22. Mutual Funds 1: What is a Mutual Fund?
Instead of investing in stocks or bonds or securities ourselves and trying to diversify in picking a few of this stock, a few of that stock and mixing it all up and creating a portfolio, there is something called a "mutual fund" in the US or a "unit trust" in the UK, which basically allows us to achieve that objective, and even achieve it more efficiently, and slightly easier.

So what's a mutual fund?
That's the topic of this particular section. A mutual fund is a pool of money that is contributed by many small investors, or some large ones, but more typically more than one investor, and most often even thousands, or hundreds of thousands of investors that contribute some money to create a large pool of assets that is then managed by a professional who is also known as the portfolio manager, or the mutual fund manager, and he basically makes the investment management decisions on behalf of each of the investors in that fund, and the contributed money in the fund.

Mutual Funds tend to have guidelines by which they invest and they intend to have a benchmark in which they are measured. So for example, a mutual fund might be a US stock market mutual fund, or a UK stock mutual fund, or a European equity mutual fund, and those guidelines decide and define what the portfolio manager invests in and how he is measured and what his benchmark is. For example, a US stock market mutual fund might invest in the 500 most widely held companies in the US, and might have as its benchmark the S&P 500 index, so it will typically hold the stocks at a very close portion to the stocks as they are in that index, the S&P 500 index. And what that means is that the mutual fund manager would then make decisions as to whether to over or under weigh certain stocks within that index, maybe even buy a few that aren't in that index, but overall he wouldn't deviate too far from the index because he would have too much, what's known as tracking error, and the risk of not calculating a performance that is close to the benchmark gets increasingly high, so he'll pick stocks around the benchmark, overweigh those he likes and underweigh those he doesn't like, with the view of beating the performance of the benchmark.

The benchmark then could be the S&P 500. If it's up 10% a mutual fund manager would have done a great job if he performs more than 10%. And the investors within the fund can typically own units or shares, and they'll benefit from that performance as well.

So what are the benefits of mutual funds?
Well, they tend to own a lot of stocks, so they provide diversification. So it would be difficult for us, for example, with 1000 dollars to own all of the stocks that a mutual fund does, but we could own part of a mutual fund and then get all the diversification because that money is then pooled into a larger sum, and buys hundreds of stocks potentially. We could never buy hundreds of stocks with 1000 dollars. We have an investment professional who takes the investment decisions. We have better risk management, better risk control systems, and we could basically capture the performance, something that is very close to the performance of a particular index or market. So, mutual funds tend to be a very good alternative for many investors, and form the basis for many people to have their equity holdings or bond holdings through mutual funds, and particularly for those advantages that's the case.