1

Evaluating Your Investment Situation

For many investors today, mutual funds are a fact of life. According to industry data, some 93 million individuals in 55 million U.S. households owned mutual funds in 2001. Because one out of three people in this country own mutual funds, they clearly are of importance to many.[1]

Approximately 52 percent of all U.S. households are now invested in mutual funds, and the number of households owning mutual funds has been increasing, not decreasing.

Figure 1–1 shows that only 4.6 million households owned mutual funds in 1980, but by 1988 this number had grown to more than 22 mil-

1. These data, as well as data on the number of mutual funds, assets of mutual funds, types of mutual funds, and so forth, are based on data of the Investment Company Institute (ICI) available on its Web site, data from various Federal Reserve publications, and other government sources.

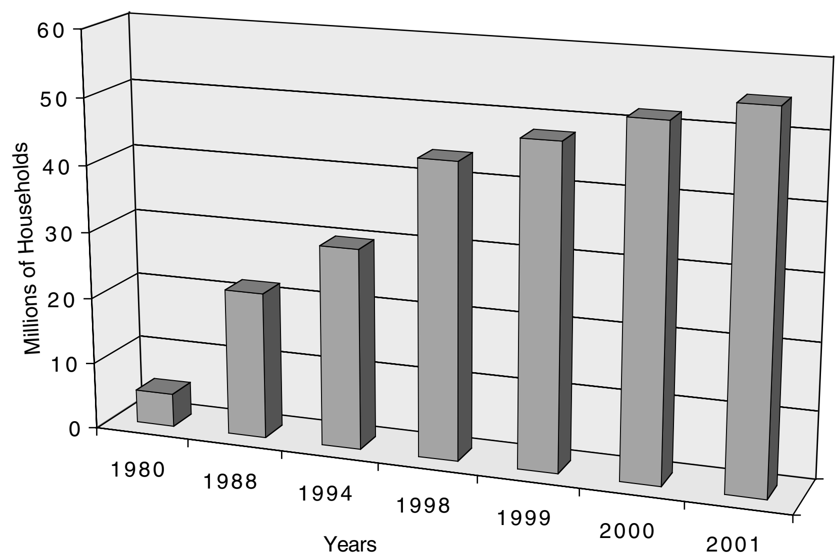

Figure 1–1 Household Ownership of Mutual Funds (millions of households for selected years).

lion, and by 1998 it had doubled to 44 million households. As shown in Figure 1–1, the number of households owning mutual funds also increased in each subsequent year, from 1999 to 2001.[2]

Clearly, mutual funds have been a growth industry, and more and more investors have become mutual fund owners over the years. There is simply no denying the importance of mutual funds to individual investors and the critical role they play in the lives of many. The facts speak for themselves—mutual funds are an important issue for average Americans because much of their financial future is tied to the success of the mutual fund industry.

Americans have been pouring money into funds in record amounts in recent years. The annual growth rate in assets of U.S.-based mutual funds during the 1990s was almost 20 percent, an astounding growth rate for such a long period. This resulted in a $1 trillion asset base at the beginning of 1990 growing to approximately $7 trillion by the end of 2000, truly an astounding accomplishment.

2. These data are from the Web site for the ICI, "About Mutual Fund Shareholders, Demographic Information," *Fact Books*, and other updates by ICI, as well as various government publications, including the Federal Reserve system.

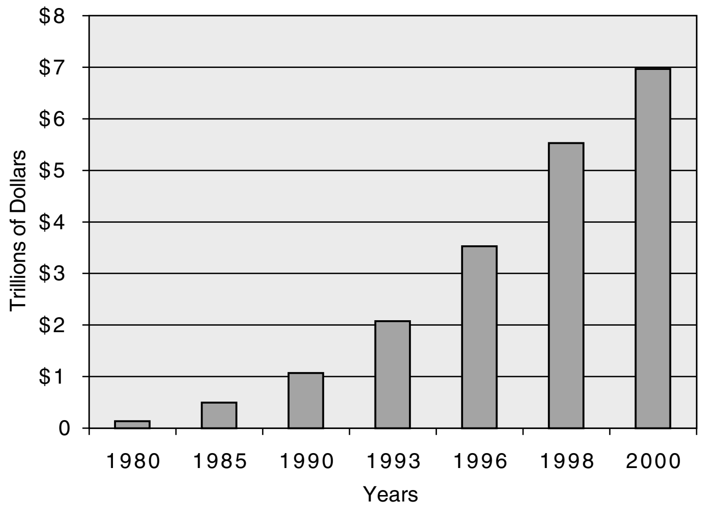

Figure 1–2 Assets of Mutual Funds for Selected Years (in trillions of dollars).

As Figure 1–2 shows, mutual fund assets have grown tremendously in a relatively short period of time.[3] In 1980 the total assets of the mutual fund industry amounted to only $135 billion, which is not a large number for a major financial asset in the U.S. economy. By 1985, assets were approximately $500 billion, and it was not until 1990 that the assets of mutual funds exceeded $1 trillion. In 1993 assets exceeded $2 trillion for the first time, and in 1996 they exceeded $3 trillion for the first time. In 1998 assets climbed to more than $5 trillion, and at the end of 2000 assets totaled almost $7 trillion.

Obviously, tremendous growth in mutual fund assets occurred in the 1990s. From approximately $1 trillion in assets in 1990 to approximately $7 trillion in assets by 2000 is incredible growth by anyone's standards. Some of this growth resulted from the strong rise in the stock market in the 1990s, as prices of stocks climbed higher and higher.

Stories abound among friends about the performance of their funds and the resulting growth in wealth. Admit it: Not only are you very impressed by the 329 percent return enjoyed by the Warburg Pincus Japan Small Company Fund in 1999, but you also figure you are smart enough to discover an opportunity like this sooner or later, and get in on the good

3. This information is available from the ICI Web site as well as Federal Reserve publications and Web sites and other government sources.

times. Or perhaps you believe you are clever enough to spot a "rookie fund" like Ameristock Focused Value, which was up about 60 percent in 2001, its first year of operations. But would you also be clever enough to avoid Black Oak Emerging Technology, which in its first year of operations in 2001 was down about 60 percent? Always remember that investing works both ways—you can achieve some nice gains, but you can also suffer some significant losses.

It appears to be a simple proposition: You have some money to invest, you think stocks are the best opportunity for achieving a good rate of return, and mutual funds make it easy to invest in a portfolio of stocks. This is particularly true when it comes to owning foreign securities; investors often use mutual funds to achieve this objective. It is typically difficult to build a portfolio of foreign securities yourself—finding the companies, evaluating the information, and so forth—but it is a simple matter to buy a mutual fund that has already done all the work for you.

Alternatively, you might want to hold a conservative portfolio of U.S. Treasury bonds or a short-term investment portfolio of money market securities. Perhaps you wish to invest in gold or real estate. You can combine multiple objectives into your total portfolio of assets by owning funds specializing, for example, in international equities, large domestic stocks, small domestic stocks, bonds, real estate, gold, and safer, short-term securities.

With mutual funds, all of these objectives are easy to accomplish. Fill out some forms, write a check, and *Voila*!—You are a mutual fund owner (shareholder). You are relieved of any day-to-day decision making—and can let the experts do it.

Yet, somewhere in the back of many investors' minds, there are some nagging doubts. Investors start to ask themselves questions: Haven't I heard about many funds with performances that failed to match the market as a whole, or match the performance of one of those index funds that John Bogle is always talking up in magazine articles and books?

John Bogle is the former CEO of the Vanguard Group, one of the top two mutual fund companies in the United States in terms of assets. He has written several books about mutual funds and has been a frequent critic of certain mutual fund practices. Bogle's book, *Common Sense on Mutual Funds*[4], is highly recommended as a good discussion of important issues

4. John C. Bogle, *Common Sense on Mutual Funds*, John Wiley & Sons, Inc., Publishers, 1999.

for investors to consider when it comes to investing in general and mutual funds in particular.

Perhaps investors are asking themselves these questions: Do I really need that much diversification? What about those sales charges and other fees? What were those recent stories in the press about big taxable distributions to shareowners in the face of a decline in the value of their shares? How can that be?

Maybe investors heard about some of the recent spectacular flameouts that occurred. Consider the case of Berkshire Focus Fund, which invested 100 percent in tech stocks. Starting in 1997 with only $300,000 in assets, it enjoyed two consecutive years of incredible returns in excess of 100 percent. Then the bottom fell out. Berkshire Focus showed a three-year record of –11 percent per year on an annualized basis.[5]

Many investors more likely see articles like the one in the December 2001 issue of *BusinessWeek* titled "The Mutual Fund Mess."[6] To quote from this article, "No doubt about it, America's long romance with mutual funds is on the rocks" (p. 103). Clearly, an article such as this in a leading business magazine warrants attention and indicates that all is not right in the world of mutual funds.

In truth, like most things in life, there are two sides to the mutual fund story. Investors generally hear one side—the reasons they should own mutual funds. They are constantly exposed to stories about mutual funds, recommendations about funds to buy now, and performance statistics. One can argue this much attention is warranted because of the importance of mutual funds to so many investors.

There is no doubt that funds are a major financial asset for many investors, and rightly so. They offer several potential advantages and help investors accomplish their investing goals. Consumers have many funds from which to choose, the mechanics of investing in funds are well established and easy to handle, the long-term results as presented are impressive, and short-term results are often spectacular.

However, because it is your money on the line, the other side of the story also deserves serious consideration. One of the lessons most investors learn (although for some it takes longer) is that investing involves both benefits and costs. It is easy enough to learn about the benefits of

5. This example is based on discussion in Steven T. Goldberg, "Beyond the Pale," *Kiplinger's Personal Finance Magazine*, February 2002, pp. 48–49.
6. See Mara Der Hovanesian and Lewis Braham, "The Mutual Fund Mess," *BusinessWeek*, December 17, 2001, pp. 102–106.

owning mutual funds. This information is readily available everywhere, often with eye-catching graphs showing the growth in wealth over time. But what about the downside? Surely, there are disadvantages as well as advantages. What can you realistically expect from mutual funds, as opposed to what you are hoping for, and probably expecting with a high degree of certainty? Are there better alternatives? Will mutual funds continue to dominate the financial landscape for individual investors as they have in the past?

Consider a quote from Don Phillips, CEO of Morningstar, perhaps the best known source for mutual fund coverage (discussed in later chapters): "The fund industry's monopoly on the American investor's mind is in jeopardy like never before."[7] This is certainly true, but it has not yet been recognized by many investors for two reasons. First, issues such as the negatives about fund costs, neglect by the fund's board of directors, the shock of large taxable distributions as the value of the shares decline, very high portfolio turnover, and so forth are only now really being talked about and noticed. These negatives about mutual funds are coming together to form a critical mass that is attracting more and more attention.

Second, effective alternatives to mutual funds have emerged only recently. Most investors have not been adequately exposed to these alternatives, and there is relatively little history to guide them. This will clearly change with time, just as more and more investors are beginning to recognize more fully the problems with mutual funds.

Insights

There are now at least three alternatives to mutual funds that may partially, or even totally, substitute for mutual funds for many investors. We consider them in later chapters:

1. Exchange-traded funds (ETFs).
2. Folio investing.
3. Separately managed accounts.

In this book we consider the ownership of mutual funds from both sides, but with an emphasis on critically examining some potential problems with them. This is not done to discourage anyone from investing in

7. See Mary Rowland, "21 Funds for the 21st Century," *Bloomberg Personal Finance*, December 2000, p. 60.

this important financial asset, because they have served the investing public well over many years. Mutual funds will continue to be—and should be—a prominent component of many investors' portfolios. This book is not anti-mutual fund; rather, it is pro-full disclosure and encourages investors to consider all of their alternatives objectively.

The chapters that follow analyze all sides of the issue and take a more objective approach to one of the most important decisions many people make during their lifetime—how to invest their money appropriately, both the funds they will depend on when they retire and those funds that are used to build wealth across time. Is your decision to buy a particular fund a good one, all things considered? Can you do better? The popular press continues to focus on the benefits, and almost always emphasizes recent hot performers, which is usually detrimental to your financial health.

The industry, as anyone would reasonably expect, is trying to serve a broad array of interests by creating new products, in particular different share classes, which confuses many investors. Only now, after the debacle of 2000, are investors realizing the enormous tax implications of mutual funds, whereby they face large tax liabilities on fund distributions in a year when the value of their mutual fund shares declined substantially.

Furthermore, times are changing—new alternatives have sprung up that could serve many individuals better than do mutual funds. However, like mutual funds, these alternatives also have some limitations and drawbacks. Investors owe it to themselves to consider all aspects of how they go about building wealth over time and preparing financially for their retirement. They might find that a combination of mutual funds and some of these new alternatives will serve them better in building wealth over time.

Radical as it might seem to most investors at first glance, you really might not need mutual funds to accomplish your goals. At the very least, you might not need them to the extent commonly believed and to the extent you did in the past. You owe it to yourself to think about this situation a little and then determine what is best for you.

Perhaps you will conclude that mutual funds are still the best alternative given your particular situation. If so, fine; this is not an either/or situation. Many investors will continue to own mutual funds, should continue to own mutual funds, and will be happy with their choice. What we are seeking to do here is make you more aware of their limitations and pitfalls. In turn, that will make you a more successful investor.