Cleaning House: Portfolio Reorganizing When You Have Too Many Mutual Funds

By Maria Crawford Scott

Roy and Julia Miller are entering retirement, living off of a combination of their savings, Social Security, and pension payments.

The couple has always invested their savings in mutual funds. Until recently they have spent most of their efforts adding to their portfolio, and very little time reviewing and pruning their existing investments. While they did add new money to funds they already owned, they typically examined the full range of mutual fund options each time they had more money to invest.

And the Millers found many funds that at one time or another struck their fancy. As a result, the number of mutual funds they own has gradually crept up over the years to a pretty hefty number. Currently, they hold over 25 mutual funds, including 20 different stock funds. Table 1 illustrates their current holdings, which total $545,000.

The Problem With Too Many Funds

Up until now, they were not bothered much by the large number of funds that they held. Such a large number, they reasoned, allows them to be diversified among funds, reducing the risk that any one fund's bad performance will affect their bottom line.

Recently, though, they have started to have second thoughts.

For one thing, their mailbox is always filled with periodic reports, prospectuses, proxies, and marketing material from the mutual fund companies. Simply sorting through all of the literature, throwing out the unimportant material and saving the important documents, has started to become a real annoyance.

In addition, fund tracking and recordkeeping has become burdensome. The Millers do try to keep up with their funds, making note of portfolio manager changes, name changes, and following the general direction that the fund is taking. One way they keep up is by subscribing to several financial newspapers and magazines. But now, when they peruse the articles, they are starting to have trouble remembering which funds they actually own and which funds they were thinking of owning.

And, of course, they must keep track of their current holdings. In the past this has included keeping track of dividend reinvestments in their taxable accounts so that when the time does come to sell, they are able to determine the correct basis for all of their shares. Now, though, they use distributions as part of their annual income.

Determining their asset allocation at any point in time is more difficult because of the large number of holdings. The Millers use a computer to help them keep track of their positions, but entering all of the data has become a nuisance.

Added to that, the Millers have come to realize that diversifying among many different actively managed stock funds is not necessarily the best approach.

What's the problem with being overdiversified?

Diversification among many securities, of course, is desirable because it eliminates the significant risk associated with each individual business; your return is an average for all of the businesses—in other words, a market rate of return for the asset category. Mutual funds that are broadly invested are already diversified; even sector funds, which concentrate on one industry, offer diversification among businesses in that industry, although obviously they are not diversified across various industries.

If you invest roughly equal amounts in a large number of mutual funds, no one fund will have much impact on your total performance. And your overall performance will be a function of the aggregate holdings of all of your funds. Now, you may have miraculously chosen funds that are all going to be top-performers in the coming years; alterna-

Maria Crawford Scott is editor of the AAII Journal.

tively, you may have chosen a list of future dogs. But most likely, your overall mix of funds will be only average, and the average mutual fund portfolio manager tends to underperform the market averages. It is easy to see why: Actively managed funds are starting out with a disadvantage because of their higher expense ratios, so even if they do as well as the market, they will underperform by the amount of their extra expenses. In short, if you invest in many different actively managed stock funds, you are paying each fund a higher fee for their management expertise, but the combined portfolios will strongly resemble the market. In effect, you will have a high-cost index fund, with lower performance than the market.

The Millers don't have equal investments in all of their funds, but no one fund really dominates—their two largest holdings each account for only 11% of their total assets. In addition, they have a number of funds with truly marginal holdings—less than 1% of their total assets.

The real catalyst for portfolio pruning for the Millers, however, came when they received their April *AAII Journal* and read John Markese's Mutual Funds Workshop entitled "How Many Mutual Funds Should You Have in Your Investment Portfolio?"

The answer: around eight, and only five stock funds—in other words, just less than one-third the number held by the Millers.

Housecleaning

Needless to say, it is easier to start with the optimal number than it is to prune down from 25, particularly when you consider the costs of selling. Most of the Millers' holdings are no-load or low-load funds, so the transactions costs are at a minimum. But many of their funds are in taxable accounts, and thanks to the strong markets in recent years, they all have some capital gains.

Here's what they decide to do. First, they determine the funds that they really want to hold:

- 2 large-cap funds
- 1 mid-cap fund
- 2 small-cap funds
- 1 international fund covering the major markets
- 1 international fund covering emerging markets
- 1 intermediate-term bond fund
- 1 high-yield bond fund
- 1 money market fund

Total: 10 funds

That's two more than suggested, but significantly less than what they hold now. The funds that they selected are, in their opinion, the best-performing in that investment category, and offer the best way to invest in that particular category. For instance, the two balanced funds are not needed because the Millers can get better performance and have more control over their allocation by investing in funds that are in one investment category. Similarly, the Scudder Global fund includes U.S. investments, so the Millers decided to go with the Harbor International Fund for their preferred fund, which invests exclusively overseas. And their sector funds, as well as the Japan Fund, are not diversified enough to represent an investment category, and the Millers don't feel that they have been very good at placing sector or regional bets.

Next, they go through their mutual fund portfolio and eliminate poor performers—funds they simply no longer should be holding because their long-term prospects do not look bright relative to other similar funds. So, the Millers decide to sell Fidelity Magellan, Value Line Special Situations and Twentieth Century Heritage—a total of three funds.

Then, they decide to sell funds that are marginal holdings—Fidelity Select Technologies, Fidelity Select Biotechnology and INVESCO Health Science, which also represent sector funds that they don't want to be invested in anyway. That eliminates three funds.

And, they decide to sell funds within their tax-deferred account that don't fit their needs. The PBHG Growth Fund has been a strong performer, but it is both a small-cap fund and is also heavily into technology; they feel that they can get better coverage of the small-cap market by investing in their other small-cap funds. The Bull & Bear Special Equities fund also duplicates their other small-cap funds, but with poorer performance. That eliminates two funds.

They also decide to eliminate one investment category that they don't feel really adds to their overall portfolio. The international bond fund has been a real disappointment to the Millers—it is much more volatile than they originally realized because the returns are so heavily dependent on currency differentials. So they will sell the Fidelity Global Bond Fund—another fund down.

At this point they have winnowed out nine funds from their portfolio and used the proceeds to add to their favored funds. But those were relatively painless decisions. Now comes the harder part—what to do about their funds that are only marginally underperforming their preferred funds, but that would incur a large tax bill if sold. In addition, one fund, Lexington GNMA Income, has been somewhat disappointing—not due to the fund, but rather the sector. When interest rates fell, the fund did not rise as much as their other fixed-income funds because of the return of principal when mortgages are repaid. Thus, the Millers find the entire sector to be marginal.

The Millers decide to hold onto all of their marginal funds for the time-being, and selectively sell if they are able to do so at a low tax-cost. For instance, if the market declines substantially, they may take advantage of the drop to sell with minimum realized gains and add to their favored funds. In fact, with interest rates rising, they expect they may soon have this opportunity with their GNMA fund.

In addition, the Millers do make withdrawals each year to supplement their other retirement income, and they

Table 1.
The Millers' Savings Portfolio

Mutual Fund (Fund Category)	Asset Class Category	Amount Invested ($)	Decision	Reason for Decision
Tax-Deferred Accounts				
PBHG Growth Fund (Aggr. Growth)	Small-Cap	5,000	Sell	Good performance but a duplicate and almost a sector fund
Bull & Bear Special Equities (Aggr. Growth)	Small-Cap	25,000	Sell	Poorer-performing duplicate
T. Rowe Price New Horizons (Aggr. Growth)	Small-Cap	20,000	Keep & add	Better-performing duplicate
Fidelity Select—Technology (Aggr. Growth)	Sector	5,000	Sell	Marginal holding
Dodge & Cox Stock (Growth & Income)	Large-Cap	60,000	Keep & add	Better-performing duplicate
Harbor International (International Stock)	Int'l: Major Countries	25,000	Keep	Better-performing duplicate
	Total	**140,000**		
Taxable Accounts—Stock Funds				
SteinRoe Capital Opportunities (Aggr. Growth)	Small- to Mid-Cap	20,000	Keep	Better-performing duplicate
Value Line Special Situations (Aggr. Growth)	Small- to Mid-Cap	15,000	Sell	Poor performer
Fidelity Select—Biotechnology (Aggr. Growth)	Sector	5,000	Sell	Marginal holding
INVESCO Strat. Port—Health Science (Aggr. Growth)	Sector	5,000	Sell	Marginal holding
Nicholas Limited Edition (Growth)	Small-Cap	20,000	Keep	Better-performing duplicate
Fidelity Magellan (Growth)	Large-Cap	15,000	Sell	Poor performer
Twentieth Century Heritage (Growth)	Mid-Cap	10,000	Sell	Poor performer
Scudder (Growth & Income)	Large-Cap	50,000	Keep & add	Better-performing duplicate
Harbor Value Fund (Growth & Income)	Large-Cap	20,000	Selectively sell/withdraw	Poorer-performing duplicate
BB&K Diversa (Balanced)	Balanced	15,000	Selectively sell/withdraw	Poorer-performing duplicate of other stock and bond funds
Northeast Investors Trust (Balanced)	Balanced	15,000	Selectively sell/withdraw	Duplicate of other stock and bond funds
Scudder Global (International Stock)	Int'l: Major Countries	15,000	Selectively sell/withdraw	Duplicates international plus some U.S. holdings
T. Rowe Price New Asia (International Stock)	Int'l: Emerging Mkts	25,000	Keep	Better-performing duplicate
Japan Fund (International Stock)	Int'l: Regional	10,000	Selectively sell/withdraw	Duplicates international fund but too specialized
	Total	**240,000**		
Taxable Holdings—Bond Funds				
Vanguard Bond Index (General Bond)	Intermediate Bond	60,000	Keep & add	Performance good; not duplicated
Lexington GNMA Income (Mortgage-Backed)	GNMA Bond	30,000	Selectively sell/withdraw	Withdraw from sector
Janus High Yield (High-Yield)	High-Yield Bond	10,000	Keep & add	Performance good; not duplicated
Fidelity Global Bond (International Bond)	Int'l Bond	10,000	Sell	Poor performing sector
Money Market Fund (Money Market)	Money Market	55,000	Keep	
	Total	**165,000**		
	Total Portfolio Value	**545,000**		

will make withdrawals from these funds until they are eliminated from their portfolio. If they should have additional money to invest—they don't spend all of their yearly distributions or they receive an inheritance or gift—they will add it to their preferred funds.

Lastly, the Millers could get the number down to eight by holding the same large-cap and small-cap funds in their tax-deferred account as in their taxable accounts. But they currently are overwhelmed with decision-making, and the need to make a choice between funds they really like puts them over the limit at this stage. They will likely review this decision at a later date.

Dealing With Too Many Funds

How do you extricate yourself from a mutual fund nightmare?

Needless to say, the individual funds mentioned in the Millers' mutual fund portfolio are only presented as examples. You will have to make your own decisions concerning funds that you want to emphasize, and those that you want to eliminate, based on your own needs and your own judgment.

However, here are several principles you can follow when trying to prune an overgrown portfolio:

- First decide which funds in your portfolio you really want to hold based on your overall asset allocation decision, your judgment as to which funds offer the best long-term performance prospects, and the ones that offer the best coverage of an investment category. Add to these funds, as you prune your portfolio, to remain fully invested.
- Assets in tax-deferred accounts can be sold without incurring any tax liabilities, so these funds are obvious candidates for switching if there are similar-performing duplicates.
- Assets in taxable accounts are more problematic because you don't want to unnecessarily incur tax liabilities.
- Make sure to sell poor performers even if you have gains in the fund—you don't want to continue with a sub-performing fund simply because you don't want to pay taxes. Eventually, the better performance of another fund manager will overcome the tax loss.
- Consider clearing out all of your marginal funds—those that have very little impact on your portfolio. Try to keep taxes low, but hopefully you will not have to pay much in taxes if there isn't much in the account
- You may also want to consider incurring losses that could offset possible gains so that you can sell funds you don't need. For instance, if you have losses in a fund that you want to continue holding, you could consider selling and then repurchasing after 30 days (to avoid the wash-sale rules). Take the loss, offset gains elsewhere, and then repurchase after 30 days.
- Hang on to funds that are marginal performers relative to the ones you want to emphasize and that have sizable gains, but be prepared to sell if the opportunity arises (for instance, a market decline leads to a loss or much lower gains, you have a loss elsewhere, or you are in a particularly low bracket one year). Otherwise, use the fund for withdrawals and do not reinvest distributions.
- If you are concerned with investing in only a few funds, you should seriously consider investing in a low-cost index fund for the majority of your investments; specialty managers could be used for smaller percentages of your assets.
- Lastly, fight the urge to invest in a new fund unless it truly covers new ground in terms of asset category and can be a meaningful part of your total portfolio.