ROBERT HOROWITZ
WEALTH MANAGEMENT

5 THINGS YOU MUST KNOW BEFORE BUYING A MUTUAL FUND

Management is everything
A particular fund's track record is dependent on the skill (or luck) of the 1 or 2 people who manage the fund. When a manager leaves a fund, the fund's track record becomes meaningless. Therefore when evaluating the historical returns of a fund, ensure that they all occur under the same manager. Often managers who do well with a fund are recruited away by other fund companies or move onto bigger funds within the same fund family. One must also make a reasonable estimate of how long you expect the manager to stay with a fund. A manager change right after you buy the fund will render all your research meaningless.

Taxes

- ***Realized capital gains and income for the year are declared annually*** to shareholders registered on a record date, usually in November or December. This means that every fund share pays equal taxes regardless of how long you may have held the shares. If you buy a fund that has performed well in the summer or fall, expect to pay substantial taxes on the gains earned before you became a shareholder. In such cases it is reasonable to expect that you can both lose money on a fund investment and pay substantial taxes on the same investment. In certain cases it makes sense to sell a fund just before the record date and buy it back afterwards.

- ***Beware the undistributed capital gains liability.*** Funds with strong historical performance may have a substantial unrealized tax liability related to stocks that have substantially appreciated and not been sold. Any new shareholder assumes that unrealized tax liability.

- When you sell a fund, you pay tax on the difference between your cost and the sale price. Consequently, trading funds in taxable accounts is usually a self-defeating strategy.

Expected annual expenses
Fund costs can be a major drag on performance. Please see our hand-out, "Understanding mutual fund costs".

Accuracy and commitment to asset class
This ensures that you get the investments you expect. Just because you buy a fund titled," Faithful Investment's Large Company Growth Fund" may not mean the fund will invest in large growth companies. Most mutual fund prospectuses are written so that the fund manager can invest in any instruments of his choosing. If the manager strays into emerging stocks and emerging stocks crash you could be in for a nasty awakening.

Liquidity of the fund's investments
When a mutual funds positions in specific securities substantially exceeds the daily trading volume of the security, risk increases dramatically. Large relative positions in a security mean that a fund may not be able to "get out" of a security if circumstances turn negative. Efforts to sell relatively large positions as the price falls will only accelerate the price drop. For example Fidelity Investments positions in many stocks would take 6 months to a year to sell at normal trading volume.

Winners often do not repeat
Many studies have found that if a mutual fund does better than the average one year, it has a better than 50-50 chance of being worse than the average the following year.

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