At first, the mutual fund was a beautiful concept.
Any investor, of any net worth, could invest and gain access to professional portfolio management. It meant the person on the street could save and build hope for the future.

Times have changed.

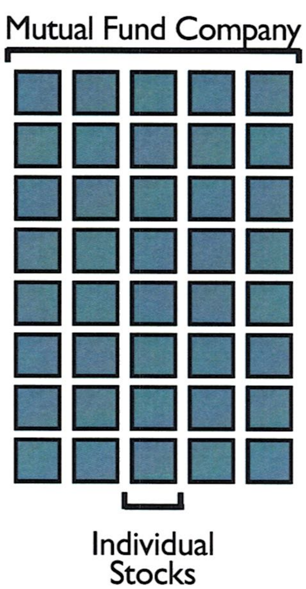
Maybe your investment habits should too.

Let us share some information that might help you grow your wealth.

We're going to take you behind the scenes of one of the largest industries in the world—mutual funds—and show you how that industry affects investors. We would like to share some information with you to give some additional transparency about the mutual fund industry that today's financial media may not regularly comment on. Let's take a look at the good and the bad in mutual funds, and then provide you with some ideas of what you can do to improve how you invest. Our goal is that you become better informed—and, hopefully, wealthier over time.

What is a mutual fund?

Since their inception in 1924, open-end mutual funds have been a fast growing, profitable industry. At the time of the Great Crash in 1929, 19 mutual funds existed[1]. At year-end 2011, there were more than 8,600—approximately three times the number of companies that trade on the New York Stock Exchange[2]. Most of this growth has occurred over the past 20 years[3]. Almost one half of all US households (52 million) have investments in mutual funds[4].



A mutual fund is a professionally managed collective investment that gathers money from many individual investors to purchase securities. Theoretically, by having access to a larger pool of money, the company is able to create a diversified basket of investments that can be accessed by many small, unrelated investors.

Investments in a mutual fund may not be limited to just stocks. Some mutual funds invest in bonds, commodities, real estate, currencies, art, precious metals and more (or any combination of these). An investor can find a mutual fund company that will specialize in just about any asset class or mix imaginable.

1 A Brief History of the Mutual Fund, Investopedia.com
2 Ibid.
3 2012 Investment Company Factbook, The Investment Company Institute
4 Ibid.

Mutual-fund structure is unique in that it provides:

- Easy access to lots of different securities. Instead of having to research and buy possibly hundreds of stocks and pay commissions on each, an investor can buy shares of this pooled company.
- Easy access for small investors. As long as an investor has enough money to buy a minimum number of shares they can be an owner.
- Easy liquidity. Shares can easily be bought and sold at the end of each business day.
- Access to professional wisdom. Mutual funds typically hire experienced people to manage these companies.

Doesn't the investor profit most from mutual funds?

Unfortunately, it's not that simple.

At the end of 2009, the more than 7,600 mutual funds of all types in the United States had combined assets of $11.1 trillion. The Investment Company Institute, a national trade association of investment companies in the U.S., reports that mutual fund assets were $23.6 trillion worldwide on the same date. In an industry this size the net profits are huge— estimated at $75.7 billion[5].

EVERY DOLLAR OF EXPENSE THAT YOUR MUTUAL FUND INCURS IS A DOLLAR THAT YOU DON'T GET TO KEEP.

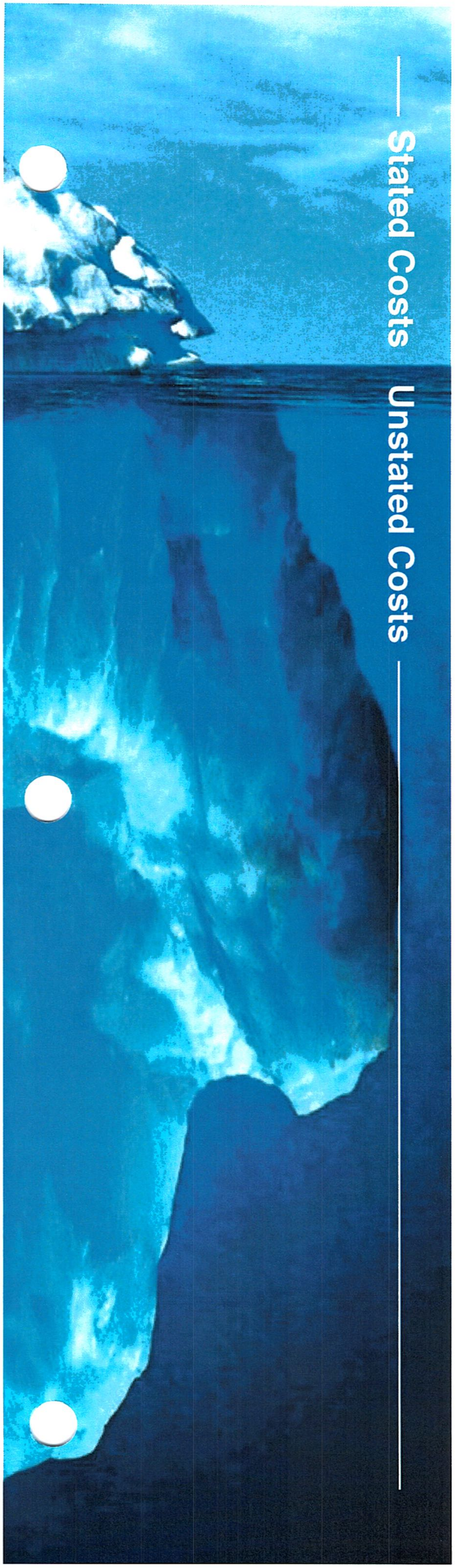
MUTUAL FUNDS CAN INCUR MANY EXPENSES, ONLY SOME OF WHICH ARE REVEALED IN THE FUND'S PROSPECTUS.

Three groups can profit from mutual funds:

1. The companies that create these funds. For the most part, the investment firms that create mutual funds make money from the fees they charge to manage and administer them.
2. The brokers that sell shares of mutual funds to their clients and generate commissions and fees.
3. The investors that buy shares (provided the investments actually make money).

As we move forward in this paper, we will see that companies and brokers almost always make money from mutual funds. Unfortunately, such is not always the case for investors.

5 Statistical Abstract of the United States 2012, U.S. Census Bureau



Mutual funds support an enormous industry and all elements take their cut.

On the periphery of the companies that create and manage mutual funds, a whole industry has sprouted up that provides information and services to investors. These include:

- Custodians to hold the funds
- Sales and wholesaling organizations to distribute and market funds
- Law firms specializing in mutual funds
- Accounting and reporting firms
- Mutual fund ratings services
- Mutual fund newsletters

A river of money flows through the mutual-fund industry, supporting hundreds of thousands of jobs and creating substantial profits for the companies involved. When any industry becomes this well entrenched in an economy and the profits are as large as they are, it invites not only greater efficiencies but also potentially ruinous competition in the long run.

Educated investors and U.S. government regulators are starting to take a hard look at the industry and what goes on behind the scenes of mutual funds. Stick with us for the rest of this paper as we outline eight of the problems and inequities we have identified for investors and how they can use this information to help themselves.

Eight things you may not know about Mutual Funds

1. Expenses can be much higher than you think.

An investor's goal is to keep as many dollars as possible, and to do that investors must keep expenses as low as possible and total returns as high as possible. Two types of expenses work against an investor's goals: stated and unstated. Together they produce a formidable obstacle for growing wealth.

Stated Costs	Unstated Costs
Administrative fees	Trading costs
Management fees	Commissions
Marketing fees	Market impact costs
Loads	Taxes

Stated expenses are listed in a mutual fund's prospectus. Most investors know to check the expense ratio of a fund to determine the stated costs. According to the Investment Company Institute, the average expense ratio in an equity mutual fund is 1.4 percent per year. Remember that this is the average—many are substantially higher (especially in smaller funds, where there are fewer investors to share those costs). The higher the expense ratio, the less the investor stands to gain. Unstated expenses are more difficult to quantify and not required by law to be disclosed (yet). Like an iceberg, the unstated costs below the waterline may dwarf the stated costs that are easily visible above. Let's look at those unstated expenses.

Trading costs

Found in all securities transactions, these can really magnify the expenses in large, active funds. Also known in the industry as the bid/offer spread, trading costs are buried in the internal workings of each fund. Trading costs are the difference between the price a buyer is willing to pay for a security and the price at which the seller is willing to sell. Each time a mutual fund manager buys and sells securities, the fund incurs small trading costs. The greater the trading activity, the higher the trading costs for the fund and its shareholders. A 2009 study of thousands of U.S. equity mutual funds discovered that trading costs investors, on average, **1.44 percent**.[6]

Transaction commissions

These are almost impossible to avoid because there is a cost to process any trade order. Even large mutual funds are not exempt from these fees. Because the trade sizes are usually larger, most mutual funds operate in a very low commission structure (pennies per share), but the costs are always there. Again, the more active a fund is, the more potentially negative the impact on fund owners. Although relatively simple to quantify, the SEC does not require these costs to be stated in the expense ratios of mutual funds.

Market impact costs

This is potentially one of the greatest costs to shareholders. There are concessions in price to which all institutional investors are subject when they execute larger trades. When funds executes these trades, it can move the

WHEN ALL EXPENSES ARE ADDED TO THE STATED COSTS IN A FUND'S PROSPECTUS, AN INVESTOR MAY FEEL LIKE A RACEHORSE WITH A 350-POUND JOCKEY ON ITS BACK.

6 The Hidden Costs of Mutual Funds, Wall Street Journal, 3/1/2010

price of a security higher (for buying) or lower (for selling) in the marketplace because of their sheer size and liquidity conditions. For example, when an individual sells 200 shares of Apple stock in the market, the price of the stock will barely move. If a large fund manager sells 200,000 shares, it could move the share price significantly lower.

The relative burden of these market impact costs on a mutual fund portfolio can be estimated, given the total size of its portfolio, the number of issues, the median market capitalization of the issues in which the fund specializes and the fund turnover rate[7].

Taxes

Tax implications for mutual fund investors are so important that we've given the subject its own section. Learn about tax inefficiencies on page 8.

Why aren't these trading costs reported by the mutual funds?

Mainly because calculating a precise number is difficult, and there is no standard method of doing it, so most companies will not report these costs until they are mandated to. It is not, however, difficult to come up with rough estimates of what unstated expenses actually cost shareholders. The key for an astute investor is to look at a measure called *turnover*, which funds do disclose, and which can be used to estimate transaction costs. Stephan Horan of the CFA Institute (a non-profit professional organization) estimates this cost to be 1% to 3% annually for equity funds.[8]

HIGH INVESTMENT EXPENSES COMPOUNDED OVER SEVERAL DECADES CAN BE A VERY BIG DEAL FOR AN INDIVIDUAL INVESTOR.

How could these costs affect the average investor?

A 55 year old with $250,000 in a savings plan begins to generate income at age 70. If he earns an average of 5 percent over 15 years, his nest egg will grow to $519,732. If he is charged just 2 percent annually by his mutual funds, the same $250,000 will be worth only $389,492—a difference of $130,240 for his retirement funds.

Remember, the impact of fund expenses reduces the compounding effect forever. The impact of high fees gets even more frustrating once the investor begins taking withdrawals from his funds. If he takes an annual income at age 70 of 5 percent to maintain his lifestyle, the fees result in an actual drain of 7 percent (40 percent more than his required income). As this impact causes his nest egg to shrink further, it requires larger and larger distributions to maintain the same lifestyle. The potential web of fees above should give investors a reason to pause and reevaluate when they choose a *retail* mutual fund path.

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7 Mutual Fund Efficiency and Performance, Dow Publishing Company, 2007
8 The Hidden Cost of Mutual Funds, Wall Street Journal, 3/1/10

2. Mutual funds can be tax inefficient

When someone buys a share of a publicly traded mutual fund, he or she is buying a share of an existing company that owns many individual investments, each with its own pre-existing tax liabilities. Whether or not that person ever sells those shares, he or she is responsible for a proportional share of the existing tax liabilities. The way mutual fund accounting works, a fund must pay out at least 90 percent of any investment income earned and 98 percent of any realized capital gains. The internal trading activity of the fund manager and fund inflows and outflows affect all shareholders, even though they may have personally performed no trading during the year.

If a fund has assets that have appreciated over time, and they sell them during the current tax year, it could create a situation where a new investor buying shares could inherit the tax liability of existing holdings. For example, an investor purchases 10 shares of an equity mutual fund for $10 per share (total investment of $100). Shortly thereafter, the mutual fund passes through a $2 per share short-term capital gain that has built up during the previous 12 months. If we assume that the shareholder simply reinvests all dividends and capital gains, here is what happens:

Starting value	$100	10 x $10
Capital gain	$20	$2 per share
New share price	$8	$10 minus $2 capital gain distribution to shareholders
Capital gain reinvested	$20 ÷ $8 per share	2.5 shares purchased
Ending value	$100	12.5 x $8

The only difference is that the shareholder now has an unexpected tax liability. Assuming the $20 short-term capital gains distribution is taxed at 25 percent, he or she has a $5 tax liability that reduces the value of the investment to $95. Direct owners of stocks are allowed to defer taxation on the appreciated value of their stock shares, while mutual fund shareholders may be forced to pay taxes yearly, even if they don't sell any of their own mutual fund shares!

How about losses? When a fund experiences net realized losses during the year, it does not have the ability to pass along these losses to the shareholder to offset against ordinary income up to $3,000 (as the shareholder would if he or she had purchased individual investments).

The inability to control their own taxes can frustrate investors and create a serious headwind for investment performance.

IF INVESTORS SIMPLY BOUGHT AND HELD THEIR FUNDS IN 2000, THEY WOULD HAVE BEEN BETTER OFF BY 1.6 PERCENT ANNUALLY BY 2010.

2010 Morningstar Study reported in New York Times article "The Mutual Fund Merry-go-round" (2011)

3. Mutual fund performance: mixed results.

Many mutual fund companies face a conflict between providing maximum performance for investors and generating profits for themselves. If you pick up a typical issue of Barron's or Money Magazine it is clear that mutual fund companies spend gargantuan sums advertising and promoting their funds in order to gather assets. Many pay brokers handsome incentives to get them to favor their products as a solution for clients. As noted above, all of the fees, costs and ancillary expenses associated with running a mutual fund work in direct conflict with maximizing returns to investors.

It is no mystery that most mutual funds have a difficult time providing above-average returns. The majority of funds have a goal to *beat the market.* That normally means they are charged with the task of outperforming a given benchmark index, such as the S&P500 Index, the Dow Jones Industrial Average or the Barclays Aggregate Bond Index, etc. If a mutual fund is faced with an expense hurdle of several percentage points, it is extremely difficult for most managers to keep pace with any benchmark index. Only a minority of fund managers are able to beat their benchmarks—and that minority is constantly changing.

IN MID-2012, 73.24 PERCENT OF ACTIVE DOMESTIC STOCK MUTUAL FUNDS WERE UNABLE TO BEAT THE BENCHMARK S&P 500 COMPOSITE INDEX OVER THE TRAILING THREE-YEAR PERIOD.

US News and World Report article "Index Funds Still Beat Most Managers" 10/12/2012

Survival of the fittest

One thing inherently wrong with the statistics commonly quoted by the mutual fund industry is that the sample of funds used includes only those funds that are still active. Each year, hundreds of mutual funds close their doors and either cash is returned to investors or funds are merged together. The main cause of this is poor performance (causing investors to abandon the fund). When a fund closes, it is no longer included in the studies. This leads us to believe that the percentage of fund managers underperforming their benchmarks is even higher than stated.

Chasing stars and comets

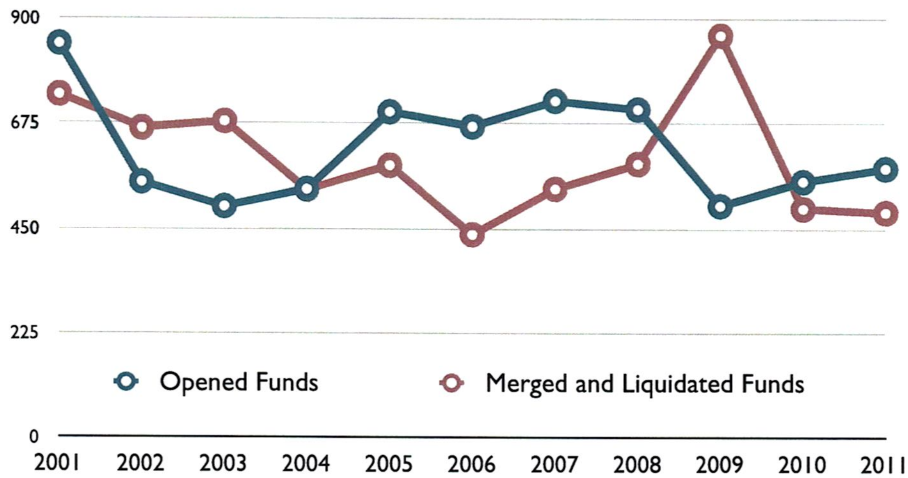
Mutual fund companies focus their efforts on promoting funds that are awarded four or five star ratings from Morningstar (a Chicago-based ratings firm). Unfortunately, these ratings identify only those funds that have performed well in the past—but provide little help finding those that will do well in future.

> *According to a study done by the Vanguard group, they found that that a given rating offers little information about expected future relative performance; in fact, the analysis reveals that higher-rated funds are no more likely to outperform a given benchmark than lower-rated funds.*[9]

In addition, most individual investors also follow the latest star ratings. Knowing the above facts, investors continue to pour money into four- and five-star funds year after year, chasing past performance. Chasing performance is not unlike chasing shooting stars and comets. In a tribute to the effectiveness of advertising, almost 90 percent of new mutual fund money inflows go to these historically top-performing funds. This behavior often results in selling poor-

9 Mutual Fund Ratings and Future Performance, Vanguard Research, 06/2010

Number of Mutual Funds Leaving and Entering the Industry



Each year, hundreds of mutual funds close their doors or are merged together.

performing funds when they are low and buying *better* ones when they are high. Poorly timed selling and buying activity like this takes its toll on investor performance over time. A 2010 Morningstar study stated that if investors simply bought and held their mutual funds in the year 2000 (without the selling and buying activity), they would have been better off by 1.5 percent annually (it should be noted that that past performance is not a determinant of future returns).[10]

The study also found that investors tend to do worse when they participate in this type of activity with funds that are more volatile (equity funds). Human nature is partially to blame for this. When the markets experience a large downward swing, people tend to panic and sell their investments that are down the most (selling low). On the contrary, when equity markets surge, investors tend to jump in at just the wrong time (buying high). Those that hold less volatile, more diversified funds tend to weather these storms better.

THE QUESTION INVESTORS SHOULD ASK THEMSELVES IS WHY WOULD I PAY MORE FOR ADVICE THAN I HAVE TO?

Too much cash, too little interest

Another reason that many mutual funds may underperform over the long-term is that they typically hold significant amounts of cash. Mutual funds are constantly receiving new money contributions and requests for redemptions. When new money is received into the fund, there is often a delay before the money is allocated to securities purchases. If the market is rising, this works to the detriment of the shareholder. At the same time, funds must hold a certain amount of cash to meet end-of-day redemptions. Especially in a low interest rate environment, cash earns virtually no interest and no dividends and works against performance for shareholders.

10 Bad Timing Eats Away at Investor Returns, Morningstar, February, 2010

4. Share classes exist to compensate intermediaries.

Investors are generally unfamiliar with the jargon that surrounds mutual funds. Funds tend to have several share class options that could impact investor returns. These include (but are not limited to):

A Shares—Also called front-end load shares, this share class can charge a sales commission, at the time of purchase. For example, if you invest $100 into the Mutual Fund that has a 5% sales load, only $95 is actually invested inside the fund. The commission goes to pay your stockbroker.

B Shares—Also referred to as back-end load shares, these shares charge no commission up front. The broker receives compensation through a combination of higher marketing fees (12b-1 fees) and contingent deferred sales charges (CDSCs), charged if you sell your shares before six to seven years. *B* shares typically have higher expense ratios during this period.

C Shares—There is typically no front-end sales load on these shares. However, normally a 1 percent CDSC is charged against the customer's holdings if these shares are sold during the first year. A higher 12b-1 fee will continue to be charged against the portfolio until the shares convert to other share classes as stated in the prospectus.

The whole share class system exists as a way to get various intermediaries compensated. The fact that mutual funds are sold by securities brokers means that the funds must charge higher loads and commissions to provide a broker's compensation. It's not uncommon for funds to have many different share classes. Investors have the choice of which type of fund they like, or they can seek out other vehicles that can carry potentially lower expenses that may benefit them over the long term. An option is to work with a fee-based advisor, who is compensated based on an agreed-upon annual advisory fee for their guidance, no matter which investments they recommend.

MANY TALENTED MANAGERS ARE DEFECTING TO THE HEDGE FUND INDUSTRY.

5. Loss of talented managers hurts mutual funds

Historically, mutual fund companies have attracted well-trained, smart, talented people to manage their funds for them. One of the goals of a fund manager is to provide superior investment performance to investors. Because of the high cost structure, large fund size, strict investment prospectus guidelines and tax inefficiency in mutual funds, it has become difficult for talented managers to deliver above-average performance. An investment manager may have a great investment idea but find that the mutual fund is so large or has so many restrictions that the strategy is impossible to implement.

Many talented managers are defecting to the hedge-fund industry, which now manages more than $2 trillion and is growing rapidly. The compensation in hedge funds is often significantly higher and the structure allows more freedom to invest "outside the box". Not only do mutual funds and hedge funds carry very different levels of risk, they are also subject to different regulations.

6. Misleading ads and limited disclosure create confusion

You can open almost any financial publication and see an advertisement for a mutual fund that has a catchy name, a smiling face, a graph with arrows pointing higher or maybe some stars. These ads could lead an investor to make a wrong turn. Unfortunately, it is up to a mutual-fund buyer to try to figure out exactly what he is investing in.

Fund names can be confusing. The Securities and Exchange Commission (SEC) requires that funds have at least 80 percent of assets in the particular type of investment implied in their names. How the remaining assets are invested is up to the fund manager. A fund with a name like *The United States Income Fund* sounds like it would be composed mostly of fixed-income investments, when in fact it may have only 20 percent of its assets allocated there with the remainder in income-generating stocks. Is it safe or risky? What is in a *growth* fund? Is it small cap stocks, international stocks, emerging market stocks, commodities? These questions need careful research.

Additionally, information released to the public is often limited, delayed and outdated. Mutual funds are required to release accurate information on a quarterly basis. It is virtually impossible to know what happens in the interim. If asked, most investors would probably prefer to use a more transparent vehicle where they know exactly where they have invested each of their hard-earned dollars at any given time.

IT IS UP TO THE CONSUMER TO DIG INTO THE DOCUMENTS TO SEE HOW THE RIVER OF MONEY FLOWS.

7. A bond mutual fund is not a bond

If you purchase a 20-year bond, its price sensitivity to changes in interest rates declines as the bond moves closer to maturity (i.e., the older the bond gets, the less interest rate changes affect your principal). If you buy a bond fund that has an average maturity of 20 years, you're dealing with a different animal. The bond fund does not have a maturity date. Quite often the fund maintains a fixed average maturity that does not decline over time. If you are a conservative investor that has adequate assets and your desire is to maintain a fixed stream of interest payments, an individual bond may serve your purposes better than a bond fund. It is up to the individual investor to take on the risks appropriate to his or her situation.

Moreover, a bond mutual fund may use leverage to increase its yield, or to pay for internal fees and commissions. This leverage may serve to magnify the holder's principal risk.

8. The murky river of money flows deep

Let's figure out where more of the money goes by talking about soft-dollar payments and shelf-space payments.

Soft-dollar payments are the payments made by mutual fund companies to brokerage houses. The reason they are called "soft" dollars is that, rather than pay brokerages in cold, hard cash, mutual fund companies direct trading activity to certain brokerages, generating commissions for them. This enables mutual fund companies to pass along the cost of services like research and software to the fund's shareholders, and can be a tremendous profit center for brokerage firms. FINRA, the Financial Industry Regulatory Authority (formerly NASD, the National Association of Securities Dealers), has brought numerous actions where the direction of soft-dollar payments has been linked to the sales volume of a particular mutual fund's shares by a brokerage firm.

Shelf-space payments are akin to what happens in supermarkets when competing brands of cereal pay for prime shelf space so their products will be displayed at eye-level for consumers. In the mutual-fund industry, companies often provide revenue-sharing arrangements with brokerage firms in exchange for the brokerage recommending a specific fund to clients. This is an obvious conflict of interest and not necessarily in the client's best interests.

It is up to the individual investor to take on the risks appropriate to his or her situation.

Such arrangements, also called *pay to play*, have been particularly prevalent in 401k plans that primarily use mutual funds. According to the General Accounting Office, any company that administers a 401k plan "may also be receiving compensation from mutual fund companies for recommending their fund … As a result, participants may have more limited investment options and pay higher fees than they otherwise would." [11]

These activities result in billions of dollars changing hands. Does it sound unfair? Mutual funds are required to disclose these activities in their prospectuses but consumers need to read the documents thoroughly to become aware of such practices.

Graduate to SMAs

We've shown you what concerns us about today's mutual funds. We admit they can be a good way for small investors to begin their savings plan and build a critical mass of assets. But once you start to accumulate significant assets, you have access to potentially more efficient investment options.

If you are in this situation, we encourage you to consider institutional separately managed accounts (SMAs) held by a reputable custodian.

11 Report #GAO-07-530T, General Accounting Office, March, 2007

An SMA is a portfolio of assets under the management of a professional investment firm. In the U.S., these firms are called registered investment advisors, or RIAs.

Like mutual funds, SMAs provide access to professional money management and diversification. At the same time, they provide the following benefits:

Potentially lower overall expenses
Compared to mutual funds, many of the costs of ownership—such as marketing fees and tax costs—may be lower in the SMA structure.

Tax efficiency
Since an SMA is composed of individual securities with an individual cost basis, your institutional manager can use this information to control the amount and timing of gains and losses. He can employ strategies such as tax-loss harvesting to reduce the overall tax drag on your portfolio.

Customization
Because your institutional investment manager is choosing individual securities, you can choose not to invest in certain companies or certain sectors of the market. Virtually any investment requirement can be satisfied. Because you will be working with an investment advisory representative (IAR), the concepts of shelf space, soft dollars and commissions will become less important. Your IAR will help you design the best portfolio possible, tailored to your needs—rather than one that is just "okay".

Control the maturity of your bond portfolio
Especially today, when interest rates are near historic lows, it may be more important to control the overall maturity (or duration) of your fixed-income portfolio, as well as have the ability to adjust quickly as market conditions change. SMAs can help you achieve that.

Transparency
The owner of an SMA can see everything that happens, including trading costs and any other deductions from their principal investment.

A tested and effective investment strategy
SMAs have been around since the 1970s. They were developed to accommodate larger clients who needed to meet specific objectives that did not fit the mutual fund structure. Technological changes have made it possible for investors to access SMAs with as little as $25,000. As of 2012, there is more than $2.7 trillion invested in SMAs in the U.S, and the amount is growing.

LIKE MUTUAL FUNDS, SMAS PROVIDE ACCESS TO PROFESSIONAL MONEY MANAGEMENT AND DIVERSIFICATION.