



BOSTON WEALTH MANAGEMENT, LLC

Disadvantages of Mutual Funds

The disadvantages of mutual funds are important for individuals to consider and understand before deciding to invest. In exchange for their expertise, mutual fund portfolio managers charge higher fees than the cost of an individual investing in stocks. Mutual funds also have more limitations on trading than investing in individual stocks. Mutual funds trade only once a day after the market closes and can only invest in assets detailed in their prospectus. If the fund does not focus their investments on dividend-bearing stocks or interest-bearing bonds, then dividend payments may also be less frequent than if you held the stock or bond as an individual. Mutual funds can be forced to invest during poor market conditions to meet their fully funded percentage requirement. Mutual funds also give investors less ability to invest in tax advantaged methods depending on their financial situation. Below are details on these challenges when investing in mutual funds.

Higher Internal Expenses ¹

Mutual funds provide investors with professional management that comes at a cost. The expenses of investing in mutual funds has been widely scrutinized. Funds typically have a range of fees that reduce investor's payout. Mutual funds fees are classified into two categories: shareholder fees and annual fund-operating fees. Shareholder fees are paid directly by shareholders purchasing (known as "load fee") or selling the fund (known as "exit fee" or "redemption fee"). Annual fund operating fees are charged as an annual percentage, regardless of the performance of the fund. These typically range from 1% to 3%.

Trading ²

Investment vehicles such as stocks and bonds that allow for trades at any point of the day, whereas mutual fund trades are only executed when the market closes which can result in a higher or lower price from the previous day's close. Whereas, individuals who invest in stocks and bonds can benefit from the changes in a stock price throughout the day, those in mutual funds are stuck with the price at the market's close. In addition to the restricted trades, a mutual fund typically requires a minimum investment that can range with various funds. Comparatively, the minimum investment of stocks is a single share.

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Must Stick with Prospectus ^{3,4}

A mutual fund prospectus is the legal document the SEC requires mutual funds to file and make available to potential investors. The prospectus details the investment objectives and strategies of a fund as well as finer points such as the fund's past performance and managerial and financial information. It outlines the fund's investment objectives or financial goals, which are reflected in the types of securities chosen to achieve their goals. Types of investment objective can include: long-term capital growth, stable income, high total return, etc. Fund companies cannot change these objectives unless investors of the fund consent to the changes through a vote.

The prospectus also shows you the fund's track record, however it is important to keep in mind that "past performance is not an indication of future performance." It is important to read historical performance critically. It is also important to be sure the benchmark chosen by the fund is an appropriate comparison.

Across several different mutual funds, an overlap of investments can be seen. For example, one mutual fund family may classify a holding as a 'large cap' when another mutual fund family classifies the same holding as 'mid-cap'. Thus, an individual investing in multiple mutual funds may experience unintended gaps or overlaps in investments.

Dividend Handling ⁵

Also outlined in the mutual funds prospectus are the dividend and distribution policy. A fund pays investors income from realized capital gains, dividends, interest, or other income stemming from the securities and investing activities of the fund. The distribution policy tells investors how these payments are made. Some funds distribute returns directly to fund holders, while others reinvest the distributions back into the fund, buying more units for fund holders. Mutual funds are required to pass on all net income to shareholders to avoid taxation, therefore a fund with dividend-bearing stocks or interest-bearing bonds, or both must pay dividends to their fund holders regardless of the investors' income needs.

In the case of interest-bearing bonds any interest generated is distributed to shareholders via dividend payments. However, unlike other investment vehicles, mutual fund dividends are not guaranteed. This is dependent on the mutual fund's investment objective as laid out in the prospectus. If the mutual fund is managed with the goal of generating significant dividend income, dividends will be distributed to fund holders. However, if the mutual fund is primarily growth-oriented dividends may be less frequent, depending on what dividend stocks the mutual fund is invested in. In all cases, it is important that investors conduct research on mutual funds to understand their investment goals and strategies and to know the fund's dividend policy.

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Fully Funded Requirement

Discussed in the mutual fund's prospectus is the fund's required percentage of funding. If the mutual fund's prospectus states that it is required to be 95% funded, and it is underfunded then it is forced to invest more to meet the funded percentage stated in the prospectus. Problems can arise when mutual funds are forced to meet the fully funded percentage during poor market conditions, such as a falling market or when an investment is overvalued.

No Tax Harvesting ⁶

Tax loss harvesting is a common strategy of selling securities that have lost value, to offset or reduce taxes on realized capital gains from successful investments. Mutual funds are not focused on this strategy because with a myriad of different investors it would be impossible to conduct a tax harvesting strategy that would meet the goals of all investors.

Tax Handling ⁷

For high tax bracket individuals, mutual funds can have negative implications due to inefficient tax management. Generally, most mutual fund distributions must be declared as investment income on your taxes. Factors such as, the duration of a security in the fund plays a role in whether the distribution is taxed as ordinary income or capital gains. A security held in the fund for less than a year and is then sold, is categorized as ordinary income, where as if the security was held for more than a year it would be taxed as a capital gain. In 2017, individuals in the lowest income tax brackets are not required to pay any income tax on long-term capital gains. Individuals in the middle tax brackets must pay only 15% tax on capital gains. Those in the highest income tax bracket are subject to a 20% capital gains tax. This tax treatment can result in mutual funds being a less impactful investment for those in a higher tax bracket.

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Sources

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Phillip L. Wong - Managing Director

Phil has served in the financial service industry since 1991 and is the founder and Managing Director of Boston Wealth Management, LLC. The philosophy at Boston Wealth is to listen, understand and advise one individual at a time in order to lead clients to their defined goals.

As the Managing Director, Phil also utilizes his experience and investment knowledge assisting other advisors with business and professional development.

Dedication to excellence allows both clients and advisors to be served at a personalized level demanded by each



Aaron Spelker, CFA - Director of Qualified Plans

As Boston Wealth Management's Director of Qualified Plans, Aaron is responsible for providing investment advice to institutional plan sponsors regarding pension and 401(k) plans. Prior to joining BWM, Aaron owner Marathon Retirement & Pension Consulting. Aaron has over 15 years of experience in the financial services and investment industry.

Aaron is a CFA Charterholder and an active member of the Boston Security Analysts Society. In addition, he has been a Certified Internal Auditor for over 10 years. Aaron received a B.S. from the University of Illinois Urbana-Champaign in finance and graduated summa cum laude with an MBA from Babson College in Massachusetts.

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