Question
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YOUR MONEY

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Don't Limit Yourself to Mutual Funds

Q. One of my New Year's resolutions entails taking a good hard look at my finances. I've since reviewed my portfolio and have realized that it includes a vast array of mutual funds – but nothing else. Should I be concerned?

A. Great question! I have come across this situation and am surprised by the number of people who are in the same boat, having unwittingly wound up with portfolios comprised solely of mutual funds. Although mutual funds can offer advantages, it is more likely you are missing excellent opportunities by limiting yourself to them exclusively.

Consider the fact that the average mutual fund has over 100 holdings. When you have a few mutual funds that are similar in their investing mandates (e.g. Canadian equity and Canadian dividend growth), you will be faced with a great deal of overlap. For example, you may find that both fund types have Petro-Canada or Royal Bank within their top holdings. This overlap can create a portfolio that is too highly correlated, limiting your potential returns. Clearly, this does not reflect a well managed portfolio.

Having your entire portfolio in mutual funds can also increase your fees – and ultimately, decrease your bottom dollar. In addition to whatever initial set-up fees you are charged, you are also subject to ongoing management expense fees. In the long run, these fees can severely cut into your nest egg.

Consider an initial $100,000 investment held inside an RRSP and invested for 25 years in funds returning 7% annually. Taking into account a very modest rate of inflation of 2% and a management fee of 2%, you will be left with a 3% return representing a compounded $109,377.79 gain. And, if that management fee was 3% in the same situation, you would be left with a mere 2% return or a $64,060.60 gain. The cost of this additional 1% in management fees is an astounding $45,317.19!

Fees are applied even if the fund doesn't generate any returns, so performance is another extremely important aspect to consider. Approximately 80% of mutual funds under perform the market. These underperforming funds track their relative market indices and then charge the management fees. Clearly, this is neither cost effective nor a performance driven solution.

So how do you guard against overlap, reduce fees, and achieve good returns? The answer lies in your asset allocation. In fact, proper asset allocation can be attributed to more than 90% of your portfolio's performance. There are a multitude of different investment vehicles including stocks, bonds, hedge funds, managed accounts, et cetera, so you don't need to limit yourself to mutual funds. Instead you can take advantage of other investments and truly diversify your portfolio.

If you are looking for specific comments on your portfolio, I would be happy to provide a complimentary review. I will go over your holdings and breakdown all the costs you are paying, analyze your performance, and offer my professional recommendations.

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