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Think about your mutual fund investments

Many investors have mutual funds in their portfolios because they want a simplified approach to investing. However, simple does not mean hands-off. Mutual funds are not all built alike so thinking must be applied in selection, and monitoring is essential.

As with any approach to investing, a critical consideration is the impact of fees. A combination of high fees and an underperforming fund means the investor loses. Roughly 80% of mutual funds either underperform their broad indices or merely track them. Therefore it is important to choose funds that provide actual, measurable value.

The first fee to examine is the Management Expense Ratio (MER). All mutual funds have an MER built into the unit price, and they are charged regardless of fund performance. The long-range difference to a portfolio's bottom line, of even a 1% MER increase compounded, is significant.

Mutual fund selection also affects the impact of other fees. Generally there are four ways of purchasing a mutual fund: back-end, front-end, low-load, or no-load.

Back-end is also referred to as deferred sales charge (DSC), where no additional fees are charged if the fund is held for a pre-determined length of time; typically six or seven years. If the fund is sold before the redemption date investors may be assessed up to 6%, depending where they are in the schedule, regardless of performance. Low-load sales fees are similar to DSCs, except the maturity date is shortened and redemption fees are fewer.

Front-end purchases entail an initial commission but investors can sell the fund at anytime without penalty. With no-load funds, investors are not locked-in and the only fees are ongoing MERs. No-load are generally for do-it-yourself investors and are often only available directly through the mutual fund companies.

The choice in fund fee set-up depends entirely on the investor's objectives. Those wishing to buy-and-hold a particular fund may opt for DSC or low-load. Those looking for purchasing and selling flexibility may consider front-end or no-load. The latter are generally more popular in the current investing landscape as it calls for increased flexibility in portfolios.

Diversification of mutual fund holdings requires monitoring. Investors often wind up with far too many mutual funds when only five or six are needed to achieve adequate diversification. When that number is surpassed, holdings start to overlap and the portfolio becomes too correlated.

Consider that the average mutual fund has over 100 holdings. If an investor has several types of Canadian-focused funds, chances are good that all the funds have some of our big six banks and largest Canadian energy companies in their top holdings. The duplication makes it very difficult to outperform the markets.

The mutual fund's mandate is another important consideration. Some funds are required to be fully invested at all times. However, if the markets turn negative, portfolio managers faced with such restrictions have no flexibility to raise cash and preserve investors' capital.

Mutual funds are generally best suited to portfolios under $100,000, as they provide a level of diversification that would otherwise be difficult to achieve with individual securities. Once over that threshold, investors should begin expanding their

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horizons and examine other investment vehicles such as stocks, bonds, exchange-traded funds, and alternative investments.

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