THE COMPASS CHRONICLE

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A client-focused financial advisory firm dedicated to providing objective advice to individuals, families, and retirement plans.

Our financial advisory services include:

- Investment Management and Consulting
- Retirement Planning
- Education Funding
- Family Budgeting

In This Issue . . .

Five Fund Fallacies[1]

What Every Mutual Fund Investor Should Know

The mutual fund industry, despite its long history of benefiting millions of fund shareholders, has been undergoing increased regulatory scrutiny over the past few years. Eliot Spitzer, the New York Attorney General, brought to light what collectively became known as the mutual fund scandals, which included short-term and late trading in fund shares that were either already prohibited by prospectus or by law. Additional regulatory pressure by the Securities and Exchange Commission (SEC) and attorneys general of other states has highlighted the industry's shortcomings and led to changes in mutual fund companies' practices. Yet, many issues remain unresolved in order to protect mutual fund shareholders' interests; unfortunately, mutual fund companies' interests are too often not aligned with shareholders' interests.

Speaking broadly, the mutual fund industry has three main participants: fund shareholders, fund directors, and fund companies. Fund shareholders are you and I—investors in the thousands of mutual funds that are available. The role and focus of fund directors and fund companies will become clear in the five fallacies outlined below.

Fallacy #1: Mutual fund companies look out for their shareholders' interests.

An overriding focus of most mutual fund companies is to build the assets in each of the funds it manages. Why? Fund companies derive their revenues based on the amount of assets they manage—more assets lead to greater revenues (and profits). Funds with larger asset bases can run counter to shareholders' interests in that as a fund's assets build, the portfolio manager's nimbleness may be reduced. For instance, as assets flow into a fund, the portfolio manager will be forced to (1) purchase additional shares of existing holdings, which may lead to reduced liquidity when the manager ultimately attempts to sell the shares and/or (2) buy positions in new holdings, diluting the impact of the manager's best ideas.

So if fund companies are not charged with looking out for shareholders' interests, who is? The answer: fund boards. In fact, fund boards have the authority to hire and fire a fund's advisor (i.e., fund company) if it is not meeting the criteria established by the board. But guess who historically has been in control of the board makeup? Fund companies. So, at too many fund companies, fund boards have been rubber stamps for actions taken by fund companies.

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Five Fund Fallacies

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Recent events may indicate a change in trend. Last year, Pacific Financial Research, the advisor to Clipper Fund, announced that its portfolio managers would be leaving the firm at the end of 2005. Early speculation was that Barrow, Hanley, Mewhinney & Strauss, a subadvisor on Vanguard Windsor II and owned by Old Mutual (along with Pacific Financial Research), would be selected by the fund's board. However, the board ultimately selected Davis Selected Advisors, which is not part of Old Mutual, as the fund's new advisor.

Another development since the mutual fund scandals broke is an SEC ruling, originally scheduled to take effect in January 2006, which is designed to improve fund board independence. Unfortunately, a lawsuit by a group representing business interests has temporarily halted implementation of the ruling.

Fallacy #2: Mutual fund companies close their funds to new investors when appropriate.

Based on Fallacy #1, we know this is not true. Though fund boards are ultimately responsible for determining if a fund should close, too many funds suffer from asset bloat, which can impair the ability of the fund manager to replicate prior success.

As the asset level in a particular fund increases, fund companies will often comment that the asset base is perfectly reasonable and that the fund manager will be able to continue to pursue his or her strategy without hindrance. However, do not assume that your manager is only managing the mutual fund in which you are invested. Some managers are also responsible for managing additional assets in the same strategy, such as separate accounts for institutions or variable annuity subaccounts for insurance companies, as well as mutual funds or accounts with different strategies.

Recent news from two of the largest fund companies may indicate some positive changes are afoot. In March and April, Fidelity Investments announced that four of its funds (Fidelity Contrafund, Fidelity Advisor New Insights, Fidelity Growth Company, and Fidelity Mid-Cap Stock) would close to new investors at the end of April. Earlier that same month, Vanguard closed three of its most popular funds (Vanguard Windsor II, Vanguard Wellington, and Vanguard Strategic Equity) to new investors. In fact, Vanguard went one step further with Windsor II and Wellington by also prohibiting additional investments in existing fund accounts.

Fallacy #3: You are encouraged to review your fund's prospectus as it contains important information on how your investment will be invested.

While fund prospectuses have become more user-friendly, many fund companies are still not very specific as to their investment strategies. Some fund companies deliberately word their fund prospectuses very generally to allow their fund managers the greatest degree of flexibility. This could be a detriment if you invest using an asset allocation/diversification strategy as COMPASS Investment Advisors, LLC does for its clients.

For example, a review of Fidelity Magellan's current prospectus indicates that it may invest in nearly any type of stock and even bonds (you may remember that in 1995 the fund pursued a strategy of investing heavily in bonds to shareholders' detriment). The fund has four "principal investment strategies":

- "Normally investing primarily in common stocks.
- Investing in domestic and foreign issuers.
- Investing in either 'growth' stocks or 'value' stocks or both.
- Using fundamental analysis of each issuer's financial condition and industry position and market and economic conditions to select investments."

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Did You Know . . . Debit Cards

You probably know that if you lose your credit card your liability for unauthorized transactions is capped at $50. But do you know what your liability limit is if your debit card is stolen? Under the federal Electronic Fund Transfer Act, your liability is limited to $50 if you notify the issuing bank within two business days after discovering the theft. After two days and up to 60 days, your maximum liability is $500. If you wait more than 60 days to alert your bank, you could be liable for any transactions made after the 60-day period.

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Fallacy #4: **Your fund does not share a similar strategy or holdings with other funds you hold within the same fund family.**

In the late 1990's, Janus funds became the poster child for having a host of funds, each with different names and supposedly different investment objectives, that were dominated by the same stock holdings. In effect, many investors who thought they were following the mantra of "diversification, diversification, diversification" by investing in several Janus funds were, in essence, undiversified. This can be a risk when investing in the stock funds of just one fund company.

In addition, by limiting your investments to one fund company's funds (or just a few fund companies), you may still be undiversified as to the manner in which your money is managed. For example, within a particular fund shop, stock (or bond) funds are often managed with the same philosophy or approach, such as a fundamental, quantitative, or momentum approach. By investing in the funds of several fund companies you are helping to diversify your portfolio by the various approaches that fund managers employ.

Sometimes the area that is most difficult to diversify in this manner is with employer-based retirement plans (i.e., 401(k), 403(b), and 457 plans). You may find that your retirement plan only offers the funds of one fund company (or a small number of fund companies). While you do not have any choice but to invest in your plan's available options, you should use your other accounts (e.g., IRAs, taxable accounts) to help diversify your overall exposure to the funds of any one fund company.

Fallacy #5: **Your fund's manager has changed, but there is no need to worry, as "we have a deep bench" (a phrase that Fidelity Investments has been known to use).**

Anytime a change occurs to your fund's manager or management team, it should raise a red flag and cause you to reevaluate your holding. Any reevaluation should consider the new manager(s) track record in managing similar portfolios. Changes to a portfolio management team are often more difficult to decipher, especially the actual role played by the departing individual. Often fund companies will downplay the importance of the departing person and/or overhype the background and track record of the new manager. Without knowledge of the key players, many mutual fund investors are unable to determine fact from fiction when evaluating a change to a fund's management.

Our approach at COMPASS Investment Advisors, LLC is to evaluate and monitor mutual funds with a certain degree of skepticism. This skepticism leads us to develop portfolios of mutual funds that perform consistently well in all types of market conditions.

[1] The basis for this article was a presentation made by Louis E. Conrad II, CFA, president of COMPASS Investment Advisors, LLC, to the Mutual Fund Special Interest Group of the American Association of Individual Investors' (AAII) Boston Chapter on March 21, 2006.

Did You Know . . . FDIC Insurance

Effective April 1st, the Federal Deposit Insurance Corporation (FDIC) raised deposit insurance coverage to $250,000 from $100,000 on certain retirement accounts at banks and savings institutions. This increased coverage, which protects against loss if a banking institution fails, applies to IRAs and self-directed KEOGHs, as well as 401(k) and 457 accounts held at banks and savings associations insured by the FDIC and credit unions insured by the National Credit Union Administration. To determine coverage, all of an individual's retirement deposits at the same insured bank are added together and insured up to $250,000. Note, however, that FDIC insurance only applies to deposits (e.g., checking and savings accounts, CDs) and not to investments (e.g., mutual funds, stocks, bonds, life insurance policies and annuities). In addition, the basic insurance coverage remains at $100,000 for nonretirement deposit accounts.

Written and edited by Louis E. Conrad II, CFA.