THE TROUBLE WITH MUTUAL FUNDS

The first mutual fund was invented back in the 1930s. However, mutual funds never became that popular until the great bull market of 1982 to 2000. Since then mutual funds have been preached by many advisors as “the only way to invest.” And almost every investor has owned mutual funds at some point. And many investors still own mutual funds in spite of the current scandals surrounding the industry.

But are mutual funds really that great of an investment? Let’s take a look. This booklet will introduce you to some of the “dirty little secrets” of most mutual funds. Secrets they would prefer to keep a secret and that you not know about. This booklet will take you behind the scenes and teach you how mutual funds operate. You will learn about the restrictions on your fund’s portfolio manager that keeps him/her from outperforming the market. You’ll also learn why most mutual funds will lose a lot of money during a prolonged bear market decline.

# 3 FAULTY CONCEPTS THAT MUTUAL FUNDS PROMOTE AS BENEFICIAL FOR INVESTORS

# 1. BUY AND HOLD

Mutual funds are one of the top educators in the financial services industry. And what they are teaching to most financial advisors is the “buy and hold” strategy. This strategy basically says that to outperform all other investment strategies all you need to do is buy a stock and hold it for the long-term. It is “time in the market, not market timing” that will make you a successful investor.

The bear market of 2000-2002 has shown the folly of this strategy. Retired investors, who can least afford to lose their money, watched helplessly while their investment accounts declined in dramatic fashion. Following the advice of their advisor, they “held” their funds through thick or thin and watched themselves lose money. In some cases a great deal of money.

Will the “buy and hold” strategy actually work? Yes – if you give it a long enough period of time. But how long is long enough? Nobody knows for sure. There has been only one 20-year holding period in the history of the stock market that did not make money. That was the period from 1929 to 1949. The NASDAQ in 2000-2002 lost a greater percentage than the stock market did in 1929. How long will it take it to come back? Is it feasible that we could be looking at our second 20-year holding period to lose money in stocks? Possibly – nobody knows for sure. And if you are retired, do you really have 20 years to wait for your portfolio to recover.

Yet mutual funds have done a great job of convincing investors, through their financial advisor, to “buy and hold” no matter what. Financial advisors loved the strategy. It was easy to learn, almost anybody could sell it regardless of investment expertise, and it required little work on the part of the advisor. Once they sold a mutual fund to an investor, their work was more or less done.

2. YOU WILL GET A GOOD RETURN IF YOU PUT YOUR MONEY UNDER THE CARE OF A PROFESSIONAL AND KEEP IT THERE FOR THE LONG RUN

Mutual funds have done an outstanding job of convincing investors that your money is best managed by a professional IF YOU LEAVE IT THERE FOR THE LONG RUN. Having a professional manage your money is almost always a good idea. However, mutual funds have put such restrictions on their fund managers that it is almost impossible for them to do anything but match the market. According to John Bogle, former president of the Vanguard Mutual Funds, the vast majority of fund managers fail to outperform the S&P 500 index. And with the restrictions they have on the fund managers, they likely never will.

This booklet will cover the reasons for this in a later section.

3. MEASURE PERFORMANCE BY COMPARING THE FUND TO AN INDEX

Mutual funds don’t measure their success by whether they make money or not. Rather they measure their success by how they compare to their peers and to a designated index. Morningstar routinely hands out 5 stars to funds that have lost money. Their only criteria are if they beat the index of their category and how they compared to other funds.

Where does this leave you as an investor? Shouldn’t the professional managing your money have a goal of making you money – or should the goal be just to beat an index? Somehow the mutual fund industry has convinced investors that you should judge how good a mutual fund is by comparing it to an index – not in whether it makes you money or not. As a result, fund managers are often very happy with minus 15% losses as long as the S&P 500 went down minus 20%.

So how did mutual funds get the investment world into this mess? Let’s go behind the scenes and take a look at the six dirty little secrets they would rather you not know.

1. **WHO’S DRIVING THE CAR?**

Is it the portfolio manager or the marketing department? Unfortunately in many and in probably most cases, it is the fund’s quest for new assets under management that is driving the overall philosophy of the fund. After all, this is how the fund makes more money – by acquiring new assets under management. But this quest for new money often causes your mutual fund not to perform, as it should.

What are some of the tricks of the trade that marketing departments may use?

1. Creating many new funds in the hopes of finding one that has a great track record, and then advertising that fund like crazy even though the fund is not expected to be able to continue that trend.
2. Creating new funds because they sell, not because they are good investments.
3. Using part of your dollars to fund massive advertising campaigns as opposed to investing them.
4. Giving as little information as possible to investors regarding the inherent risks of investing.
5. Manipulating the investment portfolio through “window dressing.” This is the practice of adding high performing stocks right before the date the mutual fund must report its holdings in hopes of convincing investors that it had participated in the big run up of those stocks.
6. Manipulating the investment portfolio through “portfolio pumping.” This is the practice of pouring major dollars into the stock directly before the reporting date in order to artificially increase the stock price. The price goes up which shows a good return on the date of the reporting but then will immediately drop (and usually much further) when the manager sells it off.
7. Engaging in “style drift.” Style drift is when a fund has an investment objective in an out of favor style and decides to move out of their investment objective in order to capture better returns from a more in favor style. For example, the fund manager that should be buying small cap stocks but hangs onto many of them when they reach mid cap and large cap status.
8. Changing investment styles entirely. Some funds have gone so far as to totally change their investment objective in order to improve their returns. Their stated objective may have been to invest in value stocks but then will change their objective to a broader based objective so that they can also own some growth stocks.
9. What’s in a name? Apparently a lot. Just recently the government required funds to match their investment objective with the fund name. Now if the fund owns 80% of the portfolio in growth stocks, they cannot use the term “value” in their name. Many funds have recently had to change their names in order to comply with this law. The fund name did not truly represent what they were investing in.
10. Closing or merging funds. When funds perform poorly, they get closed down or merged into another fund. But what happens to that data. It simply disappears. So when a fund family advertises that nine of its ten funds are earning over 20% a year, it may be because they closed the ones that weren’t. In 2002 alone, there were 373 funds closed along with another 733 that were merged into other funds.
11. **KEEPING INVESTORS IN THE DARK**

Mutual funds in general are not required to disclose much information. And they like it that way. Although the SEC and NASD are working to change some of this, there is still a long way to go. Here are some of the things that mutual funds like to keep you in the dark about:

* 1. Names – until just recently mutual funds did not have to invest according to their name. Names often did not and still do not reflect how they invest. Just because a fund has “growth” in its name, doesn’t mean it is buying all growth stocks. Although the law on this has just changed requiring fund companies to not use a misleading name, names often do not reflect how the fund invests.
  2. Names and credentials of portfolio managers – When was the last time a mutual fund let you know it was changing fund managers. Many of you may remember when the Janus Twenty fund was one of the hottest funds around. But when Tom Marsico, the fund manager for the Janus Twenty fund for 10 years left Janus, the Janus Twenty fund took in more money the next year than it ever had. The vast majority of the investors never knew that Tom Marsico was no longer with Janus. Mutual funds do not have to reveal the name of the fund manager, his background, or his investment expertise in the prospectus or at any other time. You, the investor, are left to find this information on your own.
  3. Portfolio holdings are only disclosed twice per year giving them plenty of time to manipulate holdings, plus the disclosure lags behind the actual holdings by 30 days. Can you ever really have a true picture of what your mutual fund is holding? No. The industry doesn’t really want you to know. They only reveal the parts that make them look the best.
  4. Lobbying expenses to promote the mutual fund industry are included in the expense ratio. The mutual funds justify this as another expense at doing business. All this means is that not all of your money is going to work for you.
  5. After tax returns now have to be disclosed in the prospectus (but who reads it and advertised returns do not reflect this). Finally mutual funds have been required to disclose after tax returns. However, few investors read this material. What they read is the marketing material where the results can be dramatically different.

# 3. MUTUAL FUNDS COSTS ARE TOO HIGH

Do you really know how much your mutual fund is charging you to manage your money? If not, you are not alone. Most mutual fund investors have no idea how much of their return dollars are lost due to mutual fund expenses. Consider the following expenses:

Sales charge or load

12b-1 fees

Expense ratio

Transaction costs

Opportunity costs

I briefly want to explain each of these.

Sales charges – also known as sales loads to many people. This is an upfront charge the investor must pay to cover a sales professional’s expenses. Some funds, commonly called no-load funds, do not sell their product through a sales professional and will not have an upfront sales charge. Some funds offer the option of paying the sales charge on the back end when the money is withdrawn. Keep in mind that all funds have sales expenses, whether they sell through a financial professional or not. No-load funds will have advertising expenses as well as the expenses of paying people to answer the phones and take applications. Usually these expenses are added to the overall expense ratio

12b-1 fees – this is a fee that mutual funds are allowed to charge to cover the cost of printing and distributing prospectuses and some other miscellaneous marketing materials. Again, all funds must be sold through a prospectus so if the fund does not have a 12b-1 fee then these charges are added to the overall expense ratio. They can also use this money to pay a trail commission to the financial professional that sold you the fund.

Expense ratio – this is a percentage of the fund’s net asset value that is attributed to their normal operating expenses. It will include all expenses – not just the cost to rent and light their offices, but also the fee that is paid to the money manager.

Transaction costs – when mutual funds buy and sell a stock or bond, they must pay a brokerage fee, just like you or I would. This is the cost associated with these transactions. Obviously this charge is largely contingent upon the number of times the mutual fund will trade. We determine this charge by using the average turnover rate times an estimated average trade charge of 1.2%. Mutual funds are not required to disclose their trading charges and therefore they do not. Because they trade in volume their charges are usually much lower than what you or I would pay. The 1.2% charge is our best estimate at their costs but could vary by mutual fund.

Opportunity costs – every mutual fund is faced with redemptions every single day. Therefore, all mutual funds keep a certain amount of cash on hand to deal with redemptions. Since this money is not invested, then the investor loses the return the fund could have been earning on this money. No-load funds, because of their ease of getting into and getting out of the fund, usually have a higher redemption rate and normally keep more cash on hand.

When analyzing the cost of the mutual fund, we do not usually include the opportunity cost however that is definitely a cost to take into consideration.

The following is the expenses (excluding opportunity costs) for the average of all mutual funds:

Sales charge 1.01%

12b-1 fees 0.37%

Expense ratio 1.35%

Transaction costs\* 1.32%

Total 4.05%

\*The average turnover of all mutual funds is 110%. The average transaction fee is estimated at 1.2%. This is an estimate only as mutual funds do not have to reveal this number and therefore do not.

Therefore if you are investing $100,000 into a mutual fund, then you are paying $4,050, on average, for them to manage your money. Remember this is the average of all mutual funds. If you own nothing but no-load funds, be careful not to automatically assume your funds are 1.38% cheaper. Usually no-load funds will have higher expense ratios. The expense ratio shown above is the average of ALL mutual funds, including no-load and load funds.

And what about opportunity costs. As of June 30, 2003, the average mutual fund was keeping 14.3% of their portfolio in cash. This means only 85.7% of your money was invested. The average mutual fund turned in a return of 9.08% during the first six months of 2003. Had your money been fully invested, then your return would have been 10.595%. Had you invested $100,000, then you would have made an additional $1,515 had all of your money been invested.

So not only are you paying your mutual fund $4,050 to manage your $100,000 investment, but you also failed to make $1,515 that you could have made had your money been completely invested.

Now do you see why I say mutual fund costs are too high?

# 4. MUTUAL FUNDS ARE NOT MEETING PERFORMANCE EXPECTATIONS

This is a question you, as a mutual fund owner, can best answer. Has your mutual fund met your expectations in terms of the return you were expecting?

There are many things that mutual funds do to help them chase performance. Mutual funds realize that to attract new customers, they must show good returns. And when you are getting paid 4.05% to manage people’s money, then there is a lot of incentive to bring in new money. However, a lot of the things, which attract new money, are not necessarily in the best interest of the shareholders and can result in lower performance.

To begin with, the mutual fund’s manager’s goal is to match the performance of a comparable index. For example, a small cap value fund manager must at least match the performance of the Russell 2000 Value Index (the small cap value index). As long as he does this, he is likely to retain his job.

So in order to make sure he matches the index what do you think he does? That’s right, the vast majority of his holdings will be similar in nature to the index. Since he is going to lose 4.05% to expenses, he has very little chance of beating the index. This is why the vast majority of mutual funds do not beat the S&P 500 index.

Most fund managers have restrictions placed on them by the mutual fund management that says they must have a certain percentage of the assets invested at any one time. So even if a fund manager thinks that the climate for his category stinks, he has no choice but to invest in it anyway.

Take the example of a biotech fund manager. This fund manager must be fully invested in biotech stocks all of the time. It doesn’t matter if the price of biotech stocks is going down dramatically, all the manager can do is invest and watch your money decline.

And you as an investor are supposed to ride out the decline, hang onto the fund, and wait for it to come back. How long? Nobody knows.

What other items can cause funds to under perform?

Changing investment strategies – many times a fund will change investment strategies in hopes of attracting new investors. Often this results in a decrease in the rate of return.

Style drift – many fund managers will not stay disciplined to their required investment style. Instead they will move into other categories in an effort to improve their returns. You may think you have bought a conservative bond fund only to find that 50% of the bonds are in the junk bond category.

Managers come and go – every time a new manager comes in the portfolio is usually replaced to reflect the new manager’s preference. Often this does not allow the prior portfolio enough time to let his plays take hold.

Funds get too large – many funds get so large they can’t buy the higher performing stocks. A mutual fund can never own more than 5% of any one company. As a result, a large fund pays no attention to the smaller company stocks – even though they potentially offer higher returns – because they can’t get enough money invested to do much good. Therefore they buy only the large companies and pretty much follow the index.

Diversification can cause underperformance – Yes believe it or not, diversification can be a bad thing. Sometimes a stock is performing very well, but because the fund has diversification requirements – in other words they can’t invest too much money into one stock – then the manager must sell some of the stock before he might like to. One of the best investment rules is to let your winners run. However, fund managers often have to cut their winners shorter than they would like if the value starts representing too much of their portfolio.

Redemptions can cause underperformance – Many fund managers have to set money aside to pay for redemptions. This means the money is not fully invested and therefore not earning as good a return. Many no load funds have this problem. Since they are easier to get out of they suffer through a higher number of redemptions. Many times a fund manager wants to be buying stocks but has to be selling because he needs more money for redemptions. This causes him to not perform as well.

Portfolio manipulations – Many funds “window dress” their portfolios right before time to report their holdings in order to make their fund look better. Many times this causes the fund manager to have to take losses and it runs up their expenses.

Fund holdings overlap – If you own more than one fund, there is a strong possibility you may own a stock in each fund. If this stock underperforms then your entire investment portfolio may under perform. Take Microsoft as an example. Microsoft is on all three major indexes – the Dow 30, the S&P 500, and the NASDAQ. And since mutual fund managers like to buy their index, a lot of fund managers are buying Microsoft. Microsoft is one of the great companies of our time, however it may be one of the most overbought. If you own three index funds, then you probably own quite a bit of Microsoft.

# 5. MUTUAL FUNDS ARE TAX INEFFICIENT

There are three major reasons that mutual funds cause you to pay more in taxes. The first one has to do with what is known in the industry as embedded gains. Have you ever bought a mutual fund, watched the value decline, only to find that you received a 1099 indicating you owe taxes? How can you owe any taxes when you didn’t make money on the investment?

The answer has to do with the timing of the sale of the underlying stocks or bonds. A mutual fund portfolio manager may have bought a stock several years ago at only $10 a share. Now those shares are worth $50 each. The $40 capital gain tax is not due until the shares are actually sold by the mutual fund. Once the mutual fund manager sells these shares then the mutual fund will distribute the capital gains to the mutual fund shareholders some time during the same year.

If you purchased into a fund that has been holding a lot of stocks for several years, then you are also purchasing the tax liability on those gains – EVEN THOUGH YOU DID NOT PARTICIPATE IN OBTAINING ANY OF THOSE GAINS. This is what we mean by embedded gains. When the market is good, it is not unusual for a mutual fund to have 25% of its portfolio with embedded gains. The only way to win at this game is to purchase the mutual fund, participate in its gains, and then get out before the tax liability is distributed. Unfortunately, mutual funds do not have to disclose this information, which makes it extremely difficult if not impossible for the investor to know what he is purchasing.

Even worse is that the mutual fund gets to determine when to create and distribute these taxable gains. While most do it at the end of the year, they can choose to do it at anytime. It goes without saying that the mutual fund will create taxable gains whenever it is going to make their rate of return look the best. Seldom is the shareholder ever considered when they make their decision.

The average mutual fund turns over its entire portfolio once a year. Each time a stock or bond is bought and sold for a profit, it creates a capital gain. When you are buying and selling this often, then you can see potential for large tax bills.

Unfortunately, the investor is at the mercy of the mutual fund when it comes to taxes.

# MUTUAL FUNDS ARE NOT GOOD FOR

# LONG TERM INVESTORS

Mutual funds are marketed as being the right investment tool for the long-term investors. But are they really?

Did you know that in the year 2002, a record 373 funds were liquidated and shut down? Another 733 funds were merged into other funds. Why were so many funds closed? Many funds are created to capitalize on investing trends. When the trend is over, then the fund gets closed. Also many funds simply get closed due to poor performance. This will be discussed again later in the booklet.

While your financial advisor and the mutual fund industry have preached the buy and hold strategy of investing, mutual fund managers appear not to subscribe to the same theory. The average mutual fund has a turnover rate of 110%. This means that they sell their entire portfolio a little more than once a year. In truth, mutual fund managers are short-term speculators and not long-term investors. Yet mutual funds push for the investor to buy and hold for the long-term.

And finally, are mutual fund owners really long-term investors? According to DALBAR, a company that does research on the mutual fund industry, the average investor stays in a mutual fund less than three years. They use this statistic as the reason the average mutual fund investor gets a return of only 2.2% while the average mutual fund is advertising returns in excess of 10%.

The truth is many mutual funds don’t last for the long-term, portfolio managers don’t invest for the long-term, and mutual fund owners aren’t holding the funds for the long-term. Can mutual funds really be classified as long-term investment vehicles?

Well they try to. Because mutual funds truly want your money to stay with them. That is why they have sales charges. This is a common trap among mutual funds. By having a sales charge, either to get into the fund or to get out of it, makes the investor much more likely to leave their money invested. There are a number of investors that would leave their fund, except it would cost them too much money to do so.

Commission charges are mutual funds way of getting you to leave your money there for the long-term even though you may not want to. Once the investor subjects himself to a sales charge, or a surrender charge, or a penalty for early withdrawal, then the investor is “trapped” in that investment. Most investors are extremely reluctant to pay what it takes to get out of the investment – regardless of how poor it may be. Often times another investment will more than pay for any exit charges in a short time, however since the exit penalty is a known charge and the future gains of another investment are usually unknown or not guaranteed, most investors will not leave. This helps promote the long-term investment whether the investor likes it or not.

## WHAT ABOUT THE COMING MUTUAL FUND CRISIS?

Mutual funds are a good investment during an up market. However, they are a very poor investment in a down market. Their ability to invest is severely restricted and doesn’t offer them the opportunity to really outperform the market. And they have even less opportunities to make money in a down market.

The mutual fund industry does not have the best interest of investors at heart. Instead they have put their own interests ahead of their clients. Somewhere along the way the people in charge of looking out for your money became more concerned about keeping your dollars than giving you the right advice.

If the big firms gave you the right advice, you would have more wealth today, and you’d never move your money away from them. However, with the wrong advice – where the professionals you trusted told you not to sell under any circumstances – you now have less money and even less trust.

This is a serious breakdown in the business of managing your money. The chain of accountability leads nowhere. The result could be financial ruin for many individual investors. When people start to figure out all of the problems with mutual funds, you could see a stampede of investors trying to get out. You don’t want to be in the way or to be the last one out the door.

If a fall in a major stock like Microsoft were to occur, it would lead to a vicious downward spiral of all three indexes. When investors finally get tired of poor performance, they will start to sell their mutual funds. And as this occurs, the indexes will be driven down even further as funds sell off their portfolio to handle redemptions.

The potential panic from shareholder liquidations will affect not just Microsoft but all of the big stocks that make up the indexes. This type of price action started to occur in the summer and fall of 2002, but it was nowhere near a full-scale panic – yet. Let’s hope it never occurs, but I suggest you be ready in case it does.

# I hope you are enlightened a little bit about the way mutual funds operate. And I haven’t even touched on the mutual fund scandals and how they put the smaller investor behind the major investors. A recent survey shows that 73% of mutual fund investors do not trust their mutual fund. However, 72% will continue to invest with them.

There was no conclusion given as to why? My theory is that investors don’t know where to go or what to do differently. Most financial advisors are still preaching the same thing – after all they were educated by the mutual fund industry and most have had very little formal training anyway. So what is an investor to do?

Mutual funds are not necessarily bad investments. They can still be used to the investors’ advantage at certain times. However, you – or your advisor – must know how to take advantage of the mutual fund as an investment. And not the other way around. There are alternatives to mutual fund investing. And there are alternatives to the buy and hold strategy. If you are interested in learning more about these alternatives, please contact my office at 512-218-8100.

*Disclaimer – The above information was obtained from several different sources. While I believe the sources to be accurate, their accuracy cannot be guaranteed. The above information should be considered as my opinion only and not necessarily as fact.*