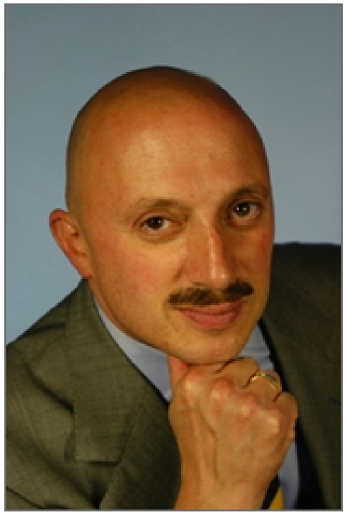
The Feeling Isn't Mutual:

How to escape the mutual fund trap and take charge of your own IRA investment

By David R. Fried, Editor and Publisher, The Buyback Letter

Now that traditional pensions are nearly extinct and Social Security is neither a sure thing nor assured of being a substantial benefit for many people, all of us must face facts and

take charge of our own retirement money.



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Other than tossing a dart at the various mutual fund portfolios trotted out by human resource departments across the land during open enrollment season, how should we best invest our IRA money? This question is even more important this year, since the maximum contribution for 2005 has increased to $4,000. The short answer is a self-directed IRA that invests in stocks, not mutual funds. (Ask your human resource department if that option is available to you.)

I'll tell you how to do that later on, but first, let's discuss why mutual funds -- one of America's most popular investments and the principal vehicle for retirement savings and college funds -- are inherently flawed.

Mutual fund investors tend to pay high taxes and high fees for an investment that invariably underperforms the S&P 500. Investors also often choose their mutual fund poorly, in part because making that choice is complicated by changing management, misleading marketing and confusing prospectuses and fee schedules. In addition, a successful fund one year tends to be a bad fund the next year, and even a fund with good returns year after year tends to have lower profits as the years pass.

There are several key reasons for these problems.

1. Managers face difficulty in guiding a large mutual fund. When a fund is profitable, investors flock to it. If management doesn't cap the fund at a certain dollar amount, the manager soon faces a fund whose size inhibits its success. The fund becomes so large, and often has taken such large positions in individual stocks, that simply selling one of its stocks can make that stock's price go down, thus lowering profits. The same thing happens if management wants to buy; it's hard to get the best price. The favored stock then rises in price, once again lowering potential profits.

This phenomenon also causes a corollary problem for fund managers. They cannot unload stocks quickly, and yet sometimes they are forced to do so when investors cash out of a fund and stocks must be sold to repay them. Thus, profits may suffer simply when investors leave.

A manager of a large mutual fund also often has to diversify into too many stocks. While diversification is good in theory, too much diversification means that if one stock does well, it has little effect on the portfolio. In addition, management must stick to big companies' stocks because there are not enough small, growing companies to make a difference for a $2 billion mutual fund, for example.

For management, this situation isn't bad, because the way the fund operator makes money is by taking a percentage of investors' money. So, the more investors, the better. But for the investors, a large, unwieldy mutual fund, on average, underperforms an index fund while charging higher management fees.

For example, from 1993-1998, in the 45 biggest stock fund families, each with $2 billion or more in assets, only one outperformed the S&P 500, and that one, the Janus 20, beat it by only 2/3 of a percentage point, according to Forbes (August 1998). At the same time, these funds earned $6 billion annually for their companies, while index funds would have generated only $1.5 billion in fees. (Index funds charge lower fees, of course, because there is no active management and little need for promotion. The only time an index fund buys or sells a stock is when the index it mimics makes a change and the fund is then forced to follow the lead of the index.)

So giant funds generate huge management fees for their sponsors, but give less than index-fund performance. In other words, the more money you manage, the more profit you make, but the less able you are to serve your shareholders.

Smaller funds can do a little better, but not much. For example, of domestic stock funds with $25 million to $1 billion, 7 percent, or 38, beat the market from 1993 to 1998, according to Forbes. But small funds can turn to losers when they get too many investors because they then incur the same problems as big funds. Even if investment is capped to keep the fund small, it will likely continue to grow at perhaps 10 percent a year simply with successful investments, and thus it eventually becomes unwieldy.

2. Fees eat up investors' mutual fund profits. Fees can be 2 to 3 percent when added together, often creating bond-like returns with stock-size risks. Fees include the standard percentage (about 1 percent) charged by the fund, both front end and deferred loads, as well as the broker fees for each stock purchase. These fees increase with trigger-happy managers. A fee of only 1 percent can reduce an investor's final account balance by 17 percent on a 20-year investment. In addition, a prospective investor may have trouble learning what the actual fees will be due to complicated and confusing prospectuses and fee schedules.

3. Prospective investors may get misleading information about a fund. A tactic called "incubation" has become a standard way for companies to create attractive funds with high, but misleading past profits.

It works like this: Fund managers use the firm's money to create several new funds that have ideal start-up conditions, to internally and quietly test various fund managers' strategies. Then they choose the best performer to bring to market. At first, these funds will not be advertised to the public, and since there are no investors other than the firm, no money will be removed. So, managers have an advantage since they don't have to deal with selling off stocks when investors leave the fund.

After a short period of time, the managers typically keep only the highest performer and then market it as though it had been created under normal conditions.

4. Management driven by marketing concerns. The ploy mentioned above is only one of the problems created when management creates specialty funds to lure investors instead of creating solid funds that perform well in the long run. For many managers, the game is not about profit, but more about attracting investors, since more investors means more money for them.

Even if an investor finds a fund with a quality manager, the quick-changing nature of management jobs may mean someone different manages that fund the next year. Often the new manager will sell off much of the portfolio, increasing investors' tax burden and broker fees.

In addition, most managers tend to have a herd mentality. They simply follow whatever is popular with other managers at the moment. Often that is the same standard stocks in which an investor could more safely and profitably invest through an index fund or a personal stock portfolio.

5. Investors. Most investors tend to have an unerring ability to buy at fund highs and sell at fund lows. Thus, they whittle away their money by moving it around. Also, just like managers, investors typically don't follow the buy-and-hold philosophy, and thus increase the headaches for managers who must cash them out, often incurring losses in the fund because of it.

One of the oldest and most successful funds is Fidelity's Magellan Fund. Had you invested $10,000 in this fund when it started in 1963, your money would have grown to more than $10 million. However, the joke at Fidelity is that if they were to have a party for all of the original investors who still had money in the fund, the party could be held in a phone booth!

6. Cash. The overwhelming majority of mutual funds always have a cash balance on hand. They keep cash to cover redemptions. Also, as money comes in from new investors or dividends, it accumulates in cash before it can be invested. The cash can amount to up to six percent of the portfolio in many cases. The cash is kept not to benefit the investors but rather to make it easier for the managers to run the fund. Since all funds, including no-load funds, have a management fee, the investor winds up paying a management fee on cash. This is ultimately a drag on performance.

The mutual fund scandal.

Even people who swore off newspapers, avoided the networks and hid their heads in the sand couldn't escape hearing about the industry-wide mutual fund scandal of 2003. It involved some 15 mutual fund companies, a dozen brokerage firms, hedge funds and dozens of executives, affecting some of the best-known and heretofore well respected funds, fund families, brokerages and banks.

Some fund managers broke the rules and did some old-fashioned cheating. They got caught lining their own pockets at our expense. New York's district attorney blew the whistle, proving improper trading practices that padded their wallets and those of favored clients at the expense of the other 95 million average-Joe shareholders.

Their anti-investor practices included allowing illegal and improper trading in funds and overcharging certain customers. Essentially what they did was allow certain of their best customers (and in some cases, employees) to trade in and out of funds in a way that let them skim some of the profits from the funds, by "late trading" and "market timing." These fund managers showed a reckless abandon by putting their personal profits ahead of their shareholders. Fund managers have a fiduciary duty to put their investors' interests first. This was retirement and college tuition money they stole, and that made it not only shocking, but morally bankrupt.

The solution

Fortunately there is a solution to these built-in problems. Own stocks directly, not through a mutual fund. Create your own diversified index, using a solid, careful investment strategy, such as our Buyback Letter stock picks. Invest in our 20-stock Buyback Index® to get all the benefits of diversification without the many drawbacks of investing in a mutual fund. The gains and losses will be your own, you will not pay any management fee on cash and you don't have to worry about a fund manager leaving. The portfolio is easy to follow, understandable and it works. **As of the end of March 2005, *The Buyback Letter's Standard Edition* was outperforming the S&P 500 by 329.35% since inception (March 1997).**

Another strategy to insure diversification would be to combine a few of our smaller portfolios, for the same benefit. For example, the combination of the 5-stock Buyback Dogs® portfolio with the 10-stock Buyback Income Index® and the 5-stock Buyback Health & Bio-Tech Portfolio® would also give you 20 different stocks with a winning record. They are all beating the S&P since inception – the Dogs by 121% (started March 1997), the Income Index by 56% (started March 1997) and the Health & Bio-Tech by 202% (started December 2001).

Let me put that another way: **If you had invested in our 20-Stock Buyback Index, you would have done 4 times better than the S&P 500**. Can you say the same for your mutual fund?

Fortunately, we can avoid the world of mutual fund scandal, liars, cheats and people with a callous disregard for your money. We don't need to do after-hours trading to achieve our successful results. We most assuredly don't time the market, and we don't bury research fees and charge you for them in hidden costs. What we do is help you make wise, reasoned, rules-based choices for your investments.

Our Buyback Strategy might not be sexy, it might not attract as much attention as some others, and we might not swagger all over the financial community tooting our own horn. But we do something, so many others don't: We follow the rules. We narrow the stock-picking universe first by only considering those companies that buy back their own stocks, and then we apply a passel of other research filters, one after the other, to narrow the playing field further. What ends up in the neck of our funnel are only the best of the buyback stocks, those most likely to grow and add value without undue risk. We don't let the heart overrule the head when it comes to buying, holding or selling stocks. It is not about what's hot, what's trendy or what's going to be the next best thing. It is not about what our gut tells us to do, or a hunch passed on by a brother-in-law. It is not subject to giddy impulses as a result of a few fantastic stock buys, or driven by fear of failure from a few bad choices.

It is simple, but not simplistic. It is about following rules we have set up to govern our stock selections.

Beat the market with buyback stocks. That's money you can take to the bank, and money that will fuel your future.

More Information on Stock Newsletters, Index Funds and Mutual Funds

Question: How do you check up on stock advisory newsletters to see how credible they are?

A single source – the monthly Hulbert Financial Digest – does the work for you. Not an investment advisor, the authoritative HFD is rather an independent, impartial rating service and source for financial newsletter performance evaluation. The HFD was acquired by **Marketwatch.com** in 2002, and can only be purchased through that Web site ($59 per year).

What about index funds?

Index funds are mutual funds based on a specific stock or bond market index or benchmark that try to mirror its performance. An investment manager tries to replicate the results of the target index by holding all of the securities in the index, or a portfolio that matches the key characteristics of the index. There is no hand picking of individual stocks or narrowing of the field to certain sectors. Index funds are considered a "passive" investment approach, with low portfolio trading activity. Because of this, low cost (low advisory fees, low operating expenses, low portfolio transaction costs) is an advantage.

There are many index mutual funds, so investors can pick a favorite strategy, such as large, medium, or small companies; "value" or "growth" stocks; international stocks; or fixed income investments.

Below is a sampling of some well-known indexes and examples of funds that mimic them.

Standard & Poor's 500 Index: The S&P 500 is seen as the benchmark of the U.S. stock market – one of the best benchmarks in the world for large cap stocks. In fact, the performance of most equity managers is pegged against the S&P 500. By including 500 companies, it offers diversification and accounts for some 70% of the U.S. market. The performance of the S&P 500 is considered one of the best overall indicators of market performance and a mutual fund manager's goal is to beat it. The **Vanguard 500 Index Fund (VFINX)**, one of the largest mutual funds on the market and the original mutual fund index fund, is designed to track the performance of the S&P 500.

Wilshire 5000 Index: The Wilshire 5000 is often referred to as the Total Stock Market Index because it tries to track the returns of practically all publicly traded, U.S.-headquartered stocks that trade on the major exchanges. It is the largest index by market value, and the most diversified index in the world. **Fidelity Spartan Total Market Index Fund (FSTMX)** mimics the Wilshire 5000 Index.

Dow Jones Industrial Average: At more than 100 years old, the DJIA is the oldest continuing U.S. market index, made up of 30 of the largest and most influential blue chip stocks. The DJIA is the best-known market indicator in the world, and is often referred to as "The Market." **Diamonds Trust, Series 1 (DIA)** tries to provide investment results that generally match the price and yield performance of the DJIA.

Nasdaq: The Nasdaq Composite Index represents all the stocks that trade on the Nasdaq stock market. **The Nasdaq 100 Trust Series 1 (QQQQ)**, is made up of the 100 largest non-financial companies on the Nasdaq stock market and is seen as a way to mimic this index.

Russell 2000 Index: The Russell 2000 is used to measure the performance of U.S. small company stocks, and is the most widely quoted measure of the overall performance of the small- to mid-cap company shares. The **Vanguard Small Capitalization Index Fund (NAESX)** tracks this index.

David Fried is the editor and publisher of The Buyback Letter (www. buybackletter.com), the only investment newsletter devoted to finding opportunities among companies that repurchase their own stock. His asset management firm -- Fried Asset Management, Inc. -- offers separate investor advisory and money management services which use the "Buyback Strategy" principles. All of his portfolios are beating the S&P 500 since inception, and the prestigious Hulbert Financial Digest ranked The Buyback Letter #3 for risk-adjusted returns among stock-picking newsletters for the five-year period ending 3/31/2005. The Buyback Letter had an annualized gain of 14.3%, vs. the Wilshire 5000 total return of -2.6%.. Subscriptions for the Standard Edition are $195.00 per year.