WP&M

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Mutual Funds, the Truth

(The last paragraph is the important paragraph.)

A mutual fund is a packaged investment vehicle that owns securities, as few as 25, as many as 500 or more. Therefore, a mutual fund is **inherently diversified** within its objective. A fund with a stated objective of growth owns dozens of securities defined by someone as growth securities. A fund that provides tax-exempt income owns dozens of tax-exempt municipal bonds. A money market fund owns commercial paper, bankers acceptances, treasuries and certificates of deposit. An international fund owns securities domiciled all over the world.

A mutual fund is **professionally managed.** One or more full-time money managers supervise the fund, deciding what to buy or sell, and when. The primary goal of a professional mutual fund manager is to perform, or to appear to perform. The first priority is to protect the fund, to maintain its relative performance and marketability. A corollary goal is to avoid actions that reduce marketability. Generation of realized gains is marketable. Realizing losses, though economically attractive, is not marketable.

A mutual fund is a mass market institution. "Mass market" refers to two fundamentals of fund operation. The first is that the fund is owned by many public investors, often tens of thousands of them. The second fundamental is that the fund owns many securities, perhaps hundreds, more than an individual investor owns in a personal portfolio. The important effects of being a mass market

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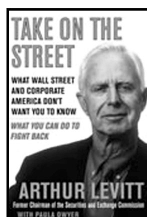
The Best Recent Book about Investing



Take on the Street, by Arthur Levitt, former chairman of the Securities and Exchange Commission, is the clearest summary of the craziness of the past decade (Enron, etc.), but it is much more. This book also is a "how-to" instruction regarding evaluation of companies, balance sheets, income statements, quality of management, and corporate governance. In addition, Levitt gives complete advice on how to invest 401(k) accounts.

If you have a dime in the stock market, or contemplate investing a dime, read this work.

Mutual Funds, *continued from page 1*

institution result from these two fundamentals. Since a mutual fund is owned by tens of thousands of investors, the interests and personal circumstances of any one investor are subordinate to the interests of the fund as a whole. Also, the professional who manages the fund not only must follow and be aware of dozens and dozens of different securities. He/she also must be aware of the relative weight of each security and each industry owned by the fund. Regardless of opportunities for profit, or the probability of loss, the fund must meet regulatory requirements plus the requirements in its published statement of objective.

While the objectives and day-to-day management of a mutual fund do not always meet the needs of a specific investor, mutual funds—in general—provide a level of supervision and diversification that passive investors cannot achieve on their own. On the other hand, active, interested investors can achieve results similar to the results of mutual funds by following appropriate criteria in acquiring individual securities. An individual investor can achieve a statistically valid level of diversification, almost identical to the statistical diversification of a mutual fund, by acquiring 15 to 25 different equity securities from different industries.

Mutual funds emerged in the 1940s as a way to own stocks. The mutual fund was a money management service. An investor, instead of acquiring individual stocks through personal research, could convey funds to a professional manager by purchasing a fund. Upon acquiring shares of a mutual fund, the investor took solace that someone was watching the farm while the investor pursued activities of greater personal interest. "I like to build homes," said the investor. "I do not like to manage my money. It's too much work. It takes my attention off my career, or travels, or whatever. The mutual fund manager will do it for me, leaving me free to live as I like."

In the early 1950s, a concept of risk and reward emerged. The concept is "modern portfolio theory." This theory, or approach, became accepted and popular in the late 1960s and early 1970s and found a place in laws affecting retirement plans and tax-exempt foundations and endowments. Process became more important than specific selections of securities. "Asset allocation" became the most commonly occuring word in investment finance. No longer was "prudent" selection of individual securities the criterion for fiduciaries. Instead, following a "prudent process," with defined and widely accepted prescribed steps, determined whether the fiduciary survived legal challenges. At the same time, "asset allocation" became the tool of personal financial planning for individuals. Today, persons who advise individuals usually present an "asset allocation" plan, commonly packaged in large booklets, with many colorful charts and graphs. The words "asset allocation" appear prominently in materials that promote financial plans and planners, as well as in written proposals and in complete financial plans.

Investors can achieve valid diversification within a category by acquiring one fund, because funds are inherently diversified within their categories. No benefit is available by switching from one fund to another within the category because all funds are managed by individuals having similar competence.[1] No fund manager has proved to be statistically superior to another over planning periods of five years or more. Hence, little is gained by switching from one growth fund to another because both are diversified, and both hold certain securities in common. The same is true of switches in other categories, such as "balanced," "small cap," "tax-exempt," "growth & income," and so on through the list of the available investment categories (sometimes called "asset classes," although these words usually are used more broadly to distinguish between real estate, collectibles, stocks, and bonds). To the extent that switching between funds within a category is not productive, services purporting to make timely switches are not productive.

The first decision in acquiring mutual funds is to select categories and to allocate money to the selected categories. Commonly, an investor places 60 percent in stocks, 40 percent in bonds. This investor is conservative. When this choice and allocation is final in the client's mind, two funds may be acquired, one in stocks, the other in bonds, resulting in sufficient total diversification. If an investor wants a recommendation about allocating

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[1]Looking back, some managers appear to be more competent than others. However, predicting future competence, or continuation of past success, is not possible.

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MISCONCEPTIONS HEARD IN A BEAR MARKET

"I do not want all my eggs in one basket. I need several advisors and custodians."

No text recommends that investors have multiple custodians and advisors. All texts and advisors recommend diversification among classes of investments. Multiple custodians produce multiple statements, each unique in appearance and organization. Investors tend to file without reading statements that are hard to decipher.

Reliance on multiple financial advisors leaves the investor with counterproductive conflicts of opinion. Relying on multiple financial advisors results in reduced diversification. Suppose one advisor recommends 60 percent in stock, 40 percent in bonds, while the other advisor recommends 100 percent in stocks. The client who uses both advisors, without data sharing, cannot effectively implement the strategy of either. The client winds up with an obscure compromise having no clear and visible asset allocation strategy. Or, suppose that the investor's standard of prudence is to have no more than five percent of net worth in one stock, but two of his advisors and/or mutual funds own the same stock, producing a total weighting greater than five percent.[1] The personal standard of diversification is not implemented.

Investors should have a primary financial advisor who works effectively with an attorney and an accountant. Investors may have more than one investment advisor, provided that the financial advisor is aware of the activities of each investment advisor, and the financial advisor receives data from each.[2] The best way to share data is to have all investment advisors implement through one custodian, thereby facilitating data sharing.

"I want you to take profits whenever available, at least once a year."

This desire results directly from the present decline in securities prices. This investor is saying to himself, "You should have taken profits when you had them a year ago."

The fallacies of this proposition include the inability to perceive and the costs of switching. At any point in a bear market, securities appear to be bargains. When a stock declines from 60 to 40, 40 appears to be a bargain relative to the recent high. The next price of this stock might be 39 or lower, and the trend might continue down. A few weeks later, 40 might appear to be a high price compared to the present lower price. Our perception of price is limited to what we see today. No one can predict a future price; we cannot envision our perspective about price on a future date. Professional buy-hold investors, comprehending that today's perspective is limited, and knowing that market timing is impossible, hold quality securities during a decline, believing that the recovery (also unpredictable) might start any day, and that the chance of missing the recovery is high.

The economics of taking profits also mitigate. Suppose that thirty stocks are available to purchase, and that an investor owns ten of those stocks. In a bull market, all securities tend to rise. At the same time that our 10 stocks rise, the 20 stocks not owned also rise. Proceeds of a sale having a realized profit are used to purchase a security that has risen by about the same magnitude as the stock sold. The stock purchased has about the same relative value as the stock sold. The new stock is above its low price, and the person who sells us the new stock might be realizing a profit at the same time we realize our profit. By switching from our appreciated stock to someone else's appreciated stock, we experience no increase in inherent value. Meanwhile, we pay two commissions, and we pay taxes on realized capital gains (in taxable accounts).

The investor responds:

"Professional investors are able to find bargains, stocks going counter to the average."

True enough, but professional investors are humans with limited analytical skills and with no capability to see the future. We find bargains more often than casual investors, but we do not find bargains every day, or even every year. At the top of bull markets bargains are rare, almost impossible to find. With experience during two of the most severe bear markets in recent times, the professional serves by sitting tight and by advising clients to sit tight. The professional adds value by discouraging frequent trading. Our experience tells us that a bull market might commence at any moment. Experience tells us that we do not want to miss the early stages of that bull market. We do not want to sell now and then see stocks sold rise 10, 20, or 50 percent. No investor, measured over periods of five years or more, beats the market by selling and buying. Today's headline making super hero, the person cited by casual investors as an example of how to invest, is tomorrow's vagrant.

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[1] Large accounts, such as endowments, foundations and retirement plans, hire many money managers. To avoid inadvertent concentration when more than one manager acquires the same stock, the fund executives have computer programs to provide an alert. On seeing an alert, the executives either ask managers to reduce the concentration, or the fund creates a sophisticated hedge to ameliorate the risk.

[2] Wealth Planning&Management is both a financial advisor and an investment advisor.

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assets, he/she can go to the web site of a mutual fund company, enter data about age, income, personal temperament (risk tolerance), the nature of the assets (taxable or tax-deferred), and the ages of dependents (heirs). With this information, the mutual fund's asset allocation computer program will generate a plan. Because no advisor, researcher, or investor can prove that one asset allocation plan is superior to another, the computer-generated plan of a mutual fund company is adequate. These plans usually are offered without charge. If an investor requires assistance in working with asset allocation programs, he/she can hire a professional advisor. An asset allocation strategy should endure several years, or at least until a major life event, such as marriage, birth of a child, or retirement.

Since mutual funds are inherently diversified and professionally managed, since creating an asset allocation plan is primarily intuitive (even if generated by a computer using the intuitively created ideas of the computer programmer), and since a plan should endure five years or more, investors should not pay a continuing fee for professional monitoring of mutual funds. A continuing fee is not earned because frequent change is not required. The fee for mutual fund advice should be hourly, based on the amount of time spent helping the investor to become familiar with asset allocation principles and programs.

Fear and Folly

During 2002, questions and actions by clients revealed fear of loss.

Fear of loss is greater than joy of gain. The magnitude of emotion, its impact on daily life, is greater for loss than for gain. During rising markets, when net worths are increasing, investors do not feel delight. When investors receive a monthly statement showing a 5 or 10 percent appreciation in total value, they do not:

1. Phone home
2. Call friends to announce the achievement
3. Telephone their brokers and investment advisors to express gratitude or personal satisfaction
4. Take wives and family to dinner
5. Call a talk show or write a letter to the editor proclaiming confidence in markets and thanking the national administration for wise economic policy

On the other hand, when markets decline, fear and anxiety invade the psyche. The mind envisions an irreversible road to financial ruin, to a retirement without financial security. Some investors make decisions arising from pain. Some abandon the ship. At the point when the largest number of investors have jumped and the ballast is lighter, the ship enters calm waters and begins its turn to profitable harbors.

Tax Revolt—Pay More?

The weather bureau predicted heavy snow on Christmas Eve. In Indianapolis, more than seventy trucks prepared the roads. As snow began to accumulate about 5 p.m., those trucks continued to work, all night and into Christmas afternoon. We had a white Christmas. Thanks to those seventy trucks, and to the men and women who drive them, and to other crews working throughout the state, and in adjoining states, we also had navigable roads. For these wonderful people and equipment, I'll gladly pay taxes.

* * * * *

The large letter box at Greenbriar shopping center was full. I could not find room to push in another envelope. That one box must have contained a thousand envelopes, maybe more. For me to sort those envelopes would have taken a week, provided that I could find space. The postal service retrieves those envelopes, and millions more, every day. It sorts the envelopes in a few hours. The service seldom loses one, and most envelopes arrive at the right place within three days. How do they do that? It is a miracle. The cost is 37 cents an ounce. What a deal. In those rare times when USPS revenues fall short of expenses, I'll ante up a few tax dollars to cover the difference. Maintaining the United States Postal Service is worth it.

"Taxes are the price of liberty."

Good night, Dorothy. You done good.

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