

WealthWise

Investment Perspectives from HSBC



The Making of a Mutual Fund

What exactly are you getting into when you decide to hold one of these popular investment products? Take an exclusive behind-the-scenes look to learn more.

You probably have held—and continue to hold—several mutual funds in your investment portfolio. But how much do you really understand about this class of investments?

What you don't know might surprise you, and what you could learn may help you make more informed decisions about investing for your long-term goals. Read on to learn more about how mutual funds work—from how they're built and managed to how you can compare one fund with its peers.

A Popular Choice

Mutual funds seem ubiquitous now, but it wasn't always so: They held only around \$370 billion in assets in 1984. In the past few decades, investors have ramped up their relationship with mutual funds, socking away more of their savings in these professionally run portfolios. By the end of 2010, that number had risen to \$11.8 trillion.

Why have mutual funds become so popular? Put simply, they offer investors an easy way to gain exposure to a broad range of stocks, bonds and other types of assets.

This includes access to asset classes that can be very difficult for individual investors to acquire, such as international equities, or for which the minimum direct investment may be significant, such as municipal bonds.

But one of the most compelling factors is that the potential benefits of accessing a broad range of portfolio securities are available to the individual investor for relatively low cost, especially when compared with other options for gaining access to actively managed investments. "Mutual funds can help investors build a diversified portfolio without requiring a huge outlay as an initial investment," says Guillermo Ossés, portfolio manager of the HSBC Emerging Markets Debt Fund.

Despite mutual funds' popularity, choosing the right fund can still be a challenge for those investors who don't know what to look for. With more than 8,500 funds available to investors—from target-date to index-tracking funds, and from domestic stock funds to international debt funds—it's easy to be overwhelmed by the options. But the more you know, the easier it can be to feel confident about your decision-making.



HSBC Securities (USA) Inc.

452 Fifth Avenue
New York, NY 10018

1-800-662-3343

Talking Points

Consider raising these questions with your Financial Advisor as you review your portfolio:

- ▶ What role do mutual funds currently play in my investing?
- ▶ In what other ways could I use mutual funds to achieve a diversified portfolio?
- ▶ How well do the mutual funds I currently hold support my objectives?

The Birth of a Fund

When an investment adviser to a mutual fund complex sees high investor interest in an underserved part of the market, it might launch a new fund to target that specific area. An early step in that process involves consulting with a portfolio management team, which can range from just two people to several dozen, to participate in drafting a prospectus. The prospectus is basically the fund's offering document to sell the fund's securities: It's a detailed description of the fund and how it will operate, including details such as the fees investors will pay, the risks involved and the types of investments the fund will hold.

Next, the portfolio management team takes the proposed investment strategy on a dry run by creating a model portfolio. "The model includes securities that the team feels will best accomplish the goals outlined in the draft prospectus," Ossés explains. "For example, it may track an index or target specific types of assets such as small-cap value stocks that meet certain criteria."

The team then runs the model portfolio through a set of theoretical market scenarios to gauge how the strategy is likely to perform under different market conditions. If the model portfolio appears to carry too much risk or doesn't offer enough growth potential, the portfolio management team may return to the drawing board (or just have the strategy tweaked). But if the model portfolio passes, the next step is to file the prospectus as part of the registration statement with the Securities and Exchange Commission. The SEC reviews the prospectus for compliance on its face with the various rules governing disclosure before it can become effective and offered for sale to investors.

Once the fund is ready to launch, the company seeds the mutual fund with its own startup capital and opens the fund to new investors. Ossés says the whole process, from concept to filing, can take anywhere from a few months to several years, depending on the complexity of its investing strategy and the success of the model portfolio, among other factors.

What a Fund Does Daily

Each mutual fund has its own investment process, including how often its portfolio management team meets and what personnel are involved. Ossés says his management team holds strategic meetings on a weekly and monthly basis but is also very involved in the fund's day-to-day operations. "We monitor asset prices throughout the trading day," he says. "And we have colleagues in other offices who alert us to any significant changes in the markets during hours when U.S. markets are closed."

Under normal market conditions, daily adjustments, which for many strategies tend to be relatively minor, are a way for the team to keep the fund in line with its strategy. But the moves can also be more strategic in order to react to market developments.

For example, Ossés' fund invests in fixed income securities in emerging markets such as Mexico and China. He and his team may decide to reduce exposure to the Mexican bond market if yields change dramatically on those securities. At the same time, the management team may see attractive opportunities in another country's currency futures market, leading them to boost the fund's exposure in that area. The challenge lies in making these decisions against a fast-changing market backdrop while still adhering to the fund's guiding strategy.

The team also rebalances the mutual fund portfolio as the manager sees fit, just as any individual investor might. That may mean selling some strong-performing holdings and purchasing some underperforming holdings to achieve the desired balance as outlined in the prospectus. But the team also adjusts the fund's operations as conditions warrant. "The basic investment objective of the fund doesn't change, but the instruments we use to achieve our goals can vary," Ossés explains.

How to Start Looking for a Mutual Fund

Choosing the right fund or funds to include in your portfolio depends on your personal situation. What's right for one investor may be completely wrong for another, depending on what the investor already holds, risk tolerance, time horizon and other factors. Ossés recommends starting a fund search by working with your Financial Advisor to review your portfolio's allocation and diversification. Together you may find, for example, that you could use more diversification away from large-cap domestic holdings. Such a review may make it easier to identify the types of funds to consider adding to your portfolio.

Ossés advises investors who are comparing funds to keep an eye out for fees, which can include the costs to buy or sell shares of a fund, a potential sales commission, and even ongoing fund management fees. "Certain distribution fees and sales charges can vary quite significantly from broker to broker, even for the same fund," he says.

That said, fees are not inherently bad. A mutual fund fee may involve a more streamlined investment approach and provide more value because of the fund's active portfolio management than a comparable investment directly in equities

or fixed income instruments. Talk to your Financial Advisor to make sure you understand all the fees associated with a given fund. You may decide that for some elements of your portfolio strategy, paying the fee makes sense.

Ossés recommends weighing a fund's performance against that of its immediate peers. For example, make sure you measure a small-cap value fund against other funds in the same category; your Financial Advisor can help you locate and assess similar funds. Ossés prefers to focus his analysis on longer-term results, including three-, five- and 10-year returns. "Any fund can have one banner year, but it takes a well-run fund to post strong returns year after year," he notes.

Another consideration when choosing a mutual fund: Carefully review its holdings. Some funds have looser requirements than others for the types of investments they are allowed to hold, meaning that a large-cap value fund may actually be able to hold some growth-oriented stocks or even some mid-cap stocks. Reviewing the fund's most recent listed holdings—another task your Financial Advisor can support—before you buy can help you avoid duplicating your existing holdings or inadvertently allocating too much of your portfolio to one investing style or asset. Investors should review the fund's investment limitations contained in its prospectus before purchasing a mutual fund.

Mutual funds offer a great opportunity for investors to build a truly diversified portfolio—without spending a fortune. But as with any investment, you must consider your choices thoroughly before making a decision, a process your Financial Advisor can help you navigate. "These investments can be complex," Ossés says. "It's important to do your homework and truly

understand the investment objective, strategies, risks and costs associated with any given mutual fund or other investment before you invest."

¹ Investment Company Institute, *The Investment Company Factbook*, 2011, http://www.ici.org/pdf/2011_factbook.pdf.

² Ibid.

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