



Investment Insights

Kevin Kennedy

Selecting the right mutual funds

In today's volatile, fast-changing investment world, more and more investors are turning to mutual funds as the investment vehicle of choice. According to the Investment Company Institute, over \$100 billion has flowed into mutual funds in just the first four months of 2004. And despite the recent scandals and bad press that has plagued the mutual fund industry, there are good fundamental reasons why investors should consider using mutual funds in a portfolio. These reasons include diversification, professional day-to-day management, and simplicity. When it comes to building a portfolio of mutual funds, there are a number of dos and don'ts investors should be aware of to position themselves for success.

Don't rely entirely on past performance. Although all mutual fund advertisements and literature always point out that past performance is no indication of future returns, investors are quick to "chase performance" and focus solely on funds with stellar recent performance. Often the popular press exacerbates this problem by publishing lists like "10 Funds To Own Now", "The Best Funds For You", and other "hot lists". According to a Reuters article published May 31st of 2004, Morningstar studied the consistency of performance of top funds, and the results were staggering: less than 30% of the time did a top-quartile performing fund (top 25% of its peer group) stay in the top quartile the following year. When Morningstar looked at funds in the top quartile over three- and five-year periods, only 20% of those funds managed to stay in the top quartile for the following three- and five-year periods!

Don't invest in a fund because "my buddy said it was a good fund" or "I heard someone on t.v. recommend it". The funds you invest in should have relevance to your particular goals and financial plan. Too often, investors come to me concerned about a fund they bought because they "heard good

things about it” but didn’t do the background work to find out something as basic as what the fund invests in. Buying a fund because it got a good review, and not looking first at your own circumstances, is putting the cart before the horse.

Do pay attention to the factors that are within your control. Ultimately, we won’t know how well a fund performs until after the fact. But there are a number of areas where you can tip the playing field in favor of your success.

Do build a diversified investment game plan. This sounds basic, but it is the most commonly overlooked part of investing. In a rush to get money to work, investors often don’t have a structured, personalized approach to investing. What mix of assets should you have? What type of return do you need to reach your goals? How do you best mix all of the available choices out there (U.S. and international stocks and bonds, cash, real estate) to minimize risk and maximize return? Consider all of these questions before you rush out to throw hard-earned money into investments.

Do consider expenses. Although studies regarding expenses and returns on mutual funds don’t show conclusively that lower-cost funds generate higher returns to investors, prudent steps should be taken to minimize investment expense. In particular, be cognizant of transaction costs involved with buying and selling funds that carry sales charges that can eat into your earnings.

Do pay attention to taxes. Individual investors are subject to taxes on dividends and capital gain distributions from mutual funds in taxable accounts (i.e. individual, joint, Trust accounts). Over time, taxes can eat away at investment returns. For taxable individuals, mutual funds with low turnover (not a lot of trading within the fund) typically generate lower tax consequences than high-turnover funds because gains are deferred until a stock in the portfolio is sold. Turnover information in any fund is readily available in the fund prospectus or from Morningstar (www.morningstar.com).

In my practice, we address these issues by taking advantage of institutional fund portfolios. These funds typically carry lower expenses, are tightly monitored and updated, and can be structured for “tax-sensitivity”. Once we’ve built a game plan for a client centered on that client’s unique goals and needs, we put the plan to work through portfolios like these.

No one knows for sure what the future holds, and how the markets will perform, but by taking smart steps like these, you can put yourself in the best position for success.

Kevin Kennedy is president of Kevin Kennedy, LLC, a registered investment advisor firm in Alameda. Reach him at 510-748-1898 or Kevin@KevinKennedyLLC.com. Stocks, bonds, and mutual funds involve risk, including loss of principal. Past performance is no guarantee of future results.