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Five Things You Should Know About Funds

By Brett Arends

The people who sell you mutual funds will tell you various things about them. They'll tell you about the fund company's great reputation. The fund's impressive "stars" and the awards it's earned. The terrific one, three or five-year track record.

Bah, humbug.

Here are five things you really want to know about a mutual fund before you invest—but that nobody wants to tell you.

1 What are the fund's total fees, and where do they go?

You may think you know, but you probably don't know the whole story.

The adviser pushing the fund may get a commission. Sometimes, it's as high as 5.75%. There may be a charge if you sell the fund within a specified period of time. There are

the annual fees—the so-called expense ratio, which can vary from 0.1% of your money each year to 2%. These may include a 12b-1 fee, where you actually pay for the fund's marketing. And then there are all the costs the fund incurs buying and selling stocks. These are buried in a document, called the Statement of Additional Information, that the fund company has to give you only if you ask for it specifically. If a fund trades a lot, these costs will mount up.

The higher the fund's turnover, the worse it will be. A turnover rate of 100% means, in effect, the fund churns through its entire portfolio each year.

How much does all this matter? Fund companies typically do better than you do, just as Las Vegas casinos typically make out better than Las Vegas tourists.

Over 30 years, a fund with investments earning 7% a year, with no fees, would turn $10,000 into $81,500. A fund charging a 5.75% sales load, and 1.5% a year: just $49,500. That's barely half the profits.

Think about where the rest went.

2 Does the fund manager eat his own cooking?

A study by Morningstar a few years ago found that mutual funds tended to do better when the manager had a big chunk of his own wealth tied up in the fund, alongside yours.

Big surprise.

Now try finding out which ones do.

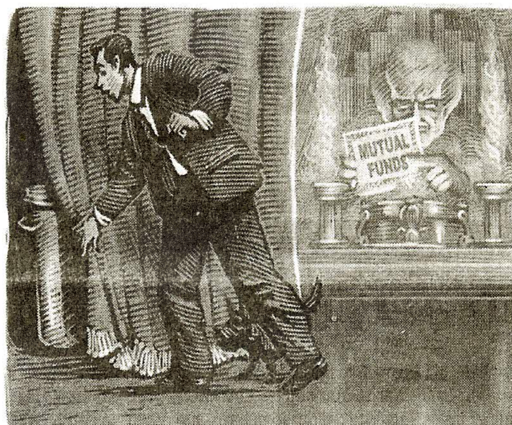
It's also buried in that Statement of Additional Information. Even this disclosure is new. And it's incomplete.

The statement will only give you a range for the investment—a manager has no money in a fund, or between $50,000 and $100,000, and so on.

And, critically, it won't tell you what share of the manager's wealth this is. A manager worth $30 million has $100,000 in his fund? So what?

Bottom line: Most fund managers have no money in their own funds. No kidding.

Warren Buffett is one of the richest men in the world, but he holds 99% of his wealth in his investment vehicle, Berkshire Hathaway, alongside his investors. It shows.



Tim Foley

3 Will the fund company put your interests before its own?

There is a conflict of interest between you and the company managing your mutual fund.

You make money if a mutual fund performs well. The fund manager makes money if the mutual fund gets really big. That's because their main source of income is a slice of the assets under management.

Alas, the bigger the fund gets, the less likely it is to keep outperforming. Elephants don't dance.

As new money pours into a successful mutual fund, even the best managers find it harder and harder to make great investments. They struggle to find enough good opportunities for all that cash. They find they can no longer take significant stakes in smaller companies. And they can't sell out of bad positions so easily, either.

Investors do less well.

Meanwhile, the fund company takes in a management fee on greater and greater assets.

By definition, this problem generally afflicts only successful mutual funds anyway.

If a fund company puts investors first, it will shut a mutual fund to new money fast, when the fund is still pretty small. Some do. Plenty of others don't.

4 Do your fund's performance figures mean anything?

Your broker will probably try to sell you funds that have done well over a one, three or five-year period.

It may mean something. But it may not mean anything at all.

Why?

First, the fund may have changed managers. Great investment is an art, not merely science. If it could be transferred from person to person, everyone would outperform.

Second, good performance over a few years is probably pure luck.

Do the math. There are thousands of mutual funds on the market. Over any given time period, some of them must do well.

Brokers and fund companies market the ones that have done well, while quietly ignoring the others under the carpet.

It doesn't mean all fund performance figures are worthless. A fund manager who has done well over a decade or more probably has what it takes. But all performance figures need to be taken with skepticism.

5 Who runs the fund—management or marketing?

Traditional investment managers tried to manage risk. They tried to buy attractive securities at attractive prices. If they couldn't find any they liked, they held cash and waited for better opportunities.

Do you think that's still how it works? Not at most big mutual-fund companies.

Instead, they stick each manager in a "style box"—large-cap growth, small-cap value and so on. The manager must buy only stocks within that box—maybe with a little leeway.

A mid-cap growth manager must buy mid-cap growth stocks, even if they're overvalued. He can't touch small- or large-cap stocks, even if they're cheap. He has to stick close to "benchmarks." He can't hold cash. He has to be fully invested at all times.

All sorts of bad things can follow. During the dotcom bubble, growth-stock managers had to keep buying those high-growth tech stocks, regardless of the crazy valuations. A few years back, value-stock managers were pressured to load up on bank stocks for their dividend yields.

Mutual-fund companies will tell you they don't want to "time the market." OK. But it's notable that the marketing departments love this system. It makes funds easy to sell, outsources risk management to the client and covers their rear. If the market goes up, the funds aren't left behind. If the market tanks? "Oh, that's the market. Everyone's down."

Sure. That's because everyone used the same system.

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