



What Everyone Should Know About Mutual Funds

The goal of this newsletter is to introduce each of you to some of the issues I consider in order to select better funds for your investment portfolios, to help you get better returns with lower costs.

For many years, my most popular stock market investment vehicles have been No-Load Mutual Funds. They still are, for many reasons. Firstly, by design they have the ability to offer excellent diversification. Secondly, they have an active manager that should be knowledgeable and experienced. Thirdly, each fund is required to publish performance results and portfolio holdings. And finally, if we know which ones to buy, they can yield excellent returns and be very cost-effective.

However, as is the case with investing, we must be well-informed consumers in order to select the best-performing funds with the lowest fees and the lowest expense ratios. And, we must also look for other red flags to make sure we are not selecting funds with hidden fees, high turnover, excessive taxation and large distributions.

1. Mutual Fund Fees

The term "load" refers to the sales charges/commissions added to a mutual fund when you purchase it. (Most brokerage firms do charge a "transaction fee" to purchase certain mutual funds.) Even though a "no-load fund" doesn't charge commissions, it does charge its shareholders for the costs of doing business. These include everything from the advisory fee paid to the fund manager to administrative costs like printing and postage. These costs are expressed as an "expense ratio," which is an annual percentage of the fund's average net assets under management. High expenses do not mean better management. The fact is that low-expense funds are more likely to outperform high-expense funds over the long-term. In 2004, the average expense ratio for domestic equity funds was about 1.5%. For fixed-income funds it was about 1.1%. Foreign funds have higher expense ratios, averaging around 1.7%. However, there are plenty of top-performing funds with expense ratios of 1.30% and less. And, index funds can have expense ratios as low as .20%. 12b-1 fees are fees the fund charges for marketing and distribution expenses. They're included in the expense ratio, but often are talked about separately. Some no-load funds charge them, too. Note that once a 12b-1 fee rises above 0.25%, the fund is no longer considered a no-load.

2. Share Classes

Have you ever wondered what the deal is with all those A's, B's and C's that you often see after the names of some funds? These letters indicate the different share classes a fund offers. Although these classes are not standardized, they primarily apply to load funds and determine the various ways that investors can pay the sales charge. For example, "A" shares traditionally indicate a front-end load, while "B" shares most often indicate a back-end load. Other share classes include "C" shares, which usually incorporate a small back-end load and the maximum 12b-1 fee. I see these as more reasons to focus exclusively on "no-load funds".

3. Taxes

When it comes to mutual funds and taxes, the basic issue is that when a fund manager sells a stock for a gain, the law says it becomes a taxable

event. That transaction may be offset by any losses the manager incurs when he sells a losing stock. But if the sum of all the transactions during the year adds up to an overall gain, the result is that the shareholder has to pay the tax bill. Net gains are paid out in the form of taxable distributions. There's nothing worse than ending the year with a fat one you weren't expecting. It's even more bitter when the gain falls into the short-term category — a big problem with fund managers who trade often. Short-term gains are taxed as regular income instead of at the lower 15% tax levied on most long-term capital gains. A high turnover ratio can be a sign of a high capital-gains distribution further down the line. One way to avoid this potential problem is to be wary of managers who trade a lot. A fund with a turnover ratio of, say, 500%, indicates that the average holding in the fund lasted less than three months. And all that trading could produce a capital-gains liability for you. That is, unless the fund manager happens to offset his or her gains with losses. But quick trading isn't always the issue. Substantial shareholder redemptions can force stock sales which result in taxation to the remaining shareholders.

4. Hidden Costs

Other costs that are difficult if not impossible for an investor to track, are "rebates and soft costs". Even though these rebates must be fully disclosed by law, most individual investors are not experienced enough to figure out mutual fund trading commissions less rebates for a net commission figure. Currently the SEC is investigating various funds to make sure all rebates have been and are being received legally and with full disclosure to shareholders.

5. Fund Selection Criteria

When I select no-load mutual funds, I look for a fund that:

- performs well compared to industry benchmarks
- has low expense ratios
- has a fund manager with at least a 5-year tenure and who performed well relative to the indexes during the 2001 and 2002 downturn (this shows the ability to manage well during a downturn as well as during up-trending markets)
- has no 12b-1 fees
- was not involved in the "after-hours mutual fund trading scandal" of two years ago (call me to find out which funds were involved).

No-load mutual funds have proven to be successful investment vehicles for many years. The total number of mutual funds has grown to over 8,000. We cannot expect them to be "perfect" in their structure, perhaps because they are managed by humans. However, if we as investors do our homework, we can successfully choose funds that will help us increase our overall annual returns. Let's discuss *your* unique investment needs and create a highly effective mutual fund portfolio for you now.

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