Designations and Sales

So, what are all these helpers with their designations trying to sell you? A lot sell mutual funds. And, while there's nothing inherently wrong with than, there is a problem in how some of them get paid for doing so.

Mutual funds invest shareholder assets (your money) in stocks, bonds, options, futures, currency, cash, and a raft of other investment vehicles. You do not OWN the securities the Fund buys, you own a fractional interest of the fund. The value of the fund (it's NAV) changes daily at the end of trading based upon a weighted average of the securities it owns. There are over 7000 mutual funds today and they come in all sizes, shapes and costs.

Before you actually buy a mutual fund, you have to figure out what they buy. What are their investment philosophies, their investment objectives? Don't be misled by their name. The XYZ Income and Growth fund may not actually provide any real income, and it may not buy "Growth" companies, but that's a subject for another class.

Salespeople are quick to point out the so-called advantages of mutual funds:

1. They provide diversification, owning as many as perhaps 100 securities. The salesperson will tell you that diversification reduces the risk of large losses in the event of a financial collapse of one particular sector (Think Banks and Mortgage-backed securities). What they usually don't tell you is that diversification limits your upside and does NOT protect you from loss caused by overall market free-fall. **Remember: Diversification is a myth. It only works until you need it.**

2. Mutual funds provide you with professional money management with access to extensive research and the best traders. What they don't tell you is whether the fund manager is a grizzled veteran of Wall Street Wars or a 28 year old MBA who has barely started to shave.

3. Mutual funds are liquid and can be bought and sold every day. What they don't tell you is that the combination of sales commissions, internal operating expenses and the fund manager's fees and trading costs can eat up as much as 2.5% of your money annually.

4. Mutual funds offer convenience by being available for purchase by mail, in person, through brokers or other financial advisors, or on the internet. What they don't tell you is that many funds can be purchased directly without a Helper.

There are lots of different mutual funds, share classes and expenses, but let's look at two broad categories:

1. Actively managed funds buy and sell securities daily, seeking to provide investment returns better that a target benchmark, like the S&P 500, for instance.

2. Index funds buy baskets of stocks that replicate a benchmark. An S&P 500 index fund may buy all 500 stocks in the index and hold them unless there is a change in the composition of the index.

There are fundamental problems with both categories:

1. Active managers rarely beat the market. In fact, you can't outsmart the market because the capital markets rapidly discount all known information and any new investing techniques quickly become obsolete by overuse.

2. Index funds are by definition assured to underperform their benchmark by the amount of their expenses and fees.

So, which is better? It depends on your individual investment objectives and preferences. Index funds usually have lower costs than actively managed funds because their fees are lower and trading costs are small because they rarely trade. But says the local at the Bozeman, "My Helper showed me a fund that was up 38% last year and USA Today said last week's winner was up 6% in a week!"

Well that big hitting fund and last week's winner might be invested in Ugandan Gold Mines or Bolivian Emerald Futures. Buying a fund like that for investment is like starting out in the cattle business by buying one cow and hoping it grows to 42,000 pounds so you can make a killing.

Yet, mutual funds are the investment vehicle of choice in America and will likely remain so for years to come. Today, over 50 million consumer households own mutual funds, and mutual fund assets under management are over $9 trillion, with over half of that in stock funds.

There are some other mutual fund issues to be aware of:

1. Taxes. Mutual funds are required to distribute their capital gains every year to all investors as of a certain date regardless of when they bought in. That means you could lose money in a fund and still have to pay taxes on what they distributed to you. Seriously! REMEMBER -- TIMING MATTERS.

2. While regulated by the SEC, funds have NO GUARANTEES. Even if the fund invests in US Government securities, its value will still fluctuate.

Exchange Traded Funds (ETFs) are another investment vehicle your Helper may try to sell you. Looking a little like index funds, ETFs try to track an index and can be bought and sold throughout the trading day. Unlike mutual funds, they can be sold short and there are options and arbitrage schemes. An S&P 500 ETF may not own the entire 500, but a representative "sampling" of the index. They are low cost, but they have trading expenses attached to them. You can't buy them from a broker for free! Capital gains are relatively insignificant unless you sell the ETF. However, not all ETFs are created equal. There are thousands, and no two S&P 500 ETFs produce identical results. So, "Buyer Beware." If a Helper offers to actively "manage" an ETF portfolio for you, ask yourself, "What is the skill level of this Helper, and is the cost effectiveness of ETFs mauled by the Helper's management fees?" Do NOT pay 1% for any "service" like this.

Let's pretend you were talking with a person who had been to see one of these credentialed financial advisors for investment advice. You asked what the Advisor said. The local replied, "Said I was a 6 on a scale of 1-10." You asked what that meant and got hemming and hawing and the conclusion that neither the local or the advisor knew. Herein lies the problem in dealing with partially trained product salespersons. They ask a few simple questions like, "Would you be more comfortable owning stocks when the market was in a freefall, or holding cash when the market was roaring up?" What a stupid question. Investment questionnaires are intended to let the salesperson limit their risk of losing your money rather than in actually making you money. This is NOT personalized investment advice.

Often the end result (unless you have a couple hundred thousand or so) is to offer to put you in some mutual fund or series of funds, or maybe ETFs. What's the difference, you say? I'm glad you asked. Check out the sample investment objectives questionnaire resource in this course.

So, where are the "Free" Helpers? You may as well ask me the weight of a sparrow. There are websites that claim to be objective, though, so we'll look at a couple.

1. "Talk to Chuck". Schwab charges fund families huge fees to be included in their "Objective" fund base. In addition they used to charge financial advisors fees to be included as a "Recommended" advisor. Their web site leads you to buy their stuff (naturally), but it is by no means objective.

2. Fidelity. The "other supermarket" tries to sell you something (naturally), and most of the portals lead you to a fund choice.

3. Do it yourself (Buyer Beware)

4. Get complimentary advice only when you need it. Ask "How old is this Helper and what training did they have?" When you think you need it, it's probably too late.

5. Or pay a "nominal" fee for professional ongoing advice (ask the same questions as the first two, plus "How much?"

Free Resources:

1. Morningstar. They used to be in the business of rating mutual funds, and they still do that, but the have moved into the investment management Advisor business for the same reasons everybody else has (there's big bucks in it). They still have their star funds but also offer analysis of your portfolio and feature "Free" membership for awhile. I didn't have the patience to see what and when you have to pay something.

2. Vanguard. The low cost brainchild of the fine gentleman, John Bogle. They have the best information for investors, including modules on:

   a. Planning and education
   b. Controlling costs
   c. Retirement
   d. General investment planning
   e. College planning
   f. Investment basics
   g. Tax central

   Their funds are lower in costs that just about anybody else and are focused on index funds and ETFs. Look at their Admiralty Treasury Funds for some good income options.

3. Financeware. A non-brokerage related site developed by our colleague, David Loeper using methodologies we developed 15 years ago to match expected returns with objectives. There is some good stuff there.