



Mutual Fund Wake-Up Call

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It's time for a reality check. In a Paine Webber/Gallup poll last July, investors with less than five years' experience investing in the stockmarket said they expected an average 22.6 percent annual return from stocks over the next decade. These expectations are ludicrous... but hardly surprising. **The most common investor mistake is making decisions by merely extrapolating market returns from recent, but relatively short, time periods.**

When figuring asset allocation for a mutual fund portfolio, you should consider the expected return and potential downside risk for each asset class and align those expectations with your investment time horizon and risk tolerance. No decision is more important to the long-term investment performance of your portfolio than the percentage put in stocks vs. bonds and cash.

Historically, **stocks have provided investors with the higher returns than bonds or cash investments.** From 1901 through 1999, the annualized nominal return for stocks in the US was 10.4 percent. Averages, though, can be deceiving. It might surprise you to know that over the past 99 years, stocks produced negative returns in more than one in four of those calendar years. Red alert--we have enjoyed nine calendar years in a row of positive returns for stocks, so **we are long overdue for disappointment.** And when it comes, it will probably be a *big* disappointment.

Stock valuations in general are at an all-time high, despite rising interest rates. Meanwhile, speculation in the stockmarket has risen to ominous levels. The valuations of many of the technology and Internet-related stocks investors continue to chase are so ridiculously extended that **extreme price declines are inevitable and imminent.**

If you think "this time is different" because of the Internet and other technological advances made in recent years, you might want to take a quick history lesson from the most successful investor of our time, Warren Buffett. His *Fortune* magazine article late last year on the investment performance of the new and groundbreaking technology industries of previous eras--the car and the airplane--will make you think.

Now take a good look at your mutual fund portfolio. Is the money you have invested in equity funds truly a long-term investment (longer than 10 years)? Could you stomach a decline of perhaps a third of their value in a short period of time and still hold them for the long term? If the answer to either of these questions is no, then it's time to do some rearranging. Sell some of your equity fund holdings and buy an index bond fund such as Vanguard Total Bond Market Index, which offers 6.5 percent yield and will better protect your capital in the event of a precipitous decline in stocks. Investors in higher tax brackets should look to **a low-cost municipal bond fund.**

With the truly long-term capital you keep in the stockmarket, make sure your equity mutual fund holdings are diversified. Owning 20 different tech-heavy, growth funds is not diversification. Make sure a significant part of your equity fund holdings are in value-oriented (particular small and mid-cap) and international equity funds. These two areas of the equity are much more attractive in terms of expected returns vs. downside risk.

A properly diversified portfolio of stock funds should serve long-term investors well over the coming decade. However, it would be imprudent to plan for any better than "average" returns over the next 10 years. And remember, that average is 10.4 percent, not 22.6 percent.

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