

# KEYSTONE FINANCIAL PLANNING ELECTRONIC NEWSLETTER

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## **How mutual fund companies bury their mistakes**

The mutual fund industry has an open secret: each year it buries hundreds of funds that couldn't make it. Some of these funds were small unknowns while others were yesterday's popularity club winners, unable to repeat their success in changing markets.

Remember Munder funds and Amerindo funds, two big technology and Internet stock investors of the late 1990s? Well, only three years after launching the Munder Bio(Tech)2 fund, Munder is merging it with another health care stock fund. Amerindo is folding its Internet B2B fund (that was the jargon for "business to business" internet commerce) and its Health & Biotechnology fund into its Amerindo Technology fund.

Burying mistakes makes mutual fund companies and mutual fund categories look better. A survey of existing technology stock funds shows that their average loss over the five years ended in 2002 was just 3.5% per year. That doesn't look too bad, given the huge tech stock bear market. Add in the results of dozens of tech funds that closed during this period, however, and the average return drops to a loss of 7.7% per year.

Mutual fund investors can get a sense of which fund families are bringing out trendy—and questionable—funds by looking at their death rates. Over the past 10 years companies like Vanguard, with 10 fund closures, American Funds, with one, and T. Rowe Price, with five, have done well. Meanwhile, Dreyfus has killed 47 funds in the same period, Merrill Lynch dumped 42 funds, and Prudential jettisoned 41 funds.

## **Mutual fund buyers forget to check fees**

*Out of sight, out of mind:* At least that seems to be the case when it comes to mutual fund investors and their costs of investing.

Mutual fund buyers seem to have become very educated about visible sales commissions in recent years. However, they still don't seem to pay attention to high, but hidden, operating expenses, a trio of finance professors claims in a new study of mutual fund expenses. "Purchase decisions of mutual fund investors are influenced by salient, attention-grabbing information," said Lu Zheng, assistant finance professor at the University of Michigan in Ann Arbor. "Investors are more sensitive to in-your-face fees and are more likely to buy funds that attract their attention through exceptional performance, marketing or advertising," she added.

Lu Zheng conducted a study with Brad Barber and Terrance Odean of the University of California that analyzed flows of money into and out of mutual funds from 1970 through 1999. They found that the portion of mutual fund assets invested in load funds—those that charge visible commissions when purchases are made—declined from 91% in the 1960s to just 35% in 1999. Over time they found a significant negative association between up-front load fees and commissions and mutual fund purchases.

However, they found a positive association between funds with high internal operating expenses and fund purchases, indicating that investors were buying funds without analyzing operating costs. “While operating expenses constitute a steady drain on a fund’s performance, the effect of that drain is masked by the considerable volatility in the returns on equity mutual funds,” the trio said. Internal expenses on some funds can range as high as 3%, which greatly reduces the net return flowing to investors. Average operating expenses increased 60% during the period covered by the study.

Recently, the General Accounting Office proposed that mutual funds make better disclosure to investors about the actual dollar amount of fees paid in operating expenses. Professor Zheng said the results of the study indicated that new disclosures are necessary. Otherwise “expenses that remain out of sight are likely to remain out of mind,” she said.

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