Teaching Children about Mutual Funds

One of the most valued and lasting gifts a parent can give a child is the knowledge of investing. Many children between the ages of 10 to 12 are ready to learn about the basics of investing and mutual funds are a great way to get started. Here, certified public accountants (CPAs) offer some of the key facts you should teach your child about investing in mutual funds.

Mutual funds are portfolios made up of stocks, bonds, and other investments that are professionally managed on behalf of the fund's shareholders. Some mutual funds invest in just stocks and others invest in just bonds, and there are balanced funds that invest in both. Other types of mutual funds include international funds, global funds, and sector funds that specialize in a particular industry such as telecommunications or real estate. Every mutual fund has an objective that helps to determine the investments selected for its portfolio.

Mutual funds offer diversification. You might want to refer to the old saying, "Don't put all your eggs in one basket," in discussing the benefits of diversification to your child. Explain that, with a mutual fund, you spread your investments over a greater number of stocks and/or bonds, and a drop in the value of one investment may be offset by a gain in another.

Mutual funds are sold in shares. It's important for your child to understand that when you put money into a mutual fund, in return, you receive shares of the fund. The value of the holder's shares varies with changes in the value of the fund's investments. At the end of each business day, the fund determines the value of its assets and divides the total by the number of shares to arrive at the fund's net asset value (NAV).

Here is an example you can share with your child. If you invest $1,000 in a mutual fund with an NAV of $10, you own 100 shares of that fund. If the NAV rises to $12 (because the value of the fund's portfolio has gone up), you still own 100 shares, but your investment is now worth $1,200. Of course, the reverse holds true. If the fund's NAV goes down to $9, the value of your investment is reduced to $900.

Past performance is no guarantee of future performance. When it comes to sports, young kids have a tendency to want to go with a winner. That's why it's important that young investors understand that the funds at the top of this year's list may not necessarily be there next year. Of course, a fund's track record over the past 3, 5, and 10 years is certainly worth considering.

Mutual funds are not guaranteed or insured by any government agency. It's important for your child to know that people can lose money investing in mutual funds. There are no guarantees with any investment vehicles.

Most funds require a minimum initial investment. While most funds have a minimum initial investment of between $500 and $2,500, some, particularly those marketed to children, have lower opening minimums. With many funds, after making the initial minimum contribution, you can generally invest as little as $25, which makes them perfect for young investors.

Minors cannot open a mutual fund. Your child won't be able to open a mutual fund on his or her own until attaining age 18 or 21, depending on where you live. You can set up a custodial account for a minor child with yourself or another adult as custodian.

Mutual funds offer investors liquidity. A mutual fund allows investors to sell their shares on any trading day and convert those shares into cash. Before sharing this point with your child investor, you may want to point out the benefits of long-term investing!

All funds charge investors an annual management or administration fee. Your child should know that even investing their own money has its costs. In addition to administration fees, some funds also charge a transaction fee (sometimes called a load) to buy and sell shares in the fund.

Always read the mutual fund's prospectus before investing. The prospectus is a legal document that details the fund's investment objectives and policies. It also outlines the risks, expenses, and fees associated with investing in the fund. You can help your child by translating the prospectus into "plain" English for them and impressing upon them the importance of understanding how a fund operates before making the commitment to invest in it.