



Understanding Mutual Funds

Frequently Asked Questions

Mutual funds play a significant role in ensuring that every individual, no matter what the size of his or her asset base, can choose from a variety of investments that offer low cost access to professional money managers. By purchasing shares in mutual funds, even smaller investors can benefit from investment in a diversified portfolio of stocks and bonds and pursue a broad range of investment objectives. For most investors, mutual funds offer a level of diversification that would not be possible were they to invest directly in securities, and these investment vehicles can play an important part in building a balanced portfolio.

Below you will find answers to a few of the most commonly asked questions about mutual fund investing. While this discussion is no substitute for the experience and acumen of your financial advisor, these questions can help you think about the choices you will encounter as you work with your advisor to develop a personal investment plan.

What is a mutual fund?

A mutual fund is an investment company created to pool the money of individuals and institutions and invest these funds in a variety of assets, typically stocks, bonds or money market instruments. Mutual fund investments are made by experienced professional money managers who seek to achieve stated financial objectives. Mutual funds are regulated by the Securities and Exchange Commission under the Investment Company Act of 1940.

How does an investment in a mutual fund compare to investing in individual securities?

Professional Management: The biggest advantage gained from investing in a mutual fund is access to professional money managers. Few people have the time and expertise necessary to manage their own portfolios, and a mutual fund provides an inexpensive way to access sophisticated investment management.

Diversification: By virtue of their size, mutual funds are able to invest in a large number of securities. A diverse mix of securities can reduce overall portfolio volatility since the impact of one poorly performing stock can be offset by a better-performing security. The more stocks that are held, the less one security can impact the overall result. Large mutual funds typically own many stocks in diverse industries. An individual investor would not be able to create a similarly diversified portfolio with a small amount of money.

Liquidity: A shareholder in a mutual fund can sell shares at any time without worrying about the liquidity of any given stock held in that mutual fund. Since the shares of the fund are valued at the market's close each day, the shareholder would receive the fund's current market value at the closing price (NAV) regardless of what time the sell order was placed during that day.

Simplicity: Most mutual funds require only a small initial investment, and shares can be easily purchased in a variety of ways including online. Mutual fund companies offer many convenient services for shareholders, including online account access, automatic investment and withdrawal programs, and reinvestment of distributions.

Can't investing in mutual funds be risky?

Certainly any investment carries the risk that you may lose money, and mutual funds are subject to risk. Mutual funds, unlike bank savings accounts and certificates of deposit (CDs), are not insured by the federal government. Mutual fund prices fluctuate with changes in the financial markets, and may go up or down in value like any stock. It is important to look at mutual fund investments with a view toward the long term, as staying invested over longer periods can reduce the impact of short term fluctuations.

Mutual funds may also offer several advantages in terms of managing risk. As previously discussed, mutual funds are diversified among many securities to mitigate the risk associated with any single holding. They are also highly liquid, and investors can generally redeem shares at any time for the current market value. Significantly, the mutual fund business is one of the most highly regulated in the United States, and the SEC carries out regular audits of mutual fund companies. Independent directors oversee funds' activities, while independent auditors scrutinize their financial statements and major financial institutions maintain custody of fund assets. Shareholder reports and other communications, as well as marketing materials, are reviewed by the National Association of Securities Dealers (NASD).

What kinds of mutual funds are there?

There are mutual funds to suit every investor's needs, each with a predetermined investment objective that specifies what types of investments are made and what investment strategies are pursued. Funds vary widely in the risk to return ratio, and it is important to understand that risk and reward are directly related – the higher the potential return, the higher level of risk that is assumed.

Funds typically invest in stocks, bonds and short-term money market instruments, and may target certain geographic regions, company types (small cap or large cap, for example), industries or sectors of the economy. Funds may invest according to particular investments strategies, for example value or growth. They may be actively managed, meaning that the managers select securities on the basis of the value they are believed to add to the portfolio, or passively managed, meaning that the fund is created to replicate the performance of an index, for example, the S&P 500.

How will I know what type of mutual fund is right for me?

Investment decisions are highly personal, and are based on many factors that include your individual financial goals, your time horizon, your tolerance for risk and your financial circumstances. It's a good idea to sit down with your financial advisor and talk about some of these issues.

Financial Goals: It is particularly important to give your financial advisor an accurate picture of what you would like to achieve financially, and what types of issues are important to you. Do you need to generate income in the present, or are you concerned with growing your assets to fund your retirement? Do you have a child's college education to prepare for? Would you like to purchase a second home? These are all important issues to be considered. Generally, the longer your investment horizon, or the time until you will need to realize income from your portfolio, the larger your allocation can be to growth-oriented stock investments. If you need your money in the near future, you

will want to make a larger allocation to less volatile securities like bonds. If you need liquidity in the nearest term, you will want to consider money market instruments.

Risk tolerance: Understanding your relationship to risk is an essential component in successful investing, and it is critical to understand how risk and return are related in order to develop appropriate expectations. If you are highly uncomfortable with sharp fluctuations in value, for example, an aggressive growth fund is likely not right for you. If you hope to achieve a return in excess of 10% and have a long time horizon, you should develop a willingness to assume more risk in your portfolio. Over the long term, security prices are typically determined by corporate earnings. However, in the short term emotion can influence the market. In a bull market investors tend to ignore risk, while in a bear market long term opportunities are often ignored.

Financial circumstances: Your personal situation, income, assets, tax status and family structure, as well as many other factors, all influence your investment choices. Be sure that you thoroughly discuss these circumstances with your financial advisor.

How can investing in mutual funds help me reach my college savings and retirement goals?

Most tax-advantaged college and retirement savings vehicles, for example Individual Retirement Accounts (IRAs), 401(k) retirement plans and 529 college savings plans, can be invested in mutual funds.

When you choose to make a mutual fund investment as part of a tax-advantage retirement or college savings plan, taxes are not payable until the funds are actually withdrawn, allowing you to increase the value of your investment through the power of tax-deferred compounding.

What types of fees are involved in mutual fund investing?

Many mutual funds are sold with a sales charge, known as a *load*, which can be payable either at the time of purchase or when shares are sold. This sales charge is in part used to compensate financial advisers for their work. Other funds have no up-front or back-end fee, but have ongoing expenses. All mutual funds charge annual expenses, which are paid by shareholders on a percentage of assets basis. For those investors who hold funds over the long-term, annual expenses may have a greater effect on the cost of investing in the fund than sales charges.

Frequently, mutual fund companies offer multiple share classes, each with a different fee structure, in order to provide shareholders with more flexibility. Your financial adviser can help you choose the type of fee structure most consistent with your individual needs.

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