Are Mutual Funds Most Suitable for You?

SevenBridge Financial Group

Clinton G. Smith III, CPA

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Mutual funds are one of the most popular investment vehicles for investors in the United States and abroad. The *Investment Company Institute* published a statistic in 2017 indicating there are $49.3 trillion invested in open-end mutual funds globally ($22.5 trillion held in the United States). These funds offer certain characteristics to investors such as professional management, diversification opportunities, and compliance with regulatory requirements.

At SevenBridge Financial Group, we understand the benefits of mutual funds, but we also consider the disadvantages. As a part of our fiduciary duty and commitment to our clients, we develop a comprehensive financial plan and invest our clients' assets in mutual funds only when the benefits outweigh the disadvantages and when these funds are the most appropriate investment vehicle to achieve our clients' goals.

One of the several disadvantages to mutual fund investing is the difficulty in managing capital gains taxes in taxable investment accounts. For mutual funds to remain tax-exempt, funds are required to distribute substantially all income each year. Some income is distributed in the form of dividends, which are usually tax advantaged, but there is no such protection for capital gains distributions. Depending on income, these capital gains distributions are taxed at 15% or 20% plus net investment income tax. There is no discretion held by the investor as to the timing or magnitude of capital gains distributed by those funds.

Another disadvantage experienced by mutual fund investors is in investment costs. Fees charged by mutual funds are confusing and hidden in many cases. Many funds charge a front-end or back-end sales charged known as "load" levied when the investor purchases or sells shares. Some fees are defined in a fund's expense ratio, including management fees, operating expenses, and 12b-1 fees (sales, marketing, and service fees). Finally, in funds with high investment turnover, there could be sizeable commissions paid based on buy/sell transactions within the fund. In total, mutual fund fees can range from 2% to 4.5%. Over the long run, these excessive and complicated costs can have a major negative impact on a client's portfolio growth.

The last significant disadvantage that we weigh is the lack of ability to manage proper diversification. Proper diversification within an equity portfolio can be achieved by holding as few as twelve securities within several sectors. Most mutual funds own between 150 and 200 securities. Add to that the fact that most investors hold shares of several mutual funds in their portfolio, and ultimately, a single investor could easily hold thousands of different equities. There is a high likelihood that these holdings overlap each other and are difficult to manage holistically, which could actually increase concentration risk.

At SevenBridge we utilize our experience and best in class technology to manage individual portfolios for our clients to help them meet their objective, often focused on capital preservation, growth, and income. Using portfolios with a foundation of individual equity securities provides a significant advantage over mutual funds as we can effectively manage diversification and tax efficiency at a fair and transparent cost to our clients.

Contact us at SevenBridge for more information on our investment management philosophy.

Clinton Smith III is the senior relationship manager with SevenBridge Financial Group, a wealth management firm with offices in Harrisburg, PA and Denver, CO.

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