THE COMPASS

NEPSIS® INVEST WITH CLARITY®

"5 DREADFUL C'S OF MUTUAL FUND INVESTING"

If one were in the banking industry the 5 C's (Character, Capacity, Capital, Collateral and Conditions) would actually have a positive connotation, as they encompass what defines a worthy borrower. If one has proven Character to manage their finances, they have the Capacity to repay the loan, they have greater assets than liabilities i.e. net worth or Capital, they are willing to assign legitimate Collateral and lastly, they are participating in a business operation that has prosperous economic Conditions that are supported by growth that the bank can count on; the bank will most likely make the loan. Again, the 5 C's of banking are a good thing all in all.

On the other hand, the 5 C's of Mutual Fund Investing are anything but good qualities. Quite the contrary, the 5 C's of Mutual Fund Investing, Confusion, Constraint, Complication, Costliness and Conflict in our mind are poor qualities and downright dreadful. Amazingly so, Mutual funds were created to allow the common investor access to the broader markets by pooling the dollars of people like themselves, and like many things in life, was created with good intentions. Make no mistake about it, mutual funds have provided younger investors or those of lesser means to access the cornerstone of capitalism, business ownership. Like many things in life however, good intentions do not always equate to good outcomes.

In our estimation, this is the current state of affairs with most investors that use mutual funds as the bedrock of their asset management process. Either because of lack of knowledge or unwillingness to change, they are unaware of the major pitfalls of investing in mutual funds. In addition, large mutual fund complexes have done very little to rectify the situation. **It is for that reason that in this paper we present what we believe to be the top five issues associated with mutual funds we call the "5 Dreadful C's of Mutual Fund Investing" and the simple steps investors can take to correct these errors.**

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1. Mutual Funds Increase Investor Confusion

Legendary mutual fund portfolio manager, Peter Lynch, in the 1980s, coined the phrase in regards to investing, "Know what you own and know why you own it." He made this statement, as he firmly believed that the more investors knew about the components of their portfolios, the more likely they were to reach their goals and objectives. Although a profound comment at the time, little did Lynch know that 25 years later how relevant his statement would become. As it pertains to mutual funds, what many investors do not know is that mutual funds by their very design, were created to be somewhat ambiguous. Following the debacle of the market meltdown of the 1929 Crash, securities legislation in the 1930s tried to thwart egregious behavior that aided the downfall. The SEC set in motion the mandatory portfolio disclosure frequency to a period of six months to prevent such illegal activity as "front-running" and other speculative activities against mutual funds. The SEC, with good intentions of course, tried to protect investors against such crimes by "keeping them in the dark" in regards to the fund's holdings. How can this be, you might ask? If mutual funds were totally transparent with what they owned and why they owned it, they would regularly disclose their daily net cash flows. This would allow the public to "game" the fund's buys and sells by simply knowing the flows of the fund. If the fund stated in prior correspondence that they like the technology sector, and a large amount of cash came into the fund, one could infer that the fund was going to be buying a large block of tech stocks. This information would permit an opportunistic investor the ability to "front-run" or make a purchase ahead of the fund and likely garner a large gain due to the foreseeable sizeable purchase that was going to be made, which would happen at the expense of the fund investors. So what is the big issue we have with this legislation? Mutual funds by design are a partially-transparent investment vehicle. **Before legislation in 2004 changed the time frame to every quarter, fund owners had to wait every six months to see what the manager owned in the portfolio.**

CAN YOU SEE THE 5 C'S?

Furthermore, this legislative pivot came on the heels of 1985 legislation that changed it from every quarter to every six months. It seems the SEC cannot make up its mind as to what is more important, to limit front-running or create a climate of transparency. We think the answer is quite clear and is supported by the landmark work of Ge & Zhang in a 2006 study titled, "The Frequency of Mutual Fund Disclosure."

In their abstract paper, Ge and Zhang found that funds with higher turnover, higher expense ratios and higher likelihood of committing fraud tended to disclose their holdings less frequently. Moreover, their findings showed a significant asymmetric relation between disclosure frequency and future fund performance. The less dated the frequency the greater the return. In nonprofessionals' terms that means that greater transparency leads to greater investor satisfaction. Simply put, mutual funds, by design, create a cloud of ambiguity around the composition of their holdings and in doing so create confusion and prevent transparency and ultimately investment clarity.

2. Mutual Funds Constrain the Ability of the Money Manager

Again, originally done with positive intentions, mutual funds (those defined as diversified) in an attempt to hold the portfolio manager accountable to a set of rules, have created an environment that constrains their flexibility and usually when it is most needed. The popularity of independent research companies such as Morningstar and Lipper has created an environment that literally confined money managers to a particular set of rigid rules and expectations that actually detract from performance. Is your money manager constrained to a certain benchmark, peer group or prospectus objective? Research done by the University of Denver and ICON Advisors emphatically states that "style box" investing constrains a manager's ability to manage money, which causes severe underperformance. Current practice has most money managers being hired to represent a particular "style box" or peer group such as Small Cap Value or International.

As the aforementioned research shows, this system has absolutely no empirical basis, but simply evolved out of convenience. Unfortunately, along the way, assumptions essential to its validity were made and believed to be true without any support whatsoever. These academic studies have concluded that "boxing in" a portfolio can increase volatility and reduce returns. In fact, Morningstar, which introduced its nine-box grid in 1992, has said that the boxes were never intended to construct a portfolio. The system imposed by boxes seems rational, but it lacks flexibility which is contrary to the ultimate objective of investing. Flexibility is required both to pursue compelling opportunities and to minimize risk. Money management requires a sound philosophy and strategy, the ability to invest with unfettered flexibility and vision that extends beyond artificial boxes. These studies make several points about investing by the box. Rigid adherence to "boxes" will force managers to work toward objectives that diverge from those of the investors. Further, efforts to fit into a box (and stay there) place constraints on investment managers that can lead to poor results. Several of these studies also indicate that diversifying among boxes does not necessarily ensure risk reduction, the often cited benefit. Finally, Morningstar has made it clear that they never intended for boxes to constrain investment managers or drive portfolio construction. What was meant as a practice of accountability and basic structure has become a strict and rigid set of rules that constrain and confine a fund manager's talent much like a zoo's cage does to a majestic lion or tiger who desires to roam and be free. **Stripping a money manager of flexibility has been quite the common practice of many mutual fund complexes.**

"It is 4 o'clock
on Wall Street;
do you know where
your money is?"

3. Mutual Funds Complicate the Investment Process

In our estimation most mutual funds do a pretty poor job of simplifying the investment process. Mutual funds were meant to be an effective and efficient way to broaden diversification at low cost. The problem today with many mutual funds is not that they are broadly diversified but that they too diversified. Hence, many mutual fund holders suffer from a case of being over-diversified. Some funds, especially the larger ones, have so many assets that they have to hold literally hundreds of stocks and consequently, so do its investors. To add fuel to the fire, many investors in pursuit of perceived diversification will end-up owning 10 or more stock funds that have 200+ holdings each and thus have a total of 2000+ holdings. This culminates in a portfolio that has a tremendous overlap of securities coupled with a minuscule percentage of ownership per security and thus equates to a severely inefficient portfolio. The investor gets the double-whammy of being over-diversified and ineffective at the same time. Warren Buffet said it very boldly and eloquently and when he commented about those who succumb to overdiversification as being a sure sign of one not knowing what they are doing. Buffet also stated that there seems to be a perverse human characteristic that likes to make easy things difficult. What should be a simple product that owns between 20-40 undervalued businesses with growth possibilities that uses a fundamental strategy to achieve its goal has turned into a complicated mess of long/short, multialternative and smart beta. **This is part and parcel why mutual fund investors tend to jump from one complicated fund to another complicated fund and, as the Dalbar Study concludes, earns a long-term return substantially less than the stocks they invest in.**

4. Mutual Funds can be very Costly

With the creation of index mutual funds, exchange traded funds and discount brokerage services it is no secret that many mutual funds have been and continue to be justly criticized for high costs. Although we believe we can definitely make the case that paying for direct active money management is a value-added service, mutual funds with their hidden cost structure and trading fees are highly questionable. With mutual funds not only do investors pay the money manager, they pay a group of attorneys to draft and distribute those nasty prospectuses and statements of additional information which is called the Transfer Agent fee; they also pay a third-party to hold your money called the Custodian and many funds levy a marketing fee called the 12b-1 fee which is used to grow the fund so your costs come down. The only problem is that rarely, if ever, do costs come down even when 12b-1 fees are assessed. Another fee that is not required to be published are the trading costs that accompany security buys and sells within a fund. In total, if you add up redemption fees, brokerage fees, back-end load fees, management fees, inactivity fees, 12b-1 fees, transfer fees, minimum equity requirement fees, commissions, the cost of limit orders, and sundry overheads like consultancy costs, bookkeeping and accounting and even more, it is not difficult to see that they can constitute a major problem. We have not even discussed the capital gains that are distributed by fund companies, because the actual fund pays no taxes, you do. The fund distributes tax gains from trading to their shareholders, even when the fund loses money. **Talk about putting a sour taste in one's mouth!**

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5. Mutual Funds are in Conflict with their own Mandate

The fund industry, despite preaching against it, promotes a culture of performance even though it knows perfectly well that it misleads investors. They know the research supporting the thesis that past performance is not indicative of future results, yet they take out expensive advertisements on websites and financial periodicals that tout their performance. In addition, most fund companies say they believe in the merits of long-term investing, yet the typical manager sells every stock in their portfolio at least once a year resulting in turnover being over 100% per annum. Another problem with mutual fund companies is what is referred to as survivorship bias, which is a result of them burying their mistakes by merging underperforming funds into the more successful ones. In essence, sweeping the dirt under the rug so no one sees it. And the last one, what we refer to as "kickbacks" in the form of what is discretely known as "soft money," where a fund manager pays a higher than normal broker's commission and gets a so-called rebate in the form of research, software and even computer equipment that should in essence either go to the shareholder or at least to their benefit. So how do the aforementioned idiosyncrasies of the fund industry equate to conflict? Very simply, mutual fund board of directors have a fiduciary responsibility to their shareholders and not to the profit margin of the fund company itself. **A conflict is present whenever this does not play itself out or come to fruition, and this happens all too frequently.**

THE OPTIMAL "C" IN INVESTING… CLARITY

One would think that in today's day and age, with the world literally at our fingertips, all of the information we just provided was made available to us and that it would clear the murk and provide us with a sense of relief. Unfortunately, that is anything but the case as investors are more confused and suffer from the dreaded 5 C's of fund investing than they have ever been. We want to be clear that we are not placing the blame on any one entity or investing vehicle, but attempting to expose the causes of investor frustration when it comes to allowing them to know what they own and why they own it. For years, investors' hopes were placed in mutual funds as the cure to whatever ailed them. We can see where that has led them. Today the new-fangled mutual fund known as the ETF have replaced that expectation and investors are again starting to feel another letdown. If more information and supposedly, simplified packaged products does not invite clarity, then than what does? At Nepsis, we firmly believe that the key pillars of investing, as depicted in our white paper, "Four Keys to Successful Investing," are what ultimately create clarity for investors. That is, investors must always be in search of a money manager who is completely open about their Philosophy and Strategy and at the same time can be held accountable to being both Transparent & Flexible. At only such time will ideal clarity be obtained and anxiety, confusion and consternation be vanquished in the investment process.

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