WHY INVESTING IN MUTUAL FUNDS COULD JEOPARDIZE YOUR RETIREMENT PLANS

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Retirement Income Source®

Why Investing in Mutual Funds Could Jeopardize Your Retirement Plans

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Unfortunately, since many financial advisors working today entered the business in the 1980s and 90s, during the best stock market in US history, they became stock market specialists, favoring growth instead of income. Many of them also became heavily focused on mutual funds.

Mutual funds, in general, are a murky pool of investments that only publish their holdings once a quarter. That means in the middle of the quarter, you don't know what stocks your money is invested in. And when you do find out, you may not always be getting an accurate picture. That's because sometimes, fund managers will engage in something known as "window dressing". Here's how this tactic works:

Let's say that during the quarter, a particular stock that the fund owns drops in value significantly and receives bad press. The fund manager may not want to sell it because its price is down. However, he might go ahead and sell that stock just before the quarter ends, so he doesn't have to disclose that it was in the fund — but then he'll go ahead and buy it back again when the new quarter starts. This is window dressing and it's one of the problems that can result from the lack of transparency in this murky pool of investments.

A Bigger Problem

Another problem with stock mutual funds is that they are geared toward growth and not income. This could be a big problem if you are retired or nearing retirement and the growth you are counting on turns into a loss or a series of losses. The reason most stock funds are geared toward growth is that they are all judged against the performance of the stock market, typically the S&P 500 Index, which doesn't have a particularly high dividend. So, fund managers are all trying to beat the S&P 500, or at least trying not to underperform it.

If these fund managers were to focus on high-dividend-paying stocks (which is a strategy that typically makes more sense for most investors in retirement or near retirement age), then in some years they would likely outperform the S&P, and in other years it will underperform it. But fund managers know investors have short memories. So even if their fund experiences a couple of good years in a row and then has a year where it underperforms the S&P 500, investors may leave the fund. This is why fund managers are always trying to avoid underperforming the S&P 500 by focusing more on growth instead of income.

Double Dipping

Another problem is that mutual funds typically have embedded management fees and other types of fees such as administrative fees—but that's not all. Sometimes you run the risk of double-dipping with fees. In these instances, you are also being charged a fee or commission by your advisor. That's right. Although the fund manager is the one conducting all the research and selecting and managing the investments in the fund, many advisors will tack on an additional fee for placing your money in that fund.

If you think about it, this is a bit like paying your mechanic to recommend a second mechanic to fix your car and then paying the second mechanic as well. Most people wouldn't do that, yet many end up paying multiple fees when their advisor puts them in a mutual fund.

A Tax Time Bomb

Another major drawback of investing in mutual funds is that there can be unfavorable tax implications. Let's say you invested in a mutual fund at the start of the year, and at the end of the year, your share values were the same. However, let's also say that during the year, the mutual fund manager decided to sell a stock that the fund had invested in years ago. This stock had appreciated quite a bit and had huge capital gains built in. Well, guess what? You are going to have to pay your share of taxes on those capital gains, even though you didn't make a dime of profit in the mutual fund. In short, when you invest your money in mutual funds you end up having zero tax control.

These are just a few of the reasons why, even though mutual funds give you an easy way to diversify your portfolio, often that easiness comes at a high price — and with a lot of risk. One of the biggest financial mistakes a retiree can make occurs because of investing in stock mutual funds.

Reverse Dollar-Cost Averaging

If you are counting on income by making systematic withdrawals from a mutual fund (whether it's to enjoy a comfortable retirement or to cover things like your required minimum distributions) and the stock market takes a downturn, it could force you to progressively liquidate more shares of that fund to get the money you need. In other words, each month the market was down, you would have to sell more shares. This is known as "reverse dollar-cost averaging" and it could put you in jeopardy of cannibalizing your nest egg.

What About Bond Mutual Funds?

Though many growth-based financial advisors may offer bond mutual funds as a more "conservative" option for investors in or nearing retirement, beware! The fact is, bond mutual funds carry many of the same risks and costs associated with stock mutual funds. A growth-oriented advisor may offer them only because he isn't qualified to offer the real alternative to bond mutual funds, which is a diversified, actively managed portfolio of individual bonds and bond-like instruments.

When you invest in an individual bond, you have a contract with the borrower that gives you two important guarantees:

1. You are guaranteed to get a fixed amount of interest regularly for the life of the bond.
2. When the bond matures, you are guaranteed that the borrower will repay the par value. Both guarantees assume there have been no defaults.

Neither of these two guarantees exists in a bond mutual fund.

Learn More

If you would like to learn much more, be sure to read our report, "The Case for Fixed Income."

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