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Intelligent Money

Current thinking from Haven Financial Advisors

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Special Notes of Interest:

- Texas residents may deduct the actual or estimated sales taxes paid on their Federal Tax Return in 2004.
- 2003 was the first year since 1988 that the mutual fund industry suffered a net redemption in investments.

The Cost of Mutual Funds

Mutual funds have received a lot of press over the past year. Much of it has been bad. Brokers have been accused of a failure to disclose their compensation arrangements to customers. Other firms have been accused of allowing favored clients to time their investments to the detriment of small shareholders. These are among the higher profile problems with mutual funds. The more fundamental problem is the persistence of a bloated cost structure. Yet there is a wide divergence of expenses among mutual fund options – with a decided advantage going to index funds. This article will identify and explain the cost components of fund management.

Indirect Costs

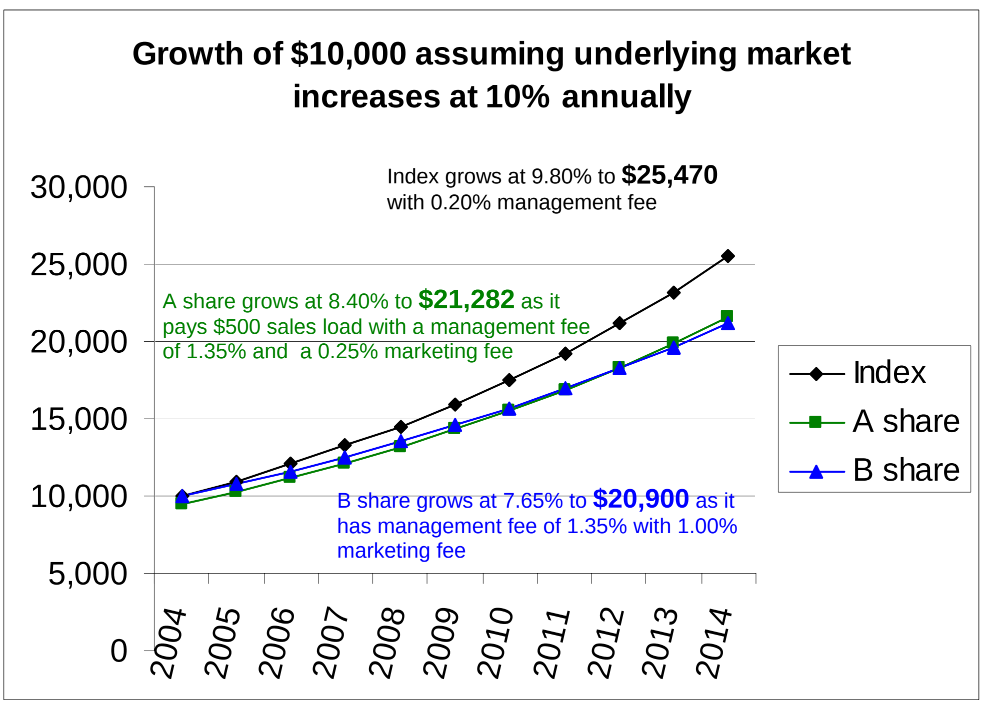
Management fees are the cost that most investors have general familiarity with. This is a fee charged by a fund's investment adviser for managing the fund's portfolio of securities and providing related services.

A second component is administrative or "Other" Expenses. These expenses include, for example, fees paid to a fund's transfer agent for providing fund shareholder services, such as toll-free phone communications, computerized account services, website services, recordkeeping, printing, and mailing.

Recent survey information from the investment company institute indicates that these indirect costs amount to 1.35% annually for equity mutual funds.

Distributions Fees

An additional cost center exists for classes of mutual funds sold through broker –



The Cost of Mutual Funds (Cont)

dealers. Funds sold through this channel have distribution charges known as 12b-1 fees deducted on an ongoing basis. Class A shares typically charge 0.25% in 12b-1 fees while class B and C shares are usually about 1.00%. 12b-1 trailers are used to compensate brokers for service provided to fund shareholders at the time of a purchase of fund shares or for administrative and advice services provided to the shareholder after the initial purchase.

Sales Loads

While A shares have lower 12b-1 fees, they charge sales loads of between 3% and 6% to new investors. This is an explicit cost deducted from the initial investment. While it does not affect the stated performance of Class A shares, the cost is nevertheless born by the investor. Class B shares have a deferred sales load that gradually decreases to zero within 7 to 10 years. It typically starts at 5% to 7% and dissipates thereafter. Investors are sold B shares in lieu of A shares as "all their money goes to work immediately". However, B shares lock in the investor for a prolonged period during which time substantial 12b-1 charges are levied. Overall B shares are the most expensive way to invest.

Index Funds are Cheaper

Index funds, available to direct investors and fee-only advisors, offer the best value. As they do not involve active management, their management and administrative fees are much lower (usually less than 0.30% annually). As there is no sales agent to compensate, they are free of distribution fees and sales charges as well.

Over the course of a ten-year holding period, an indexed equity fund will accumulate nearly 20% more wealth than a similar fund sold through a broker. The cost advantage of index funds compounds over time. The table on the preceding pages graphically depicts the advantage.

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Are Hedge Fund Returns Reliable?

Hedge funds have been one of the fast growth investment vehicles of the past 5 years. With the bursting of the financial asset bubble in 2000, investors looked elsewhere for returns ... and found hedge funds. Capital invested has swelled from $50 billion in 1990 to $1 trillion today.

Indices of hedge fund performance have been constructed such as the Credit Suisse First Boston/ Tremont index and the Van Hedge Fund Index. Index performance results can be found in most major financial publications. These indices routinely show that hedge funds in the aggregate offer superior performance with lower risk than the stock market. However, the issue of bias in return data collection dogs the hedge fund world.

Unlike their heavily scrutinized brethren in the mutual fund industry, hedge fund managers need not report their returns and only voluntarily report results to these hedge fund indices. They also have the option to report prior period returns upon joining an index – a practice known as "backfilling". Needless to say, funds that voluntarily join hedge fund indices and report prior results tend to have better performance numbers. Why voluntarily report bad results? Professors Burton Malkiel and Atanu Saha have found that backfilled performance for a given year was 5.8 percentage points higher than the returns of other funds whose results were contemporaneously reported for that year.

Funds also tend to stop reporting results when they run into trouble. After all, no one is forcing them to report and poor performance is bad advertising. The notorious Long Term Capital Management Hedge Fund stopped reporting its disastrous results for a full year before its collapse. This is called Survivor Bias.

There is too much positive spin in reported returns of the hedge fund indices. Using data from 1996 to 2003, Drs. Malkiel and Saha found that correcting for backfill and survivor biases reduced the average annual return on hedge funds, from 13.5 percent to 9.7 percent, which is almost three percentage points less than the return on the Standard & Poor's 500-stock index for that time period. Hedge funds are not as attractive as advertised.

"Correcting for backfill and survivor biases reduced the average annual return on hedge funds, from 13.5 percent to 9.7 percent, which is almost three percentage points less than the return on the Standard & Poor's 500-stock index for that time period."