The world of mutuals is changing

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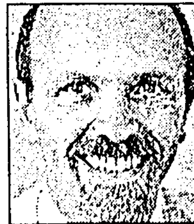

Real Money

Most people don't realize it, but the golden days of mutual funds are past. There are now 11,000 different fund offerings, more than the number of stocks that trade on the New York Stock Exchange. Unbeknownst to the general public, a growing majority of wealthy individuals and professional money managers are moving away from using these forms of "pooled" investment vehicles and are once again using individual stocks and bonds.

For those of you who aren't quite sure what a mutual fund is, here is a brief and simple explanation of how they work. First, investors put money into a common holding tank and then someone else, either a manager or a computer program, chooses the actual stocks or bonds to be bought with those combined funds. The investment philosophy to be followed in these purchases is described in a publication called a prospectus, which almost no one reads because the print is so small. The company that supplies the management expertise or proprietary software program takes a fee each year for their intellectual contribution to the effort.

When the fund managers sell any securities inside the "pooled account," they are required to pass along to the lucky shareholder any tax consequences of the transactions. In other words, what a mutual fund investor actually own is a small portion of a company whose only assets are other companies. The actual investments inside of a fund can and do change without an investor's knowledge. What does all this mean?

First, you never really know what you own if all of your money is in funds. This can be important if a majority of your funds overlap, which means they own the same companies (such as technology). If this sector of the market collapses, the goal of "diversification" (spreading risk out amongst various industries) is lost. Second, the management fees inside most funds, including their sales commissions, make it difficult for the mutual fund managers to meet or exceed the performance benchmarks set for them. Most U.S. blue chip funds under performed the Standard and Poor's 500 index, at least until 1999, when many climbed onto the "tech" bandwagon. The pressure for short-term performance inside of mutual funds increases the probability that buying and selling will occur at a fairly high level. This contributes to the tax distribution problem noted above.

There are certain markets and situations in which mutual funds do perform a valuable function. Small companies and emerging markets overseas are both areas in which investors have difficulty obtaining adequate financial information and so the tax burden, lack of control and additional fees of mutual funds are justifiable. Many employees are required to use mutual funds within their 401(k) or other retirement plans. This is because mutual funds are very convenient investment vehicles for people who have little time or interest in learning to make their own investment decisions.

Likewise, when individuals have only a moderate amount of money, say less than $10,000, it is impossible to buy the normal denomination of stocks, 100 shares, of some companies. This, by the way, is the reason why companies declare "stock splits" — it brings down the cost per share of the investment so more people can participate. New investors and those with 401(k) or salary-deferral retirement

plans are well served by some mutual fund options.

If mutual funds or pooled investments are your only options, which should you choose? I believe that "index" funds represent the best alternative for people who have to use mutual funds. Indexes are unmanaged mutual funds that buy and hold a specific segment of the market, such as U.S. large companies, European blue-chip companies, etc. They are by far the lowest cost in terms of management fees. They have the least amount of sales commissions if you buy them through a discount brokerage firm. They sometimes approach some moderate level of "tax efficiency" by consciously trying to not trade inside of the fund. But even index funds can be forced to sell stocks and distribute taxable income or capital gains to you, outside of your desired time frame or tax planning efforts. This can and probably will occur if the market heads down for a protracted period of time. When other investors or your "co-owners" of the pooled fund want to sell and the fund is forced to liquidate appreciated holdings to meet investor's demands for cash, you will have no choice but to incur taxes.

What are the alternatives to mutual funds for people who want the ease and convenience of not having to choose specific investment for themselves? A recent development at the American Stock Exchange has resulted in the creation of "baskets" of stocks, which trade as stocks and not as funds, so they have neither managers nor any taxable distributions. These stocks have instant liquidity because they are compendiums of unchanging portfolios of 20 or 30 or 100 companies in a particular industry. Biotechnology (BBH), Telecommunications (TTH), the NASDAQ technology companies (QQQ), Pharmaceuticals (PPH), Internet service providers (HHH), the Dow Jones Industrial 30(DIA), and the S&P 500(SPY) are some of the better, diversified, and lowest cost vehicles available.

Most mutual funds are run by extremely intelligent people, and they continue to be marketed to the public through amazingly sophisticated channels so they will continue to be around for a long time. The fact is that only a very few companies are contributing to the stock market's advances. Most companies, mutual funds, and indexes are down so far this year. We call this a "narrow" market. As people rush in to participate in that segment of the market that has gone up 20 percent year-to-date, the danger of a potential widespread unraveling increases if public confidence in the market falters.

The best bet in the event of a protracted down market would be to own a broadly diversified portfolio of individual companies in which you, as an individual investor, have confidence. By this I mean companies like Albertsons, Target, Intel, Johnson and Johnson. Well-managed companies that make a profit are the sanest and safest ways to build wealth over time. It doesn't happen overnight nor is it guaranteed to occur over the course of any particular 2 or 3 year period. The best gift you can give yourself in relating to investments is freedom from anxiety. The only way mutual funds fit this bill is that what you don't know, you won't worry about. My preferred option for clients is for them to know what they own and own what they know. That way, we get to turn off the financial news on TV with a clear conscience and everyone sleeps well at night.

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