There are numerous individuals who could earn for themselves that 1% to 2% advisory fee they are paying to someone else in a mutual fund.

For Chronic Fundaholics: Becoming Your Own Stock Portfolio Manager

By James B. Cloonan

Our latest survey of AAII members' asset allocation [see page 2] indicates that the percentage allocated to stock mutual funds has reached a new high of 39% (the other allocations at the same time were: stocks 29%, cash 19%, bonds 6%, and bond funds 7%). The stock and stock mutual fund allocations combined total 68% (39% + 29%), a higher amount in equities than has been allocated in recent history, and some would say this makes the market vulnerable. The amount allocated to equities, however, has been at record levels since early '91, and the market hasn't seemed to notice.

Of more concern to me is the new dominance of stock mutual funds over directly held equities. While I might expect this in the general population, I think AAII members should be able to manage their portfolios as well as the vast majority of fund managers, unless time is a severe constraint. I understand that there are many reasons for using mutual funds, and I know that not everyone should be managing their own money. But I feel that there are numerous members who could earn that 1% to 2% (maybe more with a load) that they are paying someone else in a mutual fund, and perhaps they could get better results as well.

To help those who would like to do more managing themselves, I will use this column to look at the various styles of stock portfolio management, and work through some of the concerns that seem to encourage individuals to use funds rather than do it themselves.

That said, there are some investors who should stick with mutual funds. These include:

- Investors without enough time to manage a portfolio;
- Investors who simply have no interest in stock investing; and
- Most importantly, those who cannot generate the discipline to follow a program once they have committed to it.

In addition, the newer investor with less than $25,000 probably should start out with mutual funds in order to diversify and avoid high commissions (as a percentage of the amount invested).

The first step for "fundaholics" in becoming their own managers might well be the Beginner's Portfolio. I will bring you up to date on that portfolio later. But I want to go beyond that in this series and look at various ways individuals can trade off risk for yield and find a portfolio management style, or combination of styles, that is comfortable for them.

A final plug for "doing it yourself": Years ago when commissions were fixed and there were fewer restrictions on specialists and market makers, mutual funds, with their larger transactions, had an efficiency advantage. Now they really have a disadvantage. Large transactions push the bid/ask spread (the spread between the price you can sell the stock for, and the price at which you can buy it) and, except where they can find another mutual fund that wants the opposite side, mutual funds tend to pay more for stock than you would—particularly if you are trading in 1,000 share lots or less.

Also, as we have often mentioned, there are thousands of companies out there that mutual funds cannot invest in because of their small capitalization. Finally, you can time buying and selling to your tax situation and, thus, get a better aftertax return than you might by investing in a mutual fund.

As I mentioned earlier, the Beginner's Portfolio would be a good place to start. Over the last 3½ years it has outperformed the S&P 500 index with lower volatility (risk) and it has not required much more management time than selecting mutual funds.

The Beginner's Portfolio (which as of this writing is up 13.7% for the year) is based on two criteria that academic studies have shown to provide excess returns (returns higher than expected given the risk level) over the years:

- Small market capitalization, and
- Low price-to-book value ratio.

In addition, new research gives substantial, although still not fully developed, evidence that a low price-to-sales ratio provides a strong correlation with higher returns (as reported in the March/April 1996 issue of the Financial Analysts Journal). I find it convincing; and while I would not replace our other two criteria with it, I feel it should be added to the model.

In the next column, I will review the Beginner's Portfolio with the new criteria. It will be the first step in our series on being your own portfolio manager.

James B. Cloonan is chairman of AAII.