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Publication: Asheville Citizen-Times
Day: MONDAY
Section: W
Page: 5
Keyword: COLUMNS

Date: 03/28/2005
Edition: FINAL
Sectionname: WNC BUSINESS
Byline: BY WARREN WALL

Beware: Mutual funds can fail in good markets

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We spoke recently with a potential client who explained that he had given up investing in individual stocks and had turned solely to mutual funds. Part of his rationale was that mutual funds are managed by professionals with a lot more information than he had on investing and that this knowledge would keep his portfolio out of trouble.

If only life really were that easy. It's an illusion to think that mutual funds are safe. History abounds with failed mutual funds even in good markets. You usually don't see the evidence because fund companies have a habit of sweeping failed funds under the rug by merging them into successful funds. Thus, the poor fund's performance disappears and the fund family proudly reports its record of successful management.

Fidelity Magellan should be one of the best-run mutual fund companies in the market given its tremendous resources and experienced professionals managing the fund. Yet, Fidelity Magellan dropped from a high of \$146 in March 2000 to \$72 in October 2002, a loss of 51 percent. The fund's shares are still 30 percent below its 2000 high.

Magellan is not the exception. An investment in Putnam New Opportunity B fund in 1999 would be down 90 percent today.

In bad markets, professional management has not proved capable of keeping mutual funds out of trouble. Ninety percent of stock mutual funds reported negative returns in 2002, according to Weiss Ratings Inc., the nation's leading independent provider of ratings and analyses of financial services companies, mutual funds, and stocks.

The year 2002 was the third consecutive year investors suffered declines in stock funds, averaging losses of 19.22 percent, 12.5 percent and 4.45 percent in 2002, 2001 and 2000, respectively.

The facts are that the vast majority of mutual funds do not protect investors from market downturns. The larger the fund, the more likely its results will mirror the broader market.

Funds that strive to outperform the market by concentrating their investments in hot sectors are typically the biggest losers when the market turns against them. Part of the problem is that mutual funds do not have the ability to move a sizeable portion of their assets to cash when the market turns against them. They have to stay invested and that hurts.

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"Cash ain't always trash. It doesn't yield much, though over twice what it did a year ago. And it has the uniquely redeeming characteristic of always trading at par," said Paul McCulley, PIMCO managing director in the January 2005 Fed Focus.

Among legendary investor Sir John Templeton's memorable advice to investors is to write down the value of their entire portfolio should it drop by 30 percent. "If what you see makes you uncomfortable," he said, "do something now to regain your comfort." As the market decline of 2000 to 2002 proved once again, mutual funds are not immune to drops of 30 percent or more. If this makes you uncomfortable, you need to take another look at how you invest in mutual funds.

The old adage of "find a good mutual fund and invest for the long haul" does a disservice to investors by ignoring reality. Investing in a mutual fund carries no guarantees and can offer considerable risk. You need to take that risk into consideration when building and managing your portfolio. Mutual funds, like equity investments, need to be managed.

This is not an offer to buy or sell Fidelity Magellan or any other mutual fund. That offer can be made only by prospectus. Past performance is not an indication of future returns.

WALL ON THE STREET

Investors, beware: Mutual funds can fail even in good markets

By Warren Wall

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Department: WNC BUSINESS
Docname: WALL ON THE STREET_0328
Pubdate: 03/28/2005
Typist: KATHLEEN DAVIS

Depth: 17.38
Docnumber: 971569
Source: STORY
Wordcount: 656

I-Edit

Author: KATHLEEN DAVIS
Status: Sent

Datatype: Text