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Mutual funds' simplicity does not mean hands off

Take a magnifying glass to your funds

Mutual funds have long been a favorite of Canadian investors. According to the Investment Funds Institute of Canada (IFIC), 4.6 million Canadian households own mutual funds representing $1.14 trillion in assets.

Many opt for mutual funds for their 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.

It goes without saying that choosing a mutual fund with a solid long-term track record is an important first step. Investors will want to look for consistency of performance. They will also want to make certain that the performance is attributed to the current fund manager as opposed to one that may have recently left the company. 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 underlying holdings are another important factor. Consider an investor who holds a couple of mutual funds that are similar in their investing strategies, such as Canadian equity and Canadian dividend growth. It is quite likely that both funds will have some of the big six banks and largest Canadian energy companies in their top holdings. This overlap can result in a portfolio that is highly correlated, making it very difficult to outperform the markets. Such duplication can also add to the overall level of risk in the portfolio.

Careful consideration should also be given to management expense ratios (MERs). Obviously the lower the overall cost of the investment, the greater the share of investment return. The long-range difference to a portfolio's bottom line, of even a 0.5% MER increase compounded, is significant.

Consider a $100,000 investment in a mutual fund with an MER of 2.50% and an average annual return of 5%. After 25 years the investment would have grown to $338,635 however the investor would have paid $123,906 in fees. If the investment had an MER of 2.0% instead, the investor would have paid $98,863. That's a difference of over $25,000.

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 horizons and adding other investment

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vehicles such as stocks, bonds, exchange-traded funds, and alternative investments.

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