HOW TO BE YOUR OWN PERSONAL FUND MANAGER

By James O'Shaughnessy

Until recently, high minimum commissions and limited access to information were high hurdles for small investors who wanted to build diversified stock portfolios. The Internet has changed that.

Most investors don't know it yet, but the era of mutual funds is just about over. In fact, I predict that in 10 years there may be no mutual funds. They will be replaced by "personal funds"—individually customized stock and bond portfolios that investors will buy over the Internet.

The mutual fund, which came along in the 1920s, was the first investment to give individuals affordable access to the stock market. Mutual funds for the first time gave small investors both diversified portfolios and professional management at a relatively low price, allowing them to escape the clutches of market manipulators. The mutual fund has served its purpose remarkably well—until recently.

It's no secret that mutual funds have become a sub-optimal way to invest. The taxes they inflict on investors through heavy portfolio turnover and the expense ratios they charge are a drag on returns. Mutual funds just aren't good enough in today's investment world, especially now that investors have low-cost on-line access to research and trading. Even exchange-traded funds are more efficient. Exchange-traded funds represent a basket of securities that mirror market indexes and trade on major stock exchanges like stocks. Most exchange-traded funds reduce the tax problem with virtually no portfolio turnover and minimal annual management fees. [For more on exchange-traded funds, see "Exchange-Traded Funds: A New Twist on Index Investing," by Albert Fredman in the July 2000 *AAII Journal*.]

There are other problems with mutual funds. The investor has little control over the stocks selected. You don't like your favorite fund's purchase of Philip Morris or Microsoft stock? Tough luck. The mutual fund's manager can even change the investment strategy without your consent, upsetting your overall asset allocation. Simply put, mutual funds are no longer designed to serve the best interests of the individual investor.

The obvious alternative for individual investors is to buy individual stocks. This approach lets you decide which stocks to own and which to reject, giving you more control over the taxes you pay, your expenses, and your preferred investment strategy.

Until recently, high minimum commissions on stock trades deterred small investors who wanted to build diversified stock portfolios. In the past, individual investors also had limited access to information about company fundamentals or stock valuations.

The Internet has changed all of that. Trading costs have plummeted for on-line investors. You can assemble a diversified portfolio of individual stocks, investing as little as a few thousand dollars without paying absurdly high commissions.

You also can pick your stocks using on-line research and screening tools that just five years ago were the exclusive domain of institutional investors.

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Netfolio is the official on-line portfolio provider to AAII and a basic benefit to all AAII members. Visit www.netfolio.com for more information about the service, which launches later this fall.

There are many sites that offer research. Two of the largest and most well-known are MSN MoneyCentral Investor (go to the My Portfolio section at www.moneycentral.com) and Quicken (the My Portfolio section at www.quicken.com).

As a result, individual investors can build stock portfolios that suit their goals and risk tolerance. You can avoid specific stocks or industries and time sales to minimize taxes and transaction costs. And it's absurdly easy to track the performance of your portfolio.

Unfortunately, most people who buy stocks over the Internet using an on-line brokerage aren't creating true personal funds. Instead, many investors use the Internet to buy and sell stocks based on ticker symbols they see in a chat room or on television. Other investors do their homework, but they invest on a stock-by-stock basis—so their portfolios lack a unifying theme or strategy. They can't be sure their overall investment portfolio makes sense for them. Worse yet, the portfolios often don't make much sense, strategically.

A personal fund requires a consistent and coherent investment strategy. Creating personal funds over the Internet isn't an especially complex task, but it does call for a systematic approach.

These four steps will help you do the job.

Step #1: Establish the goal of your personal fund.

For a personal fund to be effective, it needs an investment goal such as retirement, a child's college tuition, or another major expenditure. The goal's time horizon is a key factor in determining how you invest the money in your personal fund.

For example, you'll invest a personal fund more aggressively for retirement that's 20 or 30 years away, while you'll invest more conservatively if the fund must cover college tuition in five years.

The beauty of this approach is that you can target specific goals with specific investments. By contrast, it's very difficult to target specific goals with mutual funds. As a rule, a single mutual fund isn't designed to get you to a particular goal. Instead, it's supposed to play a bit part in a broader portfolio that includes a variety of mutual funds.

But who wants to build and manage a portfolio of four or five mutual funds for every single goal? Instead, most mutual fund investors try to create one portfolio to cover all their goals—a creaky solution at best. Others make vague assumptions: "Well, my 401(k) takes care of my retirement, and the kids have a college IRA…I should be fine."

It's much better to build a specific portfolio for each goal in your life.

For example, an investor saving for a goal that's 20 years away might allocate 45% of equity assets to large-cap growth stocks, 30% to large-cap value stocks and 25% to small-cap stocks. This growth-oriented portfolio provides exposure to large technology stocks that are likely to grow over time. Large-cap value stocks are mostly undervalued blue-chip companies and would limit a portfolio's downside risk during market declines. Small-cap stocks provide exposure to younger companies and would allow a portfolio to benefit during periods when small-cap stocks are in favor.

This strategy is appropriate for a disciplined investor who doesn't need to use the assets in the near future.

Step # 2: Determine your strategy for each personal fund.

The Internet is loaded with quizzes and calculators that can help you decide how to divide your assets among stocks, bonds, and cash, taking into account when you'll need the money and your tolerance for risk.

Once you know your asset allocation, you'll need to choose a strategy or mix of strategies for the stock portion of your portfolio. Internet sites including the Motley Fool (www.fool.com) and MSN MoneyCentral Investor offer hundreds of stock market portfolio strategies ranging from the Dogs of the Dow to Flare-Out Growth.

Once you choose a strategy, you need to stick to it. This is hard for many investors. Despite the stock market correction earlier this year, many investors still secretly expect ridiculous returns. When investments don't perform as expected, investors abandon the strategy and the stocks in the strategy, forgetting about how the strategy has performed over long periods of time. When you understand both, you'll be more likely to stick around long enough for the strategy to produce its expected returns.

For example, the long-term strategy mentioned above had a 12-month return in 1999 of 48.8%, but its average annual return over the past 13 years was 24.8%, which better reflects its return over a variety of past economic and market conditions.

Step #3: Select the stocks for your personal fund.

Once you select a strategy for your goal, make sure your personal fund is well-diversified among companies and industries. Within each strategy, it makes sense to diversify your assets among a dozen or so stocks that span several industries.

But which stocks? The Internet offers a variety of screening tools on sites such as Hoover's (www.hoovers.com) or Quicken that let you insert a strategy's criteria and find stocks that satisfy them. Some strategies call for you to buy small-cap stocks with below-average price-earnings ratios while others look for large-cap stocks with superior dividend growth.

Once again, you want to approach stock selection from a strategic point of view and not simply because a particular stock has a great story.

You buy Sun Microsystems not because a magazine or analyst on TV tells you it is a good stock, but because it meets certain well-defined characteristics of your strategy.

For example, you could achieve your 20-year goal by investing solely in three exchange-traded funds—those that track the S&P 500, the Nasdaq 100 and Russell 2000 indexes. This is what I call a "passive" investment, designed to mirror market indexes. You may eventually reach your goal, but you could also reach it faster by including individual stocks that share characteristics that have beaten the market in the past.

Step #4: Rebalance when appropriate.

The key to creating a personal fund is to select stocks that fit a chosen strategy's criteria. But some stocks rise or fall faster than others and can leave your portfolio out of balance.

So every 11 months, you need to revisit your personal fund's portfolio and determine whether all of the stocks still meet your strategy's original criteria. The reason I suggest 11 months is because before you sell shares, you must consider the impact of these moves on your tax bill. Remember, gains on shares held for less than a year are taxed as ordinary income. Sell the same shares after holding them for longer than a year, and you will owe only 20% on the gains.

Reviewing your stocks after holding them for 11 months gives you time to determine whether they still meet your strategy and whether to sell short-term losses to offset the tax impact of selling long-term gains when rebalancing.

This is yet another benefit of a personal fund. Unlike a mutual fund, a personal fund lets you refresh your portfolio and time sales to minimize your taxes. All of this sounds a lot better than trying to paste together a portfolio of mutual funds, which are not designed for specific individuals and are managed at great expense by people who don't know a thing about you or your goals.

And once you set up your personal funds, you will own the individual stocks for reasons that actually make sense to you.

Surprisingly few investors—or mutual fund managers—can match that claim. ✦