

# What the Mutual Fund Salesman Forgot to Mention

How sales charges, high fees, and excessive diversification will have you working way too long

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*“Exchange-traded funds or ETFs target all segments of the equity market. Many have extremely low expense ratios and these are the perfect way to participate in the most attractive segments of the stock market with low expenses that leave more money in your portfolio to benefit from compounding.”*

This article is directed to people likely to work at least another decade before retiring and whose goal is to accumulate the necessary assets. The bottom line is that, if you want to enjoy retirement, you'll have to invest in stocks. At present, bonds and money markets offer a return that's barely above the real inflation rate, so an investment in these means you'll probably end up eating cat food when you stop working. Investing in stocks means dealing with volatility and some ugly years, but that's the price of being able to maintain your lifestyle when you retire.

It's an open secret that men have generally been more inclined to deal with this risk than women, who tend to invest more conservatively. The significantly lower returns of bonds and cash coupled with longer life spans means that too many women outlive their money and spend their retirement living modestly. According to the U.S. Census Bureau, 17.3 percent of nonmarried elderly women (widowed, divorced, or never married) are living in poverty today. This statistic is too high, so we're going to attempt to raise the comfort level with equities by de-mystifying the stock market and identifying its more attractive segments.

## [A Short Primer on Common Stocks](#)

Most of the time, stock market investors appear to chase more fads than the fashion industry and it's fair to ask whether there are investment themes that stand the test of time. As it turns out, there are two relatively simple concepts that make up most of what you need to know to become a successful investor. What you need to remember can be summed up in 12 words, SMALL IS GOOD, BIG IS BAD, VALUE IS GOOD, GROWTH IS BAD.

Ever worked for a big, dumb, bureaucratic company that thinks they can shrink their way to prosperity if they fire enough people? It shouldn't be much of a surprise that smaller companies are better investments. In this case, when we refer to small or big, we're referring to the total market value of the shares of stock outstanding. In other words, it's the amount that would be paid to buy all the shares in the open market, also known as the market capitalization. Companies in the stock market are then divided into the following four groups:

Biggest companies a.k.a. "Blue Chips" = large capitalization

Medium-sized companies = midcap

Small companies = small cap

Smallest companies = microcap

The second measure is based upon an accounting measure of the value of the company known as book value. Interestingly, this is a valuable measure in spite of the fact that the accounting value of a company rarely has much to do with the real value. When the price of the stock is compared with book value per share, we get the following:

Companies with a below average stock price/book value = value stocks

Companies with an above average stock price/book value = growth stocks

At present, our benchmark for price to book value is the S&P 500 Index. Based upon today's (9/27/05) closing price, the price to book ratio is 2.87. As a result, this is considered the current dividing line between value stocks and growth stocks.

If you're getting the impression that successful investing isn't exactly rocket science, you're right. As companies get bigger and more bureaucratic, they become less attractive investments. Also, companies whose stock is cheap relative to the underlying assets outperform companies that are expensive. Sounds too simple? Here's the data from Ibbotson Associates/Univ. of Chicago:

### **Compound Annual Returns 1928–2004**

Large Capitalization Stocks (S&P 500 Index) = 9.96%

Midcap Stocks = 11.39%

Small Cap Stocks = 11.70%

Microcap Stocks = 13.14%

All Growth Stocks = 9.01%

All Value Stocks = 12.55%

This isn't to say that growth stocks and large cap stocks don't have their moments in the sun such as the 1990s. However, if you focus on smaller companies and value stocks whenever you're asked to make an allocation to your 401k or company retirement plan, you'll probably be able to retire sooner.

### **Diversification**

A common mantra among professionals is the need to diversify. In this context, you need to understand that one of the most important functions of diversification is to protect investment professionals from lawsuits. This country has a legal system that allows anyone to be sued for just about anything and some investors inevitably morph into victims whenever the stock market goes down. With the current oversupply of lawyers, someone will always take their case. Professionals know they can be sued for a lack of diversification, but rarely for too much diversification.

The result is that too many people in our industry recommend portfolios that are absurdly over-diversified. There are a handful of stock market segments that offer attractive returns with moderate risk over time and too many other segments that offer unattractive returns, too much risk, or both. For an investor that wants to retire sooner rather than later, a little bit in every

segment of the stock market means only average returns at best. Deduct high sales charges and expense ratios, and the road to retirement gets a lot longer.

Another unfortunate reality is that the stock market is currently infested with too many inexperienced hedge fund managers. Many haven't yet figured out how companies play the game of managing earnings expectations and react to almost every announcement by shooting first and asking questions later. In their world, a conservative forecast is the same as a downturn in the business and taking a stock down 40% because earnings per share missed by a penny is a rational response. The result is that any stock can be nuked in a heartbeat, so you'll save yourself a lot of aggravation by starting with mutual funds.

Mutual funds will give you diversification, which is useful for controlling risk. However, diversification isn't a panacea for transforming unattractive investments and it's very important not to get too carried away. Limiting your investments to funds that target the most attractive stock market segments will allow you to capture the higher returns these offer over time while diversifying away some investment risk.

## **A Short Primer on Mutual Funds**

The universe of mutual funds is divided into open-end funds and closed-end funds. Open-end funds include those with sales charges known as load funds and those without sales charges, known as no-load funds. In addition to the sales charges, all funds also have imbedded fees that are deducted from the cash in the funds. Most commonly, these are investment management and administrative fees. When all fees other than sales charges are combined, the result is known as the expense ratio which is expressed as a percentage. To calculate its impact, multiply the expense ratio by the value of your portfolio. Even though you won't receive a bill or see it disappear, that's the amount that will be taken out of your portfolio every year by the fund management company.

In an open-end fund, investors continually buy or sell shares when they add or withdraw their money from the fund. Open-end simply means that the total

amount in the fund can rise or fall as investors add or withdraw funds. Open-end funds are required to establish a daily price for shares, called the net asset value or NAV, and are required to buy and sell shares at the current NAV daily.

In a closed-end fund, capital is raised through an initial public offering, and the proceeds are then invested in securities that meet the investment objectives in the fund's charter. The shares trade on the New York Stock Exchange or American Stock Exchange just like stock, and like stocks, investors pay a commission when these are bought or sold. Supply and demand determines the price of the shares, although the price is still generally tied to NAV per share.

A good general rule of thumb is that the folks selling and managing mutual funds are going to get you one way or another. Mutual funds that have high sales charges usually have relatively low (under 1%) expense ratios. No load funds or closed-end funds usually make up for the lack of a sales charge with high expense ratios (over 1.25%). However, there are more than a few Gordon Geckos out there that manage to combine high sales charges with high expense ratios.

In the last few years, a new type of closed-end fund has emerged that no rational broker or mutual fund salesman is going to recommend. They're called exchange-traded funds or ETFs and target all segments of the equity market. Many have extremely low expense ratios and these are the perfect way to participate in the most attractive segments of the stock market with low expenses that leave more money in your portfolio to benefit from compounding. Here's an overview of some of the choices available [http://www.ishares.com/fund\\_info/equity.jhtml](http://www.ishares.com/fund_info/equity.jhtml).

## **Nickels, Dimes, and Serious Dollars**

A new client recently came to us for an evaluation of his proposed portfolio. He had been sold a family of open-end mutual funds with high sales charges, but those charges had run out and his broker was no longer being paid. Not surprisingly, his broker found a whole new family of funds that were touted as a

huge improvement over his current portfolio. These new funds targeted the large capitalization segment of the stock market and were a particularly egregious example of high sales charges of 5.5% coupled with a high expense ratio of 1.30%.

To see how this alternative stacks up against an exchange-traded fund, we'll use the S&P 500 Index and start with 1972. In the real world, you're going to pay at least pay an expense ratio and maybe a sales charge. We'll use the DJ iShares S&P 500 Index (symbol IVV) with an expense ratio of .09% and deduct these expenses from the historic returns on the S&P 500. We'll also deduct a 5.5% sales charge and a 1.30% expense ratio from the same returns. Once this is done, we'll compare the growth of \$1.00. Remember that a sales charge of 5.5% means that your portfolio has to increase by 5.82% to get even which is the return on 94.5 cents getting back to \$1. With the open-end fund, we'll start the portfolio at 94.5 cents while the ETF portfolio will start at \$1.00.

### **Growth in a Dollar 1972–2004 Using Exchange Traded Funds With .09% Expense Ratio**

S&P 500 Index = \$34.53

### **Growth in a Dollar 1972–2004 With 5.5% Sales Charge and a 1.30% Expense Ratio**

S&P 500 Index = \$22.63

What this illustrates is that a fairly small difference in expense ratios coupled with eliminating the sales charge can make a dramatic difference in the size of your nest egg at retirement. In this case, reducing the expense ratio by 1.21% and eliminating the sales charge increases the size of the nest egg available at retirement by over 53%. I'm sure your nephew who sells mutual funds is a nice guy, but is he THAT nice a guy?

## **Portfolios**

To take this a step further, we created two separate portfolios. One is the classic professionally managed and diversified portfolio with growth stocks,

foreign, large cap, and midcap. The other targets the attractive segments of the stock market. The difference in compound returns for these portfolios was less than 2.5% per year. That doesn't sound like much, but compounding that additional return from 1972 roughly doubles the amount available at retirement as you can see from the following:

### **Growth in a Dollar 1972–2004 Using Exchange Traded Funds**

Portfolio of MicroCap, Small Cap, REITs, & Value = \$72.70

Portfolio of Large Cap, MidCap, Foreign, & Growth = \$37.20

If you're interested in creating your own portfolio, here are the exchange-traded funds used in the above example. The only caveat is that most of these funds didn't exist in 1972, so the growth in a dollar was calculated using the index total returns from Ibbotson Associates and deducting each fund's annual expense ratios.

### **Portfolio of MicroCap, Small Cap, REITs, & Value**

Russell MicroCap Index Fund – Symbol IWC, .60% Expense Ratio

S&P Small Cap 600 Index Fund – Symbol IJR, .20% Expense Ratio

Vanguard Index Trust REIT Vipers – Symbol VNQ, .18% Expense Ratio

Russell 3000 Value Index Fund – Symbol IWW, .25% Expense Ratio

### **If You Don't Want to Manage Your Own Portfolio**

Until recently, our firm has always been reluctant to add mutual funds to client portfolios. We have bills to pay also, and by the time our management fee is added to the fund's expense ratio, there didn't appear to be enough left for clients to earn a decent return. However, that's changed with exchange-traded funds.

We still haven't found a convincing reason to invest in foreign stocks, so our investments are limited to segments of the U.S. equity market. Instead of keeping an allocation locked in place, however, our allocations change as interest rates rise and fall and as the economy gets stronger or weaker. By investing aggressively when the chances of a high return are greater and

investing defensively when the environment is likely to be more difficult, we think we can add enough value to offset the management fees.

We introduced our Equity Allocation Portfolios in May 2005 and the track record so far is short but encouraging. If you don't want to manage your own portfolio and have minimum liquid assets of over \$100,000, please feel free to contact us.

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