To: P&G Employees
From: John B. Cornetet, CPA, J.D., CFP 513-771-2444

Re: Mutual Funds 101

While my main business is estate planning as an attorney, I am also a certified public accountant and a certified financial planner. Therefore, I will also, from time to time, address financial topics of interest.

Many people use mutual funds but do not clearly understand them. This email is about mutual funds.

<u>What is a mutual fund.</u>

A mutual fund is a pool of small amounts of money contributed by many people. You put in $15,000, I put in $1,500 and someone else puts in $125,000. All of the money is pooled and invested with a particular purpose. For example, the purpose of the fund may be to only purchase: large company growth stocks, government bonds, bank stocks, or small company stocks. There are mutual funds that are balanced between stocks and bonds. There are thousands of funds to pick from. The investors in the mutual fund hire a manager who invest the money consistent with the stated purpose.

The fees paid to the management team and the administration expenses are paid off the top prior to paying a return. The fees range from .25% to 2.95%. In addition to the ongoing fees, there can also be fees to get in called a front load. There also can be fees to get out called surrender or sales charges. You must have a complete understanding of these fees before you invest.

The fees are sometimes called A shares, B shares and C shares. On A shares, you pay a front load charge but less of an annual fee. On B shares, you pay a normal annual fee and a declining sales charge. For example, if you sell in year one you pay a 7% sales charge. In year two a 6% and so on. The C shares have no front or back end charge but a slightly higher annual fee. These are general rules, you must read the prospectus of the particular fund to determine their specific fee structure.

<u>Advantage of a mutual fund</u>

The main advantage of a mutual fund is diversification. Each of us can put a little money into the pool and together we can obtain broad diversification among many types of investments within the purpose of the fund. Some people will manage their retirement account by selecting six mutual funds. For example, money is spread among: large company growth, large company value, small company growth, small company value, bonds and international. While this seems easy, the cost of managing your money can be substantially higher than a money manager. Furthermore, most money managers also provide other services included in the cost such as financial planning, estate planning and private banking.

Disadvantages of a mutual fund

The are two disadvantages associated with mutual funds. They are cost and timing.

The mutual fund charges an annual fee to manage the money. If the fee is 2.5%, you pay this rate if you invest $1,500, $5,000 or $500,000. There is no economy of scale. If you hire a money manager, the more you invest, the lower your fees go.

The second disadvantage is timing of the investments. First, you are a 62 year old retiree with a long term investment horizon. I am a 43 year old speculator who is trying to move in and out of funds to time the market. We are both in the same fund. Therefore, you are subjected to my short term ins and outs.

Further, by definition the mutual fund manager must invest new money coming in and must sell to pay out people leaving. Through the mid 1990s, large company growth stock mutual funds did exceptionally well. There was a record amount of new money deposited in large company growth stock mutual funds in 1999. The mutual fund manager must invest these new funds in stocks at absolutely the wrong time. The large company growth stocks plummeted in 2000 and many mutual fund investors pulled out. Thus, the manager had to sell at absolutely the wrong time to pay off those investors leaving the fund. By definition, mutual funds are forced to buy high and sell low. This is because many unsophisticated investors chasing market performance put money in at the high price and want out when the market goes down. They buy last years winners. If during the past two years, you held specific stocks, you would have determined the timing of sales not the short term investor and the unsophisticated investor.

Conclusion

In my opinion mutual funds are appropriate in smaller accounts where it is the only way to diversify your investments. They are also appropriate as a piece of your investment plan. For example, you need some small company stock or international exposure. Mutual funds work well. Here, the mutual fund manager earns the fee not only picking the countries to invest in, but also which companies in those countries.

The rule of thumb that I use is if a client has at least one million to invest mutual funds specific stocks and bonds are more efficient and money management fees are lower. Less than that, you need to rely on some mutual funds. Again, this is just a rule of thumb, your needs may dictate a different course of action.

Before investing in a mutual fund, understand the investment goals, review the ten year track record, read the prospectus and understand how fees are charged. Once invested, monitor the fund for changes in philosophy and personnel.

John