

# WHAT TO LOOK FOR IN THE NEW MUTUAL FUND PROFILE

By John Markese

Starting this month, mutual funds will be allowed to offer prospective investors a new source of information—the fund profile. A step-by-step walk through the points it must cover will give you an idea of what the profile can tell you—and what it cannot.

Think thin. As of the first of June, mutual funds will be allowed to offer investors a new source of fund information—the profile. Just as its name implies, the profile is a slim sketch of a mutual fund's critical character points.

Remember the mutual fund prospectus, often written by the fund's legal department with disclosure requirements in mind rather than understandable investment information? The prospectus is neither gone nor forgotten, but the first summary of fund information you are likely to see in the future is the mutual fund profile.

Because the format of the profile is a standard nine points in a specific sequence and the discussion is lean, profile-to-profile comparisons are relatively easy and efficient. The same information for each mutual fund will appear in the same place and in the same form. Funds have the option of presenting each of the nine items in a question format (for instance, "what are the objectives of the fund?"), or as a simple statement ("the fund objective is ...")—not a substantive difference.

Can you use the profile to make intelligent mutual fund decisions?

Yes.

Is the profile all you need?

No.

A step-by-step walk-through of the nine points will give you an idea of what the profile can tell you and what it cannot. To illustrate the nine points, parts of various funds' prototype profiles appear in italics under each point, followed by comments on what to look for and what to expect.

## THE NINE POINTS

### Point 1: Investment Objectives/Goals

*The fund seeks to provide long-term capital growth and some income through investments primarily in common stock.*

**What to Look for:** The example is a mutual fund portfolio of common stock, with all the risk/returns inherent in equities. The investment strategy section will give more details, but mention of income and capital appreciation implies more mature stocks that are likely to pay dividends and a mutual fund category match closest to growth and income. Is it particularly specific on details? No, but you now would have some idea of what the portfolio in general would look like and how it would behave. The asset class question is answered.

### Point 2: Investment Strategy

*The fund invests primarily in domestic and foreign stocks, but may also invest in debt securities. Although there are no limits on the amount of assets that may be invested in any security, the fund intends to spread its holdings among many companies and industries. In selecting investments, the fund focuses on companies that pay current dividends while offering the potential for growth of earnings.*

**What to Look for:** Well, the example is not a sector fund concentrating in one or a few closely allied industries. The fund's strategy is to be diversified

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by firm and industry—a less risky approach than sector concentration. The option of holding debt securities is no surprise, since stock funds do hold cash but rarely move significantly into bonds (one exception: Magellan Fund's debt play a while back). But where did foreign securities come in? The trend among managers of domestic equity funds is to have and use the flexibility to invest overseas. While not operating as a global fund, significant foreign holdings up to 25% of the portfolio are not uncommon.

Does all this "flexibility" make you uncomfortable and unsure of what this fund is really all about? It should. That's why an examination of the semiannual or annual report is necessary. The report lists the holdings of the fund broken down by stock versus debt securities; and within stocks by industry and usually by domestic versus foreign. Since this fund is focusing on firms that pay a current dividend, then the annual report should confirm a listing of more mature firms rather than small emerging stocks.

### Point 3: Principal Risk of Investing in the Fund

*This fund is primarily a stock fund; like all stock investments, it exposes the investor to potential drops in stock prices. In bull mar-*

*kets, this fund's focus on income-producing securities could dampen its performance. Declines occur even in protracted rising markets and share prices of profitable firms can fall. The fund's price will fluctuate, and there is no assurance that shares can be sold at a profit.*

**What to Look for:** This is probably the most debated and controversial section of the profile. The concept of risk is difficult to convey, and there is much disagreement on appropriate measures of risk. But this section must address the risk of the anticipated portfolio holdings and circumstances that will affect the fund's net asset value, yield, and total return.

The fund also has the option in the profile under this point to include the types of investors and the types of investment goals for which the fund is most appropriate.

There is nothing like a picture at times to get a thought across. Mandated in each profile under risk is a bar chart showing the fund's return for each of the last 10 calendar, not fiscal, years (see Figure 1).

An accompanying table provides a comparison of compound total annual returns for the last one-, five-, and 10-year periods to an appropriate broad market index (see Figure 2). In addition to the annual bar chart, profiles made available in June and beyond will be required to

**FIGURE 2. SAMPLE PERFORMANCE SUMMARY**

#### Performance Summary (Periods ended December 31, 1997)

	Average Annual Total Returns (%)	
	Fund	S&P 500*
1 Year	32.3	33.3
5 Years	20.7	20.2
10 Years	18.1	18.0

Note: Past performance is not indicative of future performance. Performance figures include the reinvestment of all dividends and any capital gains distributions. All returns are net of expenses. The performance data quoted represent past performance. The investment return and principal value of an investment will fluctuate so that investors' shares, when redeemed, may be worth more or less than their original cost.

\* The Standard & Poor's 500 Composite Stock Price Index is a diversified group of 500 securities used to measure U.S. stock market performance.

report the best and worst quarterly returns over the 10 years as a measure of short-term risk. None of the return figures would reflect sales loads.

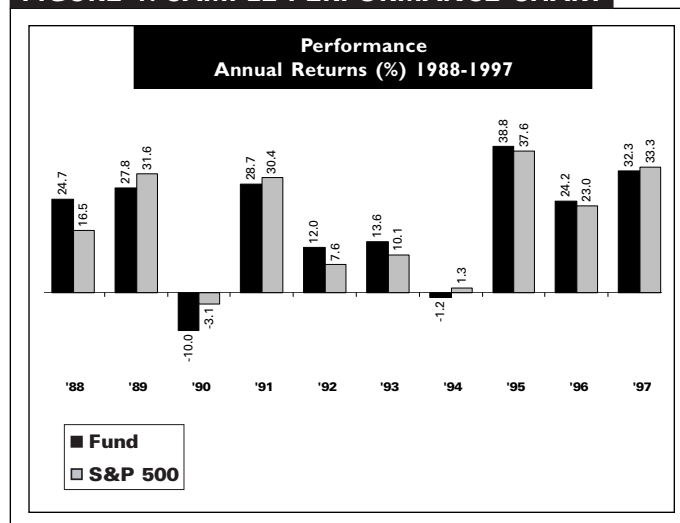
Two impressions should be formed from the risk description and particularly the bar chart. First, see how volatile the returns on this fund are in absolute terms: Are the year-to-year swings more than you can stomach, even though this volatility should be viewed in the context of your overall portfolio? In other words, you need to make a judgment of the absolute risk of this fund and your tolerance for that risk.

Second, examine how volatile this fund is compared to the broad market index on the bar chart: Does this fund have more, less, or the same risk as the broad market, and is its relative risk appropriate to your goals? This goes to the heart of relative risk.

### Point 4: Fees and Expenses of the Fund

*The fund is offered on a pure no-load basis (that is, the fund has no*

**FIGURE 1. SAMPLE PERFORMANCE CHART**



12b-1 fees or charges to buy or sell shares).

*The fund's operating expenses are deducted from its total assets before daily share prices and income distributions are calculated. The fund's expense ratio for fiscal year 1997 was 0.39% of assets.*

#### **Annual Fund Operating Expenses**

Investment Advisory Fees .....	0.14%
Distribution Costs .....	0.02%
Other Expenses .....	0.23%
Total Operating Expenses .....	0.39%

*The following example illustrates the expenses that you would incur on a \$1,000 investment over various periods, assuming (1) a 5% annual rate of return and (2) redemption at the end of each period:*

<u>1 Year</u>	<u>3 Years</u>	<u>5 Years</u>	<u>10 Years</u>
\$4	\$13	\$22	\$49

*This example should not be considered to represent past or future expenses or performance. Actual expenses may be higher or lower than those shown.*

**What to Look for:** Expenses count. Every dollar spent in expenses by a fund is a dollar less of return for the investors. All funds have expenses and different types of funds tend to have different average expense ratios—expenses stated as a percentage of fund value on an annual basis.

The expense ratio includes the investment advisory fee, fund administrative expenses, and a distribution fee, referred to as the 12b-1 charge, an annual load that cannot exceed 0.75%. The expense ratio does not include front-end sales loads, back-end sales loads, redemption fees, and account transaction charges.

When you are judging expense ratios, keep in mind that very high expense ratios relative to similar funds are difficult for portfolio managers to overcome, so an examination of category averages is useful:

<b>Fund Category</b>	<b>Average Expense Ratio (%)</b>
Domestic Stock Funds	1.1
International Stock Funds	1.4
Domestic Bond Funds	0.7
International Bond Funds	1.2
Index Funds	0.4

Expense ratios that are significantly higher than these averages—for instance, 1.5% for a domestic stock fund—are cause for concern, particularly for lower return funds such as bond funds.

The table will also note any loads or fees that are charged to buy or sell fund shares, reinvest dividends, or exchange into other funds in the family. Remember, loads reduce returns dollar-for-dollar and do nothing to improve fund performance.

The second half of the fees and expense table is the cost in dollars of a \$1,000 initial fund investment, assuming a return of 5% annually with all distributions reinvested. Since this table is in dollars and not percentages, it is fairly useless unless you are willing to multiply these dollar expenses by the number of \$1,000 investment units you have in the fund. Even then, it is more difficult to judge expenses in dollars than in terms of percentages.

#### **Point 5: Investment Advisor and Portfolio Manager of the Fund**

*The fund is managed by [a named] fund advisory firm. Responsible for the day-to-day activities of the fund is [the named] portfolio manager who has managed this fund and investments for the fund advisor over [some stated] number of years.*

**What to Look for:** Beyond who is managing the fund now, this section details how the portfolio manager's tenure matches the performance history of the fund. The year-to-year performance history of the fund may not be the work of the current portfolio manager—a critical bit of information for aggressive and actively managed funds, but unim-

portant for index funds.

#### **Point 6: Purchasing Shares**

*You may purchase shares by mail, wire or exchange from another fund in the family. The minimum initial investment is [some stated amount] and the minimum additional investment is [some stated amount]. No load is charged on purchase of shares.*

**What to Look for:** This is a simple, “how do I buy shares?” description, and if you are interested in the fund after doing further analysis, contacting the fund will secure an account application. More important, however, is the minimum initial investment—does it and any subsequent investment minimums conform to your plan?

#### **Point 7: Selling Shares**

*You may resell all or a portion of your shares on any business day by written request, telephone, or wire transfer.*

**What to Look for:** Your choice of redemption mode is made on the account application, and the choices are standard for most funds.

#### **Point 8: Fund Distribution and Tax Information**

*The fund distributes substantially all of its net income and capital gains to shareholders each year. Normally, dividends are distributed in March, June, September, and December. Capital gains are distributed in September and December. Distributions are reinvested automatically in additional shares unless you elect another option. Your distributions are taxable when paid, whether you take them in cash or reinvest them. For federal tax purposes, income and short-term capital gain distributions are taxed as dividends, and long-term capital gain distributions, if any, are taxed as long-term capital gains.*

**What to Look for:** If you are tax-alert, you know that distributions made by the fund are taxable even if reinvested, assuming you are holding

the fund in a non-tax-sheltered account, and will be taxed as ordinary income or capital gains, either short or long depending on how long the fund has held the investments. Also the frequency of distributions is noted and is important for financial and tax planning.

#### Point 9: Other Services Provided by the Fund

A wide range, including but not limited to:

- Exchanges;
- Retirement plans for individuals and large and small businesses (e.g., IRA, SEP, Keogh, 401(k),

403(b), etc.);

- Automated information and transaction services by telephone or personal computer;
- Electronic transfers between your fund and bank accounts;
- Automatic investing and automatic exchange.

**What to Look for:** This is the chance for the fund to tell you what services they offer, and as fund competition has heated up, more services have been offered and more funds offer the full menu. Not all services may be listed, so if you don't see one you need, call the fund to clarify their offerings.

#### THE COMPLETE PROFILE

Putting the new profiles for funds with the same investment objectives side-by-side will make your first cuts all the more sharper and boost your initial screening efficiency. But, is it enough information to make an investment decision?

No. Get the annual report and the full prospectus, and read them. Before making a final decision, look at performance comparisons to peer group funds as provided by AAI's *Quarterly Low-Load Mutual Fund Update* or the annual *Individual Investor's Guide to Low-Load Mutual Funds*, for example. ♦

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- George Sauter, managing director, The Vanguard Group **"Investing in Index Funds"**
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