Someone Will Make Money on Your Funds—Why Not You?

A Better Way to Pick Mutual and Exchange-Traded Funds

GARY L. GASTINEAU

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John Wiley & Sons, Inc.

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Of course, I accept full responsibility for the book's shortcomings.

One of the most frustrating tasks facing any writer over the past 30 years has been finding a way to deal sensitively with the sex distinctions embedded in English pronouns without calling unwanted attention to the issue with "he/she" or the artificial "one." In this book, I have tried a different approach. I use what I intend as a genderless "he" in most places, but I have given all the portfolio management jobs to "she's." Ideally, the reader will not notice this. If he/she does, this is my explanation.

INTRODUCTION

To make the objective of this book as clear as possible, consider two very different investors, both in their late twenties. The first investor, Joe, subscribes to several financial publications. He spends an hour or two a month working on and thinking about his financial plan and his portfolio. He examines his account statements carefully. He reads the periodic reports from each fund he owns. Joe has also read this book.

After he finished reading, Joe sold several high-cost **equity funds** he had been carrying in his **401(k) plan** account and replaced them with a large position in a low-cost fixed-income fund and a smaller position in a U.S. total market index fund. He used most of the money market balance in his personal brokerage account to buy some tax-efficient equity **exchange-traded funds (ETFs)**. Joe used the free retirement planning software that comes with his 401(k) plan to get a clearer picture of what his financial situation might look like after retirement. He has made an appointment with a financial planner to ask some specific questions. Joe is more comfortable with his financial position and his understanding of his investment risks and opportunities than he has ever been before. He is also convinced that he has improved the annual return on his portfolio by at least 2 percent.

The second investor, Pete, has a few stocks in his personal brokerage account. He bought them on enthusiastic recommendations from friends, but they have performed badly. Most of the assets in his brokerage account are in a low-yielding **money market fund**. When he joined his employer's 401(k) plan, he signed up to put 50 percent of his payroll deductions into an intermediate-term bond fund and 50 percent into a large-cap equity fund. Pete puts his unopened 401(k) statements in a drawer, hoping the fund will grow to take care of him in retirement. He has not taken an inventory of his financial assets and liabilities since he filled out a mortgage application five years ago. He does not know the **expense ratios** or the performance of the funds he owns in his 401(k) account. Pete has not read this book.

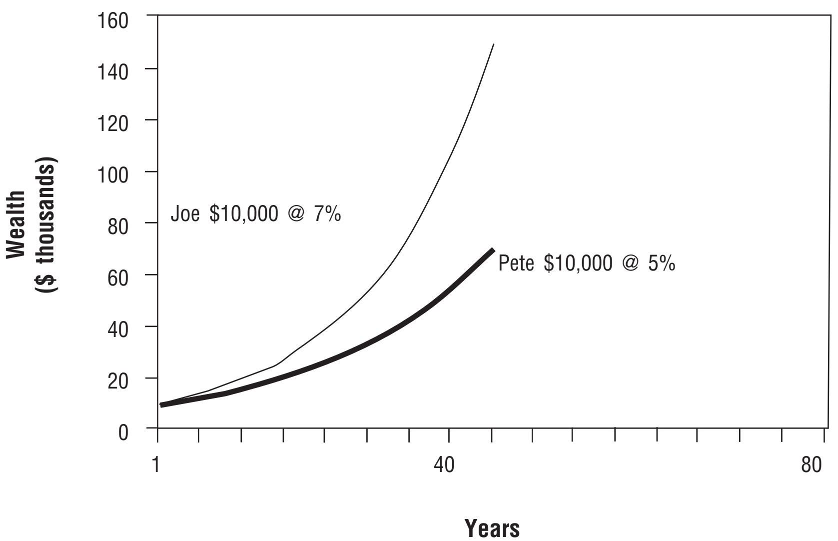
Joe and Pete, if they are like most investors, do not realize how great the difference in their respective retirement outlooks has become. Joe is correct in concluding that the changes he has made in his portfolio will increase his return by at least 2 percent per year. Pete, of course, does not have a clue.

What do Joe's changes mean in terms of the value of the two men's accounts and the amount they can spend each year after retirement? If Joe earns a 7 percent return and Pete stumbles into a 5 percent return, the difference is striking. As Exhibits I.1 and I.2 show, with a single modest investment of $10,000, at a 7 percent return Joe will have $149,745 at the end of 40 years and Pete will have $70,400 if he earns 5 percent—less than half of Joe's total.[1] If, instead of a one-time deposit, each man makes an annual contribution of $2,000 a year beginning in year 0, Joe will have $431,178 after 40 years at 7 percent and Pete will have $256,350 after 40 years at 5 percent.

EXHIBIT I.1 Impact of a 2 Percent Difference in Return

	Joe's 7 Percent Return	Pete's 5 Percent Return
One-Time Investment	$ 10,000	$ 10,000
Value after 40 Years	$149,745	$ 70,400
Annual Contribution	$ 2,000	$ 2,000
Value after 40 Years	$431,178	$256,350
Annual Withdrawal from Year 41	$ 30,000	$ 15,000
Value of the Account after 40 Years of Withdrawals	$467,610	Account Exhausted

EXHIBIT I.2 $10,000 One-Time Investment



In some respects, the most dramatic difference is in what happens to Joe and Pete after retirement (see Exhibit I.3). Based on the $2,000 annual deposit at a 7 percent return and a continuing 7 percent return during 40 years of retirement, Joe will be able to withdraw $30,000 a year from his investment portfolio and the value of the account will still increase slightly over the next 40 years. If Pete withdraws $15,000 a year, the value of his account will be exhausted in the 40th year of his retirement.[2] A few simple changes in his approach to his fund holdings have put Joe on track to significantly greater wealth and higher income for what will probably be more than one-third of his life.

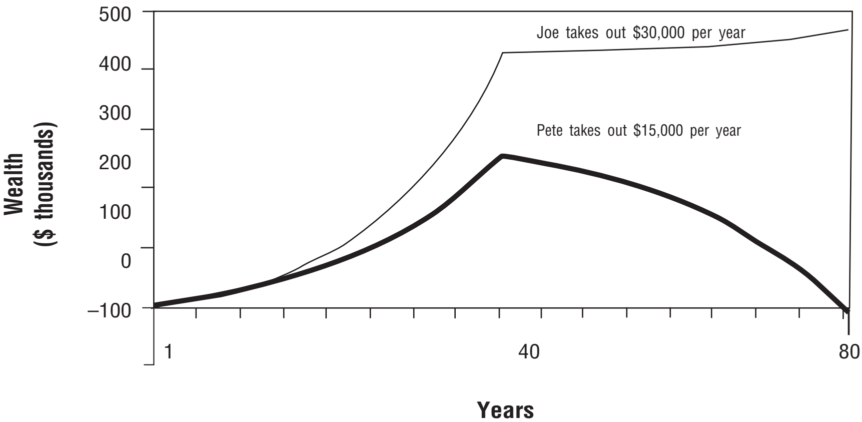


EXHIBIT I.3 $2,000 Investment Each Year for 40 Years

This book should help you improve your portfolio's expected performance, as Joe has done. Reading this book will not lead you to the one portfolio manager who outperforms everyone else next year. But you will be able to invest smarter and keep more of what your investments earn. My primary objective is to help you select the best possible funds for your portfolio. The focus is on funds—which ones to use and how and where to hold them—but you also need a basic investment and planning strategy. Because fund selection does not take place in a vacuum, I discuss some important investment and planning issues in the early chapters.

Most **mutual fund** books describe how funds work and discuss performance, basic expenses, sales charges, and the relationship between risk and return. If you are a trusting person and do not want to look under the hood, that may be enough for you. This book is for investors who want to get the most from their fund investment portfolios. They want funds that will give them the best possible performance and they want to understand why *their* funds *should* do better than other funds. You can achieve that understanding by reading parts of most chapters and learning some simple rules and techniques. The idea that you can improve your investment results by cutting costs is not new, but I apply this principle to specific costs and specific funds in more detail than other fund book authors have done.

This book is about what to look for and how to use what you find to evaluate and compare funds. Each chapter discusses a number of important investment and fund evaluation issues. At the beginning of each chapter, you will find a brief summary of what the chapter covers and, sometimes, how that chapter fits into the investment process. For readers who are not **financial planners** or financial **advisers**, these chapter summaries may give you all the information you need on a particular topic. The summaries describe what is covered in the balance of the chapter and you will be able to decide quickly how much more you need to read in that chapter. If you want to come back and read the balance of the chapter later, the detailed material will be there for you. At the end of most chapters is a brief summary and, in some cases, a list of books or articles for additional reading if you want more information on the topics discussed in the chapter.

Some of the calculations I consider essential for effective fund evaluation are not routinely extracted from fund reports and published by fund data and advisory services. Furthermore, some of the fund services are not as committed to accuracy as they should be. Unless your tax situation is pretty complicated, you will not have to do much detailed work on your own to evaluate a specific fund. That fund's annual report will have the data you need. Unfortunately, comparing more than a few funds can be time-consuming.

Appendix A provides supplementary information, including the web addresses of some useful sites. Some important words are in bold type at least the first time they appear in the text. Those words and a few other fund terms are defined in the Glossary. If you come across a word or phrase in the text or in other reading that does not appear in the Glossary or in an ordinary dictionary, use the online version of the *Dictionary of Financial Risk Management* at www.amex.com/dictionary/frinit.html to look up the word or phrase.

I have tried to make this book as easy to read and understand as I possibly can. To that end, I avoid unnecessarily complex discussions in the beginning of each chapter. Depending on your personal needs, you will find useful details in the body of the chapters and in the notes. Discussions of some special topics are separated from the narrative into topical text boxes. The text boxes are referenced in the text and in the Index. I promise that you will find useful information on topics that are not discussed in any other fund book you have read. I challenge some conventional wisdom, so you will find viewpoints that you have not encountered before. If you want to learn more about controversial issues, I have provided sources in Appendix A, in the notes, and in the reference list.

Funds Under Fire

People's capitalism—small investors buying shares of funds that offer investment **diversification** at low cost—has been one of the stated objectives of the U.S. mutual fund management industry since it was founded in the 1920s.[3] To date, the creators and managers of funds have not consistently succeeded in meeting this goal. Congressional hearings during the 1930s uncovered abuses from the early years of investment company sales and management. One result of those hearings was the Investment Company Act of 1940, which, with only minor amendments, still serves as the primary basis for fund regulation in the United States.

A more recent series of mutual fund scandals that began to surface in 2003 stimulated new reform efforts. To date, these recent attempts at reform have increased the costs borne by fund shareholders without any meaningful improvement in shareholder protection. Cost-effective regulation by market forces has been rejected in favor of bureaucratic changes expected to improve fund governance. Shareholders also have to pay for a new, but unproven, compliance function.[4] Useful disclosure and improved fund operating rules have been rejected in favor of disclosures that are of little use to investors or fund analysts. The safest and most realistic assumption that fund investors can make is that they have to look out for their own interests, rather than counting on the fund regulatory framework.

Apart from differences in the size of the average transaction, much fund marketing differs little from the sale of soap or breakfast cereal. One of the major marketing innovations of recent years is even called the mutual fund "supermarket" (discussed in Chapter 4). Many fund marketers promote hot managers and hot market segments. Both are easy to sell, even if they are not necessarily the right choice for the investors who buy them. Of course, some fund companies have delivered good performance at reasonable prices and without hype. But the inverse correlation of funds' expense ratios with fund performance—the funds with the highest expenses tend to have the worst performance—suggests that many investors do not have access to information that will help them make higher-quality, lower-cost choices. Some index funds have provided good investment performance, partly as a result of lower expenses and reduced portfolio **turnover**. But the concentration of indexed assets in funds using a small number of popular indexes has hurt index fund performance in recent years. Concentration of indexed assets in funds linked to a few overused indexes continues to increase.