get on your investment. Some of these fees are paid by you, and others are paid by the fund.

Your return will also depend on the portfolio manager's skill at picking investments. Some studies show that most mutual funds are unlikely to consistently perform better than their benchmark over the long term.

The importance of diversification

Mutual funds can make it easy and affordable to own a variety of investments. Not all investments perform well at the same time. Different investments react differently to world events, factors in the economy like interest rates, and business prospects. So when one investment is down, another might be up.

Having a variety of investments can help offset the impact poor performers may have, while taking advantage of the earning potential of the rest. This is called "diversification."

What's a benchmark?

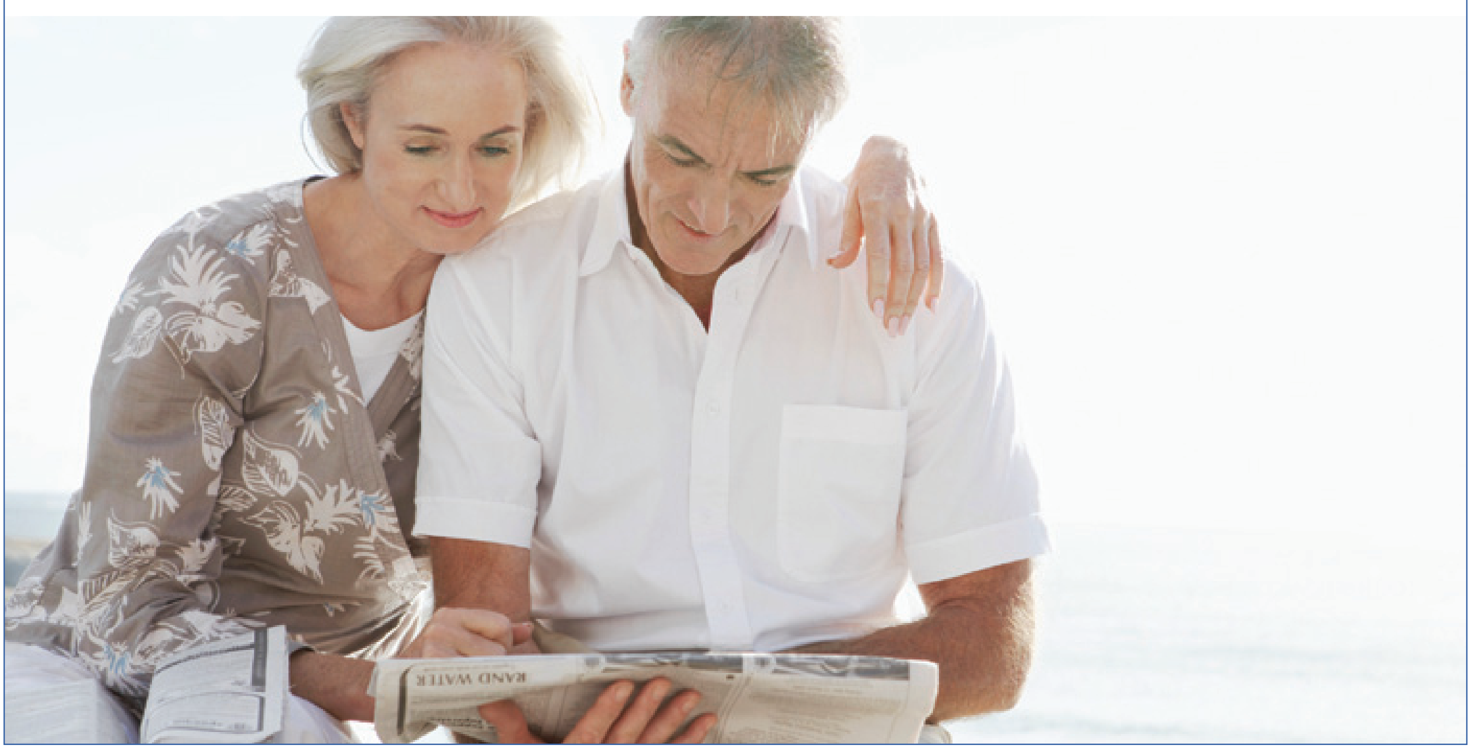
Typically, a benchmark is a market or sector index against which the performance of the mutual fund can be measured. For example, if a fund invests mainly in Canadian stocks, the benchmark might be the S&P/TSX Composite Index, which tracks companies trading on the Toronto Stock Exchange.

By comparing a fund to an appropriate benchmark, you can see how the investments held by the fund performed compared to the market or sector in general.

What do mutual funds invest in?

This table shows some of the common types of mutual funds and what they typically invest in. For more information about different kinds of investments and how they work, read the CSA's *Investments at a glance* guide.

Type of fund	What it mainly invests in
Money market	Short-term fixed income securities like treasury bills
Fixed income	Fixed income securities like government bonds and corporate bonds
Growth or equity	Equities like stocks or income trust units
Balanced	A mix of equities and fixed income securities
Global	Foreign equities or fixed income securities
Specialty	Equities or fixed income securities in a specific region (for example, Asia) or sector (for example, information technology)
Index	Equities or fixed income securities chosen to mimic a specific index, such as the S&P/TSX Composite Index
Fund of funds	Other mutual funds



How can you make money?

You'll make money on a mutual fund if the value of its investments goes up and you sell the fund for more than you paid for it. This is called a capital gain. If you sell the fund for less than you paid for it, this is called a capital loss.

Depending on the fund, you may also receive distributions of dividends, interest, capital gains or other income the fund earns on its investments. However, unless you ask for the distributions to be paid in cash, the fund will usually reinvest them for you.

Fund performance

How a fund has performed in the past can't predict how it will perform in the future. However, it can give you an idea of how the fund has performed in different market conditions. It can also give you an idea of how the fund compares to:

- other funds with the same investment objective
- a relevant benchmark

You can find performance information in the annual and semi-annual performance reports that mutual funds must issue. These reports are called "management reports of fund performance." They include the fund's returns for various periods and a discussion about what affected the fund's performance in the past year.

Management reports of fund performance are available from the fund company and on **www.sedar.com**. Mutual funds are required by securities law to file these reports and other documents on the System for Electronic Document Analysis and Retrieval (SEDAR).

You can also find other performance information on the fund company's website, in major financial newspapers and on websites like **www.globefund.com** or **www.morningstar.ca**.

How mutual funds are taxed

In general, you'll have to pay tax on the money you make on a fund. Interest, dividends and capital gains are all treated differently for tax purposes and that will affect your return from an investment. Keep in mind that distributions are taxable in the year you receive them, whether you get them in cash or they are reinvested for you.

However, if you hold your mutual funds in a registered plan, you won't pay income tax on the money you make as long as that money stays in the plan. When you withdraw money from the plan, it will be taxed as income.

Registered plans include:

- Registered Education Savings Plan (RESP)
- Registered Retirement Income Fund (RRIF)
- Registered Retirement Savings Plan (RRSP)

You may want to talk to a qualified tax expert about any taxes you may have to pay on your investment in mutual funds.

What are the risks?

Most mutual funds are not guaranteed—you could lose money on your investment. The level of risk in a mutual fund depends on what it invests in. For example, stocks are usually riskier than bonds, so you would expect an equity fund to be riskier than a fixed income fund.

Keep in mind that all investments have risk. The key is to understand the risk involved and decide if you're comfortable with it. You can help minimize your overall risk by owning a variety of investments. So before you decide on a mutual fund, think about how it fits with the rest of the investments you own.

Common types of risk

Different types of investments generally come with different types of risk. This table shows some of the common types of risk and how they could affect a fund's performance.

Assessing risk

Type of risk	Type of investment affected	How the fund could lose money
Country risk	Foreign investments	The value of a foreign investment declines because of political changes or instability in the country where the investment was issued.
Credit risk	Fixed income securities	If a bond issuer can't repay a bond, it may end up being a worthless investment.
Currency risk	Investments denominated in a currency other than the Canadian dollar	If the other currency declines against the Canadian dollar, the investment will lose value.
Interest rate risk	Fixed income securities	The value of fixed income securities generally falls when interest rates rise.
Liquidity risk	All types	The fund can't sell an investment that's declining in value because there are no buyers
Market risk	All types	The value of its investments decline because of unavoidable risks that affect the entire market.

What are the risks? cont'd

One way to assess a fund's level of risk is to look at how much its returns change from year to year. If the fund's returns vary a lot, it may be considered higher risk because its performance can change quickly in either direction.

For example, if a fund lost 5% two years ago, gained 17% last year and gained 2% this year, it is likely to be riskier than a fund that gained 6% in each of the past three years.

Remember that in investing, the higher the potential return, the higher the potential risk. If you want higher returns, you have to be prepared to accept the risks that go along with them.

How is your investment protected?

Mutual funds are not covered by the Canada Deposit Insurance Corporation, the Autorité des marchés financiers' fonds d'assurance-dépôts (Québec) or other deposit insurance. However, there are some safeguards in place to help protect investors.

For example, a mutual fund's assets must be held separately by a third party called a custodian. This is usually a chartered bank or trust company. Also, an independent auditor reviews and reports on the fund's financial statements each year.

If a firm goes bankrupt

There are two funds in place that may help protect your investment if the firm you dealt with goes bankrupt.

Canadian Investor Protection Fund (CIPF)

CIPF provides protection of up to $1 million to eligible customers of a member firm.

For more information, see **www.cipf.ca**.

MFDA Investor Protection Corporation

The Mutual Fund Dealers Association of Canada (MFDA) has an investor protection fund called the MFDA Investor Protection Corporation (IPC). The MFDA IPC provides protection of up to $1 million to eligible customers of MFDA members.

For more information, see **www.mfda.ca**.

What are the costs?

Every fund has costs, but they can vary widely from fund to fund. You can find information about a fund's costs in its simplified prospectus.

Sales charges

Sales charges are the commissions that you may have to pay when you buy or sell a fund. If you pay this charge when you buy the fund, it's called an initial sales charge or front-end load. If you pay it when you sell, it's called a deferred sales charge or back-end load. Some funds are sold on a "no-load" basis, which means you pay no sales charge when you buy or sell.

Comparing sales charge options

With initial sales charges, the cost can vary from firm to firm and may be negotiable. Shop around, and remember that every dollar you pay in commission is a dollar that does not go to work for you in the fund.

With deferred sales charges, the fee you'll pay is set. There's no negotiation. Also, you'll be locked into a fund family for a few years unless you're willing to sell the fund and pay a sales charge. And while you won't pay a sales charge on a no-load fund, it still has other costs like management fees and operating expenses.

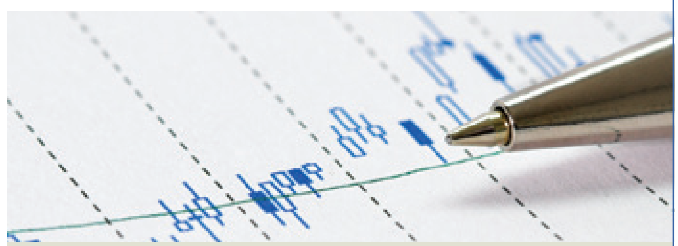
Management expense ratio (MER)

Each mutual fund pays an annual fee to a management company for managing the fund and its investments.

Mutual funds also pay their own operating expenses. These include legal and accounting fees, custodial fees, bookkeeping costs and other expenses. Some mutual funds pay a fixed administration fee to cover their operating expenses.

The management expense ratio (MER) is the total of the management fee and operating expenses. It's shown as a percentage of the fund's assets. For example, if a $100 million fund has $2 million in expenses for the year, its MER is 2%.

You don't pay management fees or operating expenses directly. These expenses affect you because they reduce the fund's returns—and what you get on your investment.



What's a simplified prospectus?

A simplified prospectus is a document that firms are required to send to investors after they buy a fund. You can also ask for a copy of the simplified prospectus before you invest. It includes information about a fund's:

- investment objectives and strategies
- risks
- suitability for certain investors
- distributions
- sales charges, management fees and operating expenses
- income tax considerations

Trailing commission

In general, the management company pays a portion of its management fee to the firm you dealt with as a trailing commission (or trailer fee). This commission is for the services and advice the firm provides to you.

It's usually based on the value of your investment and is paid for as long as you own the fund. Firms may pay a portion of the trailing commission to their advisers.

What are the costs? cont'd

Comparing MERs

MERs can range from less than 1% for money market funds to more than 3% for some specialty funds. More complex funds tend to have higher MERs because the manager needs to do more to effectively manage the fund, and these funds are more costly to run. Index funds usually have very low MERs because duplicating an index involves less research and less trading. For this reason, they often outperform actively managed funds over the long term.

However, keep in mind that a low MER doesn't necessarily mean more money in your pocket. For example, you'll make more on a fund with a 10% return and a 2% MER than you will on a fund with a 6% return and a 1% MER. Sometimes you may have to pay a higher MER to get better management and a higher return.

Other fees

You may be charged other fees if you switch funds, start a registered plan, or open or close an account.

You may also pay a short-term trading fee if you sell a fund within a certain period. Short-term trading fees are meant to discourage investors from using mutual funds to make a quick profit by "timing" the market. Mutual funds are meant to be long-term investments. Short-term trading can affect the other investors because it increases the fund's trading and administrative costs, and can decrease the value of the fund.

What you should expect for your money

The firm you dealt with may get a sales commission when it sells you a mutual fund. It may also get a trailing commission for as long as you own the fund. Here's what you should expect for your money.

First, anyone selling or providing advice about mutual funds must be registered. Call your local securities regulator or visit their website to see if a person or firm is registered.

You should expect your adviser to:

- talk to you about your investment objectives and tolerance for risk
- make clear and specific recommendations
- explain the reasons for the recommendations
- point out the strengths and weaknesses of potential investments
- outline the risks involved

Here's what your adviser should not do:

- make promises about a fund's performance
- suggest that future performance can be inferred from past performance
- offer a guarantee of your investment

For more information, read the CSA's guide to *Working with a financial adviser*.

Whenever you buy a fund, the firm you dealt with must send you the fund's simplified prospectus. They must also give you account statements at least once a year detailing your holdings and transactions. If you request it, you will also get current financial information twice a year for each fund you own.

Look into other series offered by the fund

Most funds are offered in different series or classes, usually for different types of investors. The fees and expenses will be different for each series. Ask about other series that may be suitable for you.

What if you change your mind?

In some provinces, you have the right to cancel an agreement to buy mutual funds within two business days of receiving the simplified prospectus. In some provinces, you can also cancel your purchase within 48 hours of receiving confirmation of your order. You may have more time to cancel your purchase if you buy the fund under a contractual plan.

In many provinces, you may cancel your purchase, and in some cases claim damages, if the simplified prospectus contains information that is not true.

For more information, contact your local securities regulator listed on page 20.

What about other types of investment funds?

There are other types of funds that you can invest in. Like mutual funds, you're leaving the investment decisions to a professional manager. Also, the level of risk and return depends on what the fund invests in.

However, there are differences in how these funds work and the types of costs involved.

Closed-end investment funds

These funds issue a finite number of units or shares, which may trade on a stock exchange. It may be difficult to buy or sell some closed-end funds if they are not listed on an exchange or they have a low volume of trading activity.

You'll pay a commission when you buy and sell a closed-end fund on an exchange.

Exchange-traded funds (ETFs)

ETFs hold the same mix of investments as a stock or bond market index and trade on a stock exchange. Most ETFs simply follow an index but some are more actively managed.

You'll pay a commission when you buy and sell an ETF. ETFs pay management fees and operating expenses. They may also pay trailing commissions.

The fees and expenses for an ETF are often lower than what you would pay for a mutual fund. If an ETF simply follows an index, the manager doesn't have to do as much research into investments or as much buying and selling of investments.

Segregated funds

Segregated funds are insurance products that combine investment funds with insurance coverage. You buy and sell segregated funds under an insurance contract. The contract comes with a guarantee that protects some or all of your investment if the markets go down. You generally have to hold the contract for 10 years to get this guarantee.

These funds have similar costs as mutual funds plus an insurance cost.

Questions to ask before you buy

Find out as much as you can about a fund before you invest. Read documents like the simplified prospectus and management reports of fund performance. Also take the time to research the fund in major financial newspapers and on websites like **www.globefund.com** and **www.morningstar.ca**.

Find out things like:

1. **What is the fund's goal?** Make sure the fund's goal fits with your investment goals. Does the fund provide regular income? Does it provide the level of return you're looking for? Does it fit with your time horizon? Does it work with your other investments?

2. **How risky is the fund?** Remember that you can make or lose money on a mutual fund. Can you accept the fund's level of risk?

3. **How has the fund performed?** Although past performance can't predict future results, it can give you an idea of how the fund compares to other funds with the same investment objective.

4. **What are the fund's costs?** All funds must disclose their fees and expenses in their simplified prospectus. Consider all of its costs. For example, a fund with a low MER could have very high sales charges, and vice versa. Also consider what you're getting for your money. What level of service and advice will you receive? Finally, compare the fund's costs and performance against similar funds to see what kind of value you're getting.

5. **Who manages the fund?** The success of a mutual fund depends on the portfolio manager's skill at choosing investments. What kind of education and experience does the portfolio manager have? Does the manager run other funds? How successful have they been?

6. **How will you be taxed?** If you don't hold the fund in a registered plan, do you know what types of distributions are usually made and how they're taxed? Do you know how capital gains (or losses) are taxed?

For more information, check out the Fund Facts document. It contains key information about a mutual fund including what the fund invests in, how the fund has performed, the risks involved, and the costs of investing. The Fund Facts document is available for every class and series of a mutual fund. You can find it on the mutual fund's or mutual fund manager's website and on **www.sedar.com.**

Know where to go for help

Securities regulators oversee Canada's capital markets and the advisers who sell and manage securities traded in those markets. We strive to protect investors from unfair, improper and fraudulent practices while fostering a fair and efficient marketplace.

You can contact your local securities regulator listed on page 20 to check the registration of an individual or firm, and to find out if they have been involved in any disciplinary actions.

If you have a complaint

If you believe that your adviser is not working in your best interests, you may want to make a complaint or consider finding another adviser.

Here's what to do if you want to make a complaint:

1. **Start with your adviser or their firm.** Be clear about what went wrong and when. State the outcome you expect (for example, an apology, getting your account corrected or getting your money back).

If you're not satisfied

2. **Ask about the firm's complaint process.** Follow the steps suggested. This could involve contacting a manager or the firm's compliance department. Put your complaint in writing.
   Be sure to keep notes of who you spoke to and what was discussed.

If that doesn't work

3. **Contact your local securities regulator or a lawyer.** They can tell you what your options are, depending on the type of complaint you have. In most cases, you have to go through the firm's complaint process first.

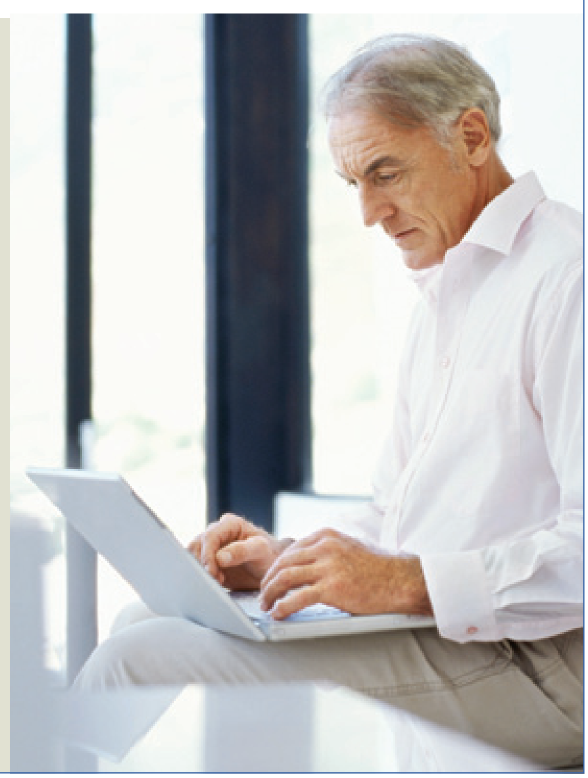
If you have lost money

Mutual funds come with risk. Therefore, you can lose money if the fund's investments perform poorly. However, if you want money back because you think you have not been treated fairly, you may want to contact the Ombudsman for Banking Services and Investments (OBSI). OBSI is a free, independent service for resolving banking services and investment disputes.

If you're not satisfied with the firm's decision on your complaint, you can bring your case to OBSI for an impartial and informal review. You have up to **180 days** after receiving the firm's response to get in touch with OBSI. OBSI can recommend compensation of up to $350,000.

For more information, see **www.obsi.ca**.

You may also want to consult a lawyer to get advice on your rights and options. Your provincial law society can help you find a lawyer. Go to the website of the Federation of Law Societies of Canada, **www.flsc.ca** for a list of provincial law societies.



Know where to go for help

For more information
Our free, objective guides can help you learn more about investing and how specific investments work. They're available on the Canadian Securities Administrators website at **www.securities-administrators.ca** or by contacting your local securities regulator.

Investing basics: Getting started
Investments at a glance
Working with a financial adviser
Protect your money: Avoiding frauds and scams

Members of the Canadian Securities Administrators www.securities-administrators.ca

Alberta Securities Commission
www.albertasecurities.com
403-297-6454
1-877-355-4488

British Columbia Securities Commission
www.investright.org
604-899-6854 or
1-800-373-6393 (toll-free across Canada)

Manitoba Securities Commission
www.msc.gov.mb.ca
204-945-2548 or
1-800-655-5244 (Manitoba only)

New Brunswick Securities Commission
www.investinknowingmore.ca
506-658-3060
1-866-933-2222 (NB only)

Financial Services Regulation Division Newfoundland and Labrador
www.gs.gov.nl.ca/securities/index.html
709-729-4189

Northwest Territories Registrar of Securities
www.justice.gov.nt.ca/SecuritiesRegistry
867-920-3318

Nova Scotia Securities Commission
www.beforeyouinvest.ca
902-424-2499
1-855-424-2499

Nunavut Registrar of Securities
867-975-6190

Ontario Securities Commission
www.osc.gov.on.ca
416-593-8314 or
1-877-785-1555

Prince Edward Island Office of the Attorney General
www.gov.pe.ca/securities
902-368-6288

Autorité des marchés financiers (Quebec)
www.lautorite.qc.ca
1-877-525-0337

Saskatchewan Financial Services Commission
www.sfsc.gov.sk.ca
306-787-5645

Yukon Securities Office
www.community.gov.yk.ca/corp/secureinvest.html
867-667-5466
1-800-661-0408