Consumer Reports March 2004

MUTUAL FUNDS: THE OTHER BIG SCANDAL

Remember Janus and Putnam, Strong, and Alliance Capital? With the stock market reaching levels not seen in two years, it's tempting to forget about the mutual-fund scandals that broke a few months ago. Investigations into shady trading practices that conferred black eyes on a dozen fund families are hardly as riveting as watching your own portfolio come back to life.

And outrageous as it is, the mutual-fund mess (See Close Up on page 13) is relatively small potatoes. The total amount lost to investors is an estimated $5.4 billion, but that's just a smidge to the $7 trillion fund industry. Moreover, most of the funds involved have announced that they will repay investors.

Before you decide to let bygones be bygones, however, you should know that there's another, bigger mutual-fund scandal that's been going on for years: high costs.

First things first, high costs in the form of loads and unnecessary fund expenses that can weigh down the most buoyant portfolio.

John C. Bogle, former CEO of the Vanguard Group, the no-load-fund giant, estimates that it costs Americans $72 billion a year to invest in mutual funds. It's hard even for a 53-year mutual-fund veteran like Bogle to say where the money goes. A major industry failing, he maintains, has been its unwillingness to break down expenses so that consumers can tell how much they are spending and for what. Nevertheless, he estimates that $17 billion of the total goes to shareholder services like recordkeeping; another $28 billion goes to operations and marketing. Only $5 billion is spent on research in stock, bonds, and money-market instruments, the expertise for which consumers pay a premium. That leaves some $22 billion in profits, or 40 percent of management expenses, earned regardless of fund performance.

Every industry has a right to profits. But Don Phillips, a managing director of Morningstar, Inc., the Chicago-based mutual-fund research company, says that gross profits in the mutual-fund industry are routinely many times those of other industries and can range from 30 to 45 percent. Those profits are remarkably steady, since fund expenses are deducted automatically from shareholders' accounts regardless of fund performance. "When tough times hit the auto industry, margins slide all the way into the red," says Phillips. "But even in a bear market when assets were down, you still had fund companies making a double-digit profit."

In our own investigation of expenses, for which we sifted through data on thousands of stock mutual funds, we found that in the last five years, the fund industry didn't just maintain its high charges but increased them-even during the recent market downturn when many investors saw their portfolios crushed.

What's more, many companies that once sold funds directly to the public have turned to commissioned brokers and financial planner; to push products-and added 12b-1 fees to underwrite the costs of advertising and marketing. To compensate salespeople, there are now "A," "B," and "C" share classes, each with its own commission structure. Such innovations not only confuse investors but also leave them with less money.

So should you avoid mutual funds? Investors don't believe that; the last quarter of 2003 saw net inflows in mutual funds increase, even as new fund infractions were popping up like mushrooms after a rainfall. That makes sense. Mutual funds still give you the greatest chance to profit from the markets by diversifying among lots of stocks or bonds with a small amount of money.

LOADING ON THE LOADS

There's no proof that paying loads buys superior fund performance. Our analysis of Morningstar data shows that load funds in the nine domestic-stock categories we surveyed did not produce higher returns than no-load funds over the last year or 3, 5, or 10 years.

Yet, in recent years, several large mutual-fund families, including Invesco Funds Group, Scudder, and even low-cost champion T. Rowe Price, as well as many smaller fund companies, have announced that they're abandoning or de-emphasizing direct sales. In a bid to recruit new investors, they now sell funds through financial advisers or brokers. That means more loads or commissions for average investors. Not only are more companies charging loads, but the loads are rising. Among companies that require such fees, the front-end load for the average equity fund has increased to 5.36 percent from 5.18 percent in just three years.

With loads typically come 12b-1 marketing fees, amounts that funds levy to sell you your own fund. These fees cost up to 1 percent of assets per year and go toward advertising, distribution, and other sales costs. Some no-load funds also assess such fees, though they are capped at 0.25 percent. The 12b-1 fee has become such a reliable source of income that funds are reluctant to give it up even when they are not doing any marketing.

In our survey, we found 50 equity funds that continued to levy 12b-1 fees although they were closed to new investors and thus not trying to sell shares to the public. AIM Investments, which distributes Invesco's retail mutual funds, had 14 such funds. A spokesman says that the fees are for "ongoing shareholder servicing." In fact, fund expense charges should pay for such items.

Fund companies are supposed to grant so-called breakpoints or discounts on commissions for investments over a certain amount, usually $25,000 to $50,000. But a 2002 study by the Securities and Exchange Commission, the New York Stock Exchange, and the National Association of Securities Dealers found that one-third of 5,515 transactions eligible to receive breakpoints didn't, often because brokers neglected to link ownership of investors' accounts. Missed discounts averaged $364. Such investors often wind up holding class- B shares, which usually end up costing shareholders more in 12b-1 fees.

Loads-wherever they fall in the alphabet-diminish a shareholder's investment. An investment of $10,000 in 1974 in a no-load fund tracking the equity market would have yielded $252,957 by the end of 2003, a gain of $28,315 over an identical investment saddled with a 5 percent load and a minimal 0.25 percent 12b-l fee.

EXPENSES ARE GOING UP

A fund's expenses, including the 12b-l fee, are expressed as a ratio or percentage of fund assets. Expenses pay for management and administration. Fund expenses are inflated by "soft dollar" arrangements in which fund companies pay brokers to steer customers to their funds. Under such programs, said Stephen I Cutler, director of the SEC's division of enforcement, in testimony before Congress last fall, payments from fund assets are "being used to foot the bill for the mutual funds' premium 'shelf space' at the selling broker's office."

Economies of scale should reduce expenses, but as the mutual-fund industry has grown, its costs to investors have grown faster. Between 1980 and 2002, fund assets multiplied 60 times. Fund management fees and expenses during the same period, however, rose at least 90-fold, according the Bogle Financial Markets Research Center, sponsored by Vanguard. Our analysis using data from 1999 through 2003 shows investors in specialty-sector equity funds were hit hardest. Communications-fund expenses, for example, rose to 1.6 percent of assets, on average, from 1.28 percent.

Higher fund costs don't sound like anything to be worried about. An expense-ratio increase of 0.32 percentage points costs only $32 extra each year paid on an investment of $10,000. But added up over decades, those fees eat away at returns. Again, a $10,000 investment in 1974 that tracks the stock market would earn $236,465 after 30 years, $19,598 more than a fund charging 1.6 percent.

High expenses, moreover, don't translate to high returns. A November 2003 Morningstar analysis found that domestic funds reporting the lowest expense ratios in 1998 generally outperformed the funds with the highest expense ratios over the ensuing five years. The cheapest quartile of small-blend equity funds, for instance, returned an annualized 11.11 percent, while the most expensive quartile returned just under 6 percent. Russel Kinnel, Morningstar's director of mutual fund research, observes: "Expenses are one of the most - if not the most - reliable predictors of whether your fund will be a leader or a laggard."

With MUTUAL FUND EXPENSES, you don't necessarily get what you pay for.

HOW TO CHOOSE

In spite of the mutual-fund industry's latest volley of fees and commissions, there are ways to shield your own portfolio. If you are new to mutual-fund investing, start with First Things First, page 12. It explains the differences among various fund types. Our Ratings, starting on page 15, offer excellent fund choices in 10 different investment styles; with the help of Morningstar, we've identified 58 no-load, low-cost offerings that pose moderate to low investment risk, and have outperformed peers in good markets and bad. Quick Picks, page 15, offers options for a variety of needs.

When you have any fund under consideration, however, you should use these guidelines for choosing a solid performer:

Buy direct. Buying through a no-load company ensures you pay no sales commission and a 12b-l fee that maxes out at 0.25 percent of assets. All the funds in our Ratings meet those criteria. If you feel you must have the guidance of a broker or adviser, find one who charges by the hour or takes no commissions on financial products. One source of such professionals is the National Association of Personal Financial Advisors *(www.napja.org).*

Buy cheap. As we've shown, expenses are more reliable predictors of the future than past performance is. Our Ratings include only funds whose expense ratios are below the category average.

Look at long-term performance. We've based our Ratings on five-year returns, which we believe are a better measure of performance than one-year returns. That period encompasses two rises and a dramatic dip in the stock market. We've also included only funds rated 4 -and 5 stars by Morningstar, reflecting superior performance over similar funds, adjusting for risk and for sales charges.

Check out a fund's taxable gains. In the Ratings, Morningstar's tax-cost ratio is the percentage-point reduction in a fund's annualized, five-year return when the maximum federal tax rate is used. Seek a lower tax-cost ratio for taxable accounts. You can find out a fund's past tax-cost ratio by going to Morningstar's Web site *(www.morningstar.com)* and

clicking on "tax analysis" on each fund's page. A fund's turnover rate- how much of its portfolio it sells within a year-may also indicate how likely it is to generate taxes. High turnover can also boost the fund's brokerage fees for trading; those fees, though not included in expenses, come out of net assets.

Choose managers with experience. In the Ratings, we've chosen funds whose managers have at least five years' experience in that fund.

Have advisers compute commissions. If you deal with a broker, make sure you choose the right share class. Avoid class-B shares, which rarely offer the best deal. Class-C shares, which have no up-front load but charge high 12b-l marketing fees, are better deals than class-A shares generally only if you hold the fund less than five years. And if you have a high combined balance with one broker, ask for a sales-fee discount or breakpoint.

Stick to your guns. Once you've made your purchase, practice patience. A recent study of data from 1984 through 2002 by Dalbar, a Boston financial services research company, demonstrates that poor timing-buying at the top of the market and selling during a plunge- has cost investors dearly. Bad decisions reduced the average investor's annualized returns to 2.57 percent, not enough to keep up with inflation. Buying and holding an S&P 500 index fund for the same period would have returned almost five times as much.

SHOULD YOU DUMP TAINTED FUNDS?

A long roster of mutual-fund companies are under investigation for two abusive trading practices that raise shareholders' costs, lower their returns, and potentially boost their tax bills.

The first is late trading, which is illegal under a 1968 Securities and Exchange Commission rule. Late trading is said to have occurred when large investors or insiders placed orders after the markets had closed. Armed with late-breaking news that affects stocks held by the
fund, insiders profit by trading at the current day's closing price, not the next day's price. Fund companies under investigation: Alger, Bank of America, Bank One, and Federated.

Still more fund personnel at Alger, AliianceBernstein, Bank of America, Bank One, Federated, Fremont, Invesco, Janus, MFS, PBHG, Putnam, and Strong Funds have been investigated for market timing, which occurs when a favored investor is allowed to buy and sell funds within days to reap short-term gains. While not illegal, market timing can dilute fund share values. It can be considered deceptive if the fund states in writing that it does not allow it.

A 2003 study estimated that late trading costs all investors some $400 million a year, while a study from 2002 calculated that market timing fleeces long-term shareholders out of about $5 billion.

To restore the public's trust, AllianceBernstein, Bank of America, Bank One, Janus, PBHG, Putnam, and Strong fired employees they deemed responsible. A few have pledged to repay investors' losses. The SEC recently proposed rules that would require fund companies to tell whether they permit market timing and to disclose expenses and fees more explicitly, but at press time it was unclear whether the proposals would be adopted.

WHAT YOU SHOULD DO

If you own a fund with a company that engaged in market timing and late trading, stick with it only if the company has taken action to ensure that the abuses will not recur. For instance, it should have axed the executives responsible, put in safeguards such as redemption fees that discourage quick trades, and repaid shareholders for losses. If the company seems unrepentant, you need not be loyal. Then, use our criteria to pick funds that will replace those you dump. And think twice before buying a fund from a company that advertises returns. A 2003 study by professors Michael Jones, Vance Lesseig, and Thomas Smythe found that funds that promote returns in ads also tended to carry more risk and higher expenses than their peers.

First Things first: Know the different styles and sizes of mutual funds.

Stock, bond, and money-market funds are components of a diversified portfolio. How much to have in each – called asset allocation -- depends on how much you have to invest, your time horizon, and your tolerance for risk. Check out sample asset allocations at *www.mfea.com,* the Web site of the Mutual Fund Education Alliance, the no-load-fund trade group. In this report, we rate stock funds. They are categorized by size and investment style. The Ratings include nine domestic equity categories and one foreign category.

INVESTMENT STYLE

Growth funds invest in companies with fast growing sales and earnings. Every portfolio needs some growth investments that in theory have the potential to keep ahead of inflation.

Value funds focus on under priced companies but rarely keep up with growth funds. In theory, they move upward slowly and steadily. Blend funds mix both approaches; the Blend section of the Ratings is where you'll find broad category index funds, whose holdings mirror those of the indexes they follow.

SIZE

Large-cap funds invest in the largest companies, encompassing about 70 percent of the capitalization of stocks in the U.S.

Mid-cap mutual funds invest in midsized companies that account for 20 percent of U.S. stock capitalization.
Small-cap funds are chosen from among companies representing the remaining 10 percent of U.S. stock capitalization. They may offer growth, but the tiny companies in which they invest may be less stable than established companies.

OTHER CATEGORIES
Foreign funds invest in companies overseas. Many financial planners suggest hedging domestic investments by keeping 5 to 10 percent of stock holdings in foreign funds. Such funds carry extra risks, however, including currency fluctuations and political instability. **Specialty or sector funds**, which focus on individual industries, aren't part of our Ratings because of the risk they represent.

Mutual Funds – the good, the bad, the ugly

Bob Adams
bob-adams@comcast.net

There are different types of mutual funds, and all are easy to buy and sell. If you do a good job of selecting you don't need to dedicate much time to watching the results. The key is in selecting good ones.

Perhaps the most common are those run by a professional money manager, or team. The disadvantages are high fees, and for most, a high turnover rate—sometimes two or three hundred percent. A 200% turnover means the entire portfolio is replaced twice during the year. High turnover equates to capital gains taxes you will need to pay at year end. It also means your tax will be based on your regular rate—likely 28% or more—rather than the long-term capital gains rate of 15%. Another type of mutual fund is the Exchange Traded Fund (ETF), which is becoming more and more popular. Each has the advantage of low fees and low turnover—resulting in fewer capital gains taxes each year. The downside is you must pay a broker each time you trade. Then there are Index Funds. Low fees and very low turnover are their forte. They always produce a return slightly below the market average they emulate. You'll never beat the market average but will always be very close. These are about as close to a "set and forget" type of investment you can invest in.

Fees and turnover take a large slice out of your bottom line, so they are important. Here is an example.

If, today, you invested $10,000 in a managed mutual fund that provides a return of 12% for the next 40 years, your portfolio would be worth $930,510 if no fees or expenses were charged. But they do charge fees, an average of 1.5%. So, let's reduce the return of 12% to 10.5% and see what happens. Your portfolio value would drop to $542,614, a difference of $387,896. Most mutual funds also charge a 12b-1 fee for advertising and other expenses, further reducing the total value–but to keep it simple we'll ignore those. Be aware though they can be as great as 1%. However there is evidence these fees can be used as a value indicator. Russel Kinnel, Morningstar's director of mutual fund research, observes: "Expenses are one of the most - if not the most - reliable predictors of whether your fund will be a leader or a laggard." Funds with high expense ratios normally under perform those with smaller expense ratios.

But wait, there's more… You must pay capital gains taxes to the IRS. Lipper, a division of Reuters, reports that in 1996 the average investor in managed mutual funds paid taxes of 1.43% of their total portfolio value. While the mutual fund doesn't benefit from these taxes, your portfolio is reduced by the tax and that value is no longer working for you. If we subtract the capital gains taxes and the fees paid over those 40 years our portfolio will grow to only $322,265 instead of $930,510. That's not a pretty picture is it?

What can we do? Invest in less expensive investment vehicles like an index fund or Exchange Traded Fund (ETF). The normal maintenance fee for both is less than 0.2%. (0.18% is typical) The expense ratio of 0.18% results in a fee of 18 cents on each $100 in your portfolio rather than $1.50 for the average managed mutual fund. And because of low turnover, taxes paid on capital gains will be very low. That's true of index funds as well as ETFs. As was pointed out earlier ETFs are purchased through a broker, resulting in a fee on each trade, and that expense needs to be taken into consideration. That's not true of index funds.

Sometimes the only choices for investment in a retirement plan are the expensive managed mutual funds. If that's true in your case I suggest talking to the retirement fund administrator and ask that index funds be added. They may already be available and it's only necessary to move from managed mutual funds to index funds to improve your return.

If we assume you have no choice except managed mutual funds, how can you tell the good from the not so good—or the ugly? Some general tips are: look for a low expense ratio—well below 1%; invest only in no load funds; look for a low turnover ratio—well below 100%; evaluate the return over a 5 year period and observe if the current manager actually managed the fund during that period, and for a minimum of 5 years.

The picture I've painted on managed mutual funds is rather dark. However, there are managed mutual funds that are exceptions, so don't blindly use this information without doing appropriate research. A good place to learn about expenses, turnover ratios, and the other criteria suggested above is at www.betterinvesting.org. However the mutual fund area is limited to members only, and by an additional paid subscription. Another excellent resource of information is Morningstar -- www.morningstar.com. It's also a paid site but the reports are available at no cost through most libraries. Log on to your library's website and look for Morningstar. It's usually found under a heading of "Databases". Or visit your library and ask for help in finding the information. Another website that might be helpful is www.mfea.com.