Mutual Funds: Understanding NAV, Yield, and Total Return

Mutual fund investors will commonly encounter three key metrics: the NAV, the yield, and the total return. Comprehending the differences and inter-relationships of these metrics is critical to understanding how well (or poorly) you have done with your mutual fund selection.

Calculating the NAV

A mutual fund's net asset value (NAV) represents its per-share price and is calculated by dividing a fund's total net assets by its number of shares outstanding. Because shares in regular open-end mutual funds are bought and sold at NAV, NAVs may seem similar to stock prices; after all, both represent the price of one share of an investment. Both appear in newspapers and on financial websites. But that's where the similarities between NAVs and stock prices end.

A mutual fund calculates its NAV by adding up the current value of all the stocks, bonds, and other securities (including cash) in its portfolio, subtracting the manager's salary and other operating expenses, and then dividing that figure by the fund's total number of shares. For example, a fund with 500,000 shares that owns $9 million in stocks and $1 million in cash has an NAV of $20.

So Alike but So Very Different

NAVs and stock prices differ in five important ways.

1. Stock prices change throughout the trading day, but mutual fund NAVs are calculated only once each day, based on the value of their stocks or bonds at the time the market closes. When you purchase a mutual fund, you buy shares at the NAV as of that day's close. As a result, you don't necessarily know the exact NAV of the fund at the time you put in your order to buy or sell. If you place an order early in a given day, you're likely to get that day's closing price for the fund. If you make your order later in the day or after trading has ended, you'll get the following day's closing price.

2. Stock investors typically specify how many shares they'd like to buy, and buy shares of a given stock in even lots, such as 50 shares of Coca-Cola or 100 shares of Microsoft. By contrast, most fund investors purchase funds in dollar amounts rather than share amounts, and fund companies willingly issue fractional shares. For example, if you have $1,250 that you'd like to put into a fund with an NAV of $14, you'll get exactly 89.286 shares.

3. Stocks have a fixed number of shares available. To change its number of shares, a company can either issue new shares or buy back its own shares in the market. By contrast, mutual funds generally have an unlimited number of shares, and the number changes on a daily basis, depending on how many shares investors buy and sell that day.

4. You can determine whether a stock is a bargain or not by its current price relative to a "fair value" price, based on such information as earnings estimates or cash flows. (This process is known as "valuing" a stock.) With mutual funds, however, NAV is tied to the current value of the fund's underlying holdings. Calculating a fair price for an entire mutual fund's portfolio, while theoretically possible, would be a cumbersome process, particularly when you consider that many funds hold well more than 100 stocks or bonds.
5. You can often use changes in a stock's price to gauge how well a stock is performing. Mutual funds, however, distribute any income or capital gains they realize to shareholders as dividends, which, in turn, causes their NAVs to fluctuate. Unless you account for such distributions, you could be underestimating a fund's actual performance by looking solely at its NAV. To accurately gauge a fund's performance, you need to examine its total return, which takes into account both the appreciation of the fund's holdings as well as any distributions the fund has paid out.

**Understanding Total Return**

There's a relationship between net asset value (NAV), yield, and total return, but it's complicated. Did you know that a fund's NAV can fall and you can still make money? Or that a fund can yield less than 1%--in fact, it can yield nothing at all--and yet its returns can still be at the top of the charts?

Before we go further, though, let's review the two key components of total return. You can earn money from your investment in two ways: income (often called yield) and capital appreciation.

**Income and Capital Appreciation**

A fund's income payout, or yield, tends to interest those investors who need regular income, because they don't necessarily have to tap into their principal for their day-to-day living expenses. Savings accounts and CDs pay income, but so do most bonds and some stocks (via dividends). If you own a mutual fund that buys income-paying stocks or bonds, the manager passes on any income to shareholders (after taking expenses off the top, of course).

Yield can be calculated in a variety of ways. Morningstar calculates this figure by summing the income distributions over the trailing 12 months and dividing that by the sum of the last month's ending NAV plus any capital gains distributed over the 12-month period.

The second key way you can gain from a fund is through capital appreciation--that is, if one or more of your fund's holdings are selling for a higher price than they when the manager purchased them. If the manager sells the new, pricier stock or bond, the fund realizes what is called a capital gain. And even if the manager simply hangs on to the stock or bond that has gained in value, the fund will enjoy capital appreciation; in other words, its NAV will increase. That's because the NAV is a reflection of the value of all of the securities in a fund at a given point in time.

**Distributions**

As counterintuitive as it may seem, looking at a fund's NAV in isolation isn't always the best way to check up on its performance. That's because the NAV is vulnerable to changes that don't necessarily affect the true value of the fund.

For example, a fund's NAV will change whenever a fund makes a payment to its shareholders, otherwise known as a distribution. By law, mutual funds must distribute any income they have received from their stocks or bonds, as well as any capital gains they have realized from their
(A fund "realizes" a capital gain when it sells a stock or bond for a higher price than when it was purchased.) But whenever a fund passes along either income or capital gains to shareholders, its NAV drops. If a fund with an NAV of $10 makes a $4 distribution, its NAV slips to $6.

Despite the shrunken NAV, shareholders are none the poorer. They still have $10: $6 in the fund and another $4 in cash. Unless they need the $4 in income to spend, most investors will reinvest their distributions back into the fund; in other words, they instruct the fund company to use that cash to buy new shares of the fund. Most total-return numbers reported in newspapers or on the Internet assume that you reinvest your distributions.

**Back to Total Return**

Total return encompasses everything we have discussed thus far: changes in NAV caused by appreciation or depreciation of the underlying portfolio, payment of any income (yield) or capital-gains distributions, and reinvestment of those distributions.

Here's how it works. Say you buy 10 shares of Fund A at $9 per share. After a few months, the fund's NAV rises to $12. The fund sells some of its winning stocks and makes a $2 per-share capital-gains distribution. It makes no income distributions. As a result, the fund's NAV falls to $10. Your distribution of $20 ($2 x 10 shares) is used to buy two more shares at the new $10 price. Finally, say the fund's NAV rises again, this time to $11 share.

So what is the yield on this investment? Zero, because it has not paid out any income. What about your overall return? Well, if you used only your NAV to calculate return, your shares would be worth the fund's final $11 NAV times your initial 10 shares, or $110. That's an NAV return of 22% on your original investment.

But that figure would be inaccurate, because you need to factor in the capital-gains distribution that you reinvested. Add that back in and you'll find your investment is actually worth that $110 plus the $22 your two new shares are worth, for a grand total of $132. Your total return is really 47%. Not too shabby.

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