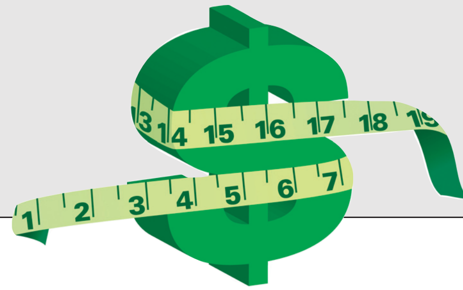

Mutual Funds in Your Trust Fund?

It's Important to Understand What's Underneath the Hood

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Do your preneed or perpetual care trust funds hold mutual funds? If so, it is crucial that you understand the dynamics of mutual fund investing and why this structure can produce drastically different results when compared to investing in stocks or bonds directly.

Here is a common scenario for a funeral or cemetery operator:

• You meet with a trust company or investment manager (adviser) to share your objectives and risk tolerance for trust portfolio planning.

• The adviser prepares a portfolio proposal for review and approval.

• The adviser is hired and immediately invests the trust assets using a platform of mutual funds.

You entrust the adviser with the critical role of investing your preneed or perpetual care trust funds. In exchange for their services, you agree to pay a management fee to the adviser, which is commonly a percentage of the balance of the trust. But what do they really do?

As soon as the adviser takes control of your trust assets, they immediately invest in mutual funds. In other words, they hire somebody else – a mutual fund manager – to actually select the stocks and bonds in your portfolio.

But wait, the mutual fund manager is not who you met with during the planning process. The mutual fund manager doesn't understand your objectives or risk tolerance. The mutual fund manager is not designing a portfolio specifically for you. In reality, the mutual fund manager is likely managing a portfolio of stocks or bonds for thousands of investors, and your trust assets represent a small fraction of the mutual fund's total portfolio.

So, what's the harm in this approach?

• You just bought into a program designed for the adviser but not for you. The mutual fund manager has no idea who you are and what you are trying to accomplish.

• The mutual fund manager does not work for free. Whether you realize it or not, you are paying an additional layer of fees for hiring this manager.

• There are many inefficiencies within a pool of mutual funds, which may impact the long-term total return potential of your trust.

Make no mistake, not all mutual funds are created equal. There are many low-cost fund structures that could play a role in an investment portfolio depending on your needs, goals and risk tolerance. But in reality, the low-cost funds are often not what is selected for preneed and perpetual care trust portfolios. While there are many issues to consider when investing in mutual funds, here are four themes that should be top of mind when evaluating the mutual funds in your trusts:

Fees: You pay your trust company and investment manager a fee, which is debited from your trust fund on a monthly or quarterly basis. This fee should appear on your investment statement as any other transaction would. A common misconception is that this is the only fee charged ... incorrect. If your trust is invested in mutual funds, this may only be a portion of the "all-in" investment fees charged. Remember, the mutual fund manager also charges a fee based on the assets he or she manages, commonly called an expense ratio. This expense ratio does not appear as a fee on your account statement. Instead, the mutual fund expense is directly debited from the value of the mutual fund. Mutual fund expense ratios can range from as little as a fraction of a percent to as much as multiple percentage points. The bottom line is when you are utilizing these types of investment structures, you probably have no idea of the total costs, which result in a drag on the overall return.

Customization: In many cases, a

trust company or investment manager will outsource to multiple mutual funds when investing your trust portfolio. Each mutual fund manager within your trust portfolio is working in a vacuum, with no knowledge, communication or coordination with the other mutual fund managers in your portfolio. Nothing is customized to you as the client.

So, what's the end result? You may end up with hundreds, if not thousands, of underlying stocks and bonds within the mutual funds in your portfolio. Well, isn't investment diversification a good thing? Yes, if structured correctly. In reality, there is often significant overlap in investment strategies and styles among your various mutual funds. In fact, you may be paying multiple mutual fund managers to invest in many of the exact same stocks and bonds. You might ask: Isn't my trust company or investment manager monitoring this process? It is not practical to assume a trust company or investment manager can understand the dynamics and risk of thousands of underlying stocks and bonds, and of course, this mix of investments is not specifically tailored to you as the client.

Cash drag: Your trust has ongoing cash needs. As such, you account for these liquidity needs by instructing your trust company or investment manager to maintain a small cash balance in the trust. This is a common dynamic in portfolio management. It is the exact same dynamic that a mutual fund manager faces. A mutual fund manager must maintain a certain percentage of cash in their funds to meet redemption requests from investors. Remember, you are one of thousands of investors that the mutual fund works with, all with varying ongoing liquidity needs. As such, the mutual fund itself may hold a substantial amount of cash within the fund. Hence, while you may think your assets are invested appropriately, a large cash balance may exist earning practically nothing. This can severely impact the total return potential of your trust.

Bond funds: Bonds often represent a portion of a portfolio for preneed and perpetual care trust funds. In many ways, bonds serve as the "sleep well" exposure in an investor's portfolio. When the stock markets are rocky, investors may take comfort in knowing that their bond investments are often less volatile and may actually appreciate during stock market turbulence.

Unfortunately, many advisers do not use individual bonds but utilize bond mutual funds instead. This is substantially different and, at times, adds risk to the "sleep well" feeling. When you invest in an individual bond, you are loaning a company or government your money for a specified period in exchange for a specified interest rate. Assuming the company or government is still in operation when the bond contract reaches its expiration date, you receive your original loan balance (or principal) back, along with all of the interest payment collected along the way.

When investing in a bond mutual fund, you are not entering into a contract directly with a company or government. Instead, you are investing in a fund holding a collection of bonds. There is not an expiration date for the mutual fund. Rather, there is the ongoing process of the mutual fund manager buying and selling bonds to maintain a constant maturity into the future, and allowing for cash inflows and outflows to the fund. This can be a relatively smooth process when interest rates are falling but can create all sorts of issues when rates are increasing. The manager may be forced to sell bonds at a loss (as rates rise) or to meet redemptions at inappropriate times. This may or may not be reflective of what you need.

Conclusion

So why do this? Why hire a trust company or investment manager for their investment expertise when they turn around and outsource the investment process?

The "why" is easy to answer from the trust company or investment manager's perspective. Outsourcing to mutual funds is easy and presents a more scalable model. It eliminates the adviser's day-to-day investment decisions at no expense to themselves and allows the adviser time to focus on finding more assets.

The "why" for an owner or operator is more difficult to answer. However, the solution is to invest like a business owner. Specifically, purchase individual stock and bond securities that are tailored to address your goals and cash flow requirements for a given amount of risk you, as the owner, are willing to assume. In this manner, you alleviate a middleman and build a direct relationship with a portfolio manager. •

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COMING NEXT MONTH:

For funeral professionals, financing is at the core of their businesses – from borrowing money to expand operations to running a leaner operation to planning for retirement. We'll give you the information you need to help put your financial house in order to build a more successful future.

We're also bringing you a special treat: an excerpt from Caleb Wilde's new book, "Confessions of a Funeral Director: How the Business of Death Saved My Life." We'll also have an interview with the sixth-generation funeral director.