Why I Avoid Mutual Funds

"The first step towards getting somewhere is to decide you're not going to stay where you are." —J.P. Morgan

"Try thinking about something else."

Happy New Year to clients, friends, and readers. The past year was a difficult one in which just about all asset classes saw declines. This, of course was very unfortunate for many of us, yet not totally unprecedented given the large amount of COVID related stimulus (both fiscal and monetary) which had juiced market performance in both 2020 and 2021. The silver lining of a down year for non-mutual fund investors invested in taxable accounts is the ability to take advantage of tax-loss harvesting and tax-loss carryover strategies – and this is exactly what we did.

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On another note, now would also be a great time for me to thank our clients for introducing us to their friends and family members throughout the year. This is a tremendous complement and a huge responsibility – something we will never take lightly.

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Similar to years past, I'd like to kick this year off with a shout out to both existing and prospective clients regarding their assets held away, particularly in mutual funds. **If you possess financial assets that sit in an old company 401K retirement plan, or with an adviser who mostly picks mutual funds instead of doing the job of managing an investment portfolio consisting of individual stocks, bonds, exchange traded funds and alternative investments, it may be time to move on to a professional that is better able to serve your needs.**

Mutual funds are a one size fits all solution for the masses. They over-diversify, meaning in many cases needlessly hold hundreds of issues, which all but guarantee higher internal transaction costs and mediocre results over the long run. In addition, mutual funds and some of the advisers who heavily utilize them may be an inferior choice due to their:

· **Tax Disadvantage** – Mutual funds have certain tax disadvantages that can negatively impact returns. Like individual securities such as stocks and bonds, profits in mutual funds are subject to capital gains tax. However, with mutual funds an investor will be held accountable for any capital gains the fund has throughout the year. As an investor, you have no control over when or what the fund sells or when it distributes these capital gains to you. For example, a mutual fund could have purchased shares in a company many years ago whose stock then increased in value. A new investor may have bought into the mutual fund after the gains in the stock occurred and therefore not received any of the benefit of the share price increase. However, when the fund goes to sell those shares, all current investors will be subject to the full amount of capital gains tax – whether or not the investor profited from the past purchase of those shares. Additionally, mutual fund capital gains can be incurred as the result of investor redemption requests, as the portfolio manager running the fund may need to sell securities to cover these sales requests. Also, because capital gains in a mutual fund are distributed to the shareholders of the fund, an investor could end up paying taxes on gains in a year where he/she didn't sell any shares themselves or even worse when the overall fund had a losing year. In other words, an investor can lose money in a mutual fund and still have to pay taxes.

· **High Fees or Complex Costs** – Typically a separate account investment manager/adviser charges somewhere in the ballpark of 1% of assets under management. However, in addition to this charge the mutual fund company/manager must also be paid as well. Mutual fund expense ratios can be as little as a couple of basis points but as high as a couple of percentage points and include management fees, 12b-1 fees (marketing), administrative fees, and operating costs. Additionally, many mutual funds have high trading turnover within their portfolios, which can mean investors are paying implicitly more in both trading commissions and bid/offer spreads. Personal Capital, a robo-advisor firm published a table of estimated charges by large institutions who heavily utilize mutual funds, which was then re-published in Financial Advisor IQ in late 2017 here. Simply put, if you are paying an investment advisory fee of 1% to your investment manager/adviser and additionally paying a mutual fund expense ratio of 1% then you are needlessly paying at least 2% away in fees annually for the management of your investment portfolio. This 2% figure is the hurdle rate an investor's investment portfolio would need to achieve each year before he/she begins to make a profit. The question an investor should ask – why am I paying double fees for an investment manager/adviser to simply pick mutual funds for me?

· **Inability to Personalize** – A mutual fund is an investment vehicle which pools together many investors' assets. For this to work well, each investors' return objectives and risk tolerance should be similar. Factors such as investment time horizon, allocation preferences, ethical considerations, tax situations, concentrated investment positions, liquidity and income needs can vary widely between investors. Mutual funds are a generic, one size fits all investment vehicle for the masses.

· **Poor Communication** – Investors in mutual funds should not expect to communicate directly into the fund investment management team. Instead, investors will be assigned a sales representative whose main objective is to sell more mutual funds, not manage investments. Mutual funds can have thousands of shareholders, which makes communicating directly with a portfolio manager difficult. Investors who have questions about strategy and or portfolio changes will be unable to speak with anyone but a sales representative. Additionally, it is unlikely a mutual fund manager or sales representative will contact investors to see if their investment objectives have changed and if that particular mutual fund still fits their circumstances.

Keep in mind, there may be situations in which a mutual fund is the most suitable choice, such as when investing within company 401(k) plans, 529 college savings plans, or participating in a systematic investment plan. Mutual funds also offer professional management and diversification with low minimums. Schedule time to talk with us regarding what is right for you.

If you have questions on my above comments or would like more information on how we do things differently, feel free to reach out anytime. There is never any obligation to speak with us and we really do enjoy helping people.
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Financial markets kicked off the year with a positive tone. This is mainly due to the inflation numbers trending down, which in turn could result in a lower terminal Federal Funds rate. Additionally, investors and investment managers appear offsides (either short stocks or underinvested), which can also bring about violent short term rallies. With that said, I believe equity investors will likely continue to sell into rallies, as the near term horizon for risk assets looks cloudy at best.

Investment portfolios are positioned more defensively. This means we have relatively higher allocations to T-bills, intermediate and long term U.S. Treasury bonds, precious metals and defensive low beta stocks. Nevertheless, I still believe in holding core allocations to large capitalization technology names as well as housing and real estate related sectors. If interest rates further out the yield curve continue to decline this could benefit those above sectors.

No one really knows what the future will bring and this is why asset class diversification is key. The best investment managers are said to be correct approximately 65% of the time (don't quote me on that one…), which is why we aim to invest in a broad array of assets classes – stocks, bonds, international markets, emerging markets, real estate investment trusts, precious metals, and alternative investments. The name of the game is risk control.

As mentioned in the past, for our risk averse investors who have new money to put to work, we are allocating a large portion of this money to US Treasury bills until things clear up. As of January 17th, six month T-bills are yielding approximately 4.7% on an annual basis and are highly liquid – that's a risk-free rate we haven't seen in about twenty years.

ASSET CLASS & SECTOR OPINIONS		
OVERWEIGHT	**NEUTRAL**	**UNDERWEIGHT**
Cash	**International Developed Market Equities**	**Small Capitalization Stocks**
U.S. Treasury Notes & Bonds	**Emerging Markets Equities**	**Financial Services Sector**
Investment Grade Corporate Bonds	**Consumer Discretionary Sector**	**Leisure & Hospitality**
U.S. Real Estate & Related Equities	**Communication Services Sector**	**Materials Sector**
Large Capitalization Technology	**Mortgage-Backed Securities**	**Energy Related Equities**
Healthcare	**Local Currency EMG Bonds**	**Leverage Loans (Floating Rate Debt)**
Aerospace & Defense		**Treasury Inflation Protection Securities**
Utilities		**High Yield Corporate Bonds**
Consumer Staples		
Gold & Gold Miners		

Sincerely,
Justin Kobe, CFA
Founder, Portfolio Manager & Adviser
Pacificus Capital Management

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Investing in the bond market is subject to risks, including market, interest rate, issuer credit, inflation risk, and liquidity risk. The value of most bonds and bond strategies is impacted by changes in interest rates. Bonds and bond strategies with longer durations tend to be more sensitive and volatile than those with shorter durations; bond prices generally fall as interest rates rise, and the current low interest rate environment increases this risk. Current reductions in bond counterparty capacity may contribute to decreased market liquidity and increased price volatility. Bond investments may be worth more or less than the original cost when redeemed. Diversification and asset allocation strategies do not assure profit or protect against loss.