

Thinking diversification? Go beyond conventional wisdom

Any money manager worth his fees will tell you that to protect your assets, your portfolio should include a variety of investments.

Conventional wisdom says that one of the best ways to do this is to rely heavily on mutual funds. But as is often the case, conventional wisdom is too conventional. Mutual funds have their place, but a serious investor with a significant amount of investment capital needs to look at other options.

A laddered portfolio of individual debt instruments and a well thought out exposure to the equity styles can provide the security of diversification, more consistent returns over time, and better tax advantages than are offered by mutual funds.

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A well-diversified portfolio can help protect you in a volatile market. However, mutual funds often provide too much of a good thing. The reason so many mutual funds hold 100 or more securities is because fund managers often cannot buy enough of the stocks they want, so they buy second- and third-tier issues to remain fully invested – and generate second- and third-rate returns. Simply put, most mutual funds do not out perform the market. When you deduct the mirage of fees, you are left with underperformance.



GUEST COMMENTARY

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Owning your own investment portfolio puts you in charge of your money. Where as, being an owner in a mutual fund subjects you to the behavior of the other owners. Suppose you have a year in which several other owners call for disbursements. The fund manager may sell off shares to raise the cash to pay them.

Now suppose this happens in a year in which the fund also loses market value. Not only did your investment lose money, you still have to pay capital gains on the shares sold. Without doing anything at all, you get hit with a double negative.

What about bond funds? In an environment of rising interest rates, the market price of bonds falls. If that happens, you can lose principal if you are invested in a bond fund. With an individual bond, there's a definite maturity date at which you will get your principal back, regardless of what interest rates do. Moreover, you are much more able to manage the credit risk associated with these debt instruments.

And consider what you leave behind to loved ones. A long-term investor who holds good securities that have appreciated over time receives a step up in the cost basis of those securities at the date of his or her death. Needless to say, this will minimize the taxes owed by the investor's heirs.

For example, if you purchase shares of a stock at \$2 and they increase in value to \$20 by the time of your death, your heirs pay capital gains taxes on the current value, not on the growth from the original purchase price. This is somewhat more problematic with mutual funds, which is why they often work best in tax-deferred accounts such as IRAs and 401Ks.

If your investable assets are of significant size to engage a firm to build your own "mutual fund" of sorts, you are likely to get many more services than just portfolio management. Many firms will assist with estate and retirement planning, estate administration, and if they have trust powers can serve as trustee of your trusts. Further, you may find that these bundled services will cost you less than what you are currently paying for the mutual fund with an 800-number.

All of this is not to say that there are no advantages to investing in mutual funds. Mutual funds and exchange-traded funds are great vehicles to provide diversification when an investor does not have the assets to build his or her own diversified portfolio. Funds can also be a good way to expose your portfolio to unique asset classes such as emerging markets and commodities.

But if you have a significant amount of capital to invest, you can expect better overall results by putting your money into individual securities, rather than mutual funds. As always, you should seek the advice of a wealth management professional for a recommendation specific to you.

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