

Funds, Funds, Funds

Confused by different types of funds? Here's a review of what's what

Mutual Funds

With over 8,000 funds available, these investment pools are what we usually think of. Strictly speaking they are *open-end* mutual funds as opposed to *closed-end* funds (see below) because the number of outstanding shares is not fixed. Every time an investor wants to invest money in an open-end fund the company simply issues more shares. Some of these, such as the Fidelity Magellan and Vanguard S&P 500 funds have grown to enormous size; with assets of \$50 or \$60 billion or more.

The price of a share of an open-end fund is calculated once a day by the fund company, after the markets have closed and is simply the total value of all of the investments divided by the number of shares outstanding. This is referred to as the Net Asset Value or NAV. Shares may only be purchased from and sold to the fund company – either directly or through a brokerage account. There is no secondary market. Note that when placing a buy order you don't know your price until after the NAV for the day has been computed.

The ticker symbol is usually 5 letters, with the last one being "X".

Money Market Funds

A Money Market Mutual Fund is a specific type of mutual fund that invests in short-term fixed-income securities. It is very similar to a bank account except that the interest rate fluctuates daily and it's not FDIC-insured. Most offer checkwriting, though generally with a minimum of anywhere from \$100 to \$1000, so they can't really replace your checking account. They are a great place for an emergency fund and can usually replace savings accounts and CDs. Currently rates are around 4.5% to 5%.

Many banks offer a similar vehicle, usually referred to as a money market account. Although they are FDIC-insured, they are usually a poor choice due to substantially lower interest rates.

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New Disclosure Rules Not Helping Investors

In April 2005, the SEC adopted Rule 202(a)(11)-1, commonly known as the Merrill Lynch or Broker/Dealer Exemption Rule. This rule allows stockbrokers to offer services similar to that of Registered Investment Advisors (RIAs) without being held to the fiduciary and disclosure standards required of RIAs. Despite the fact that brokerage firms offering financial planning and investment advisory services now must make a disclosure that their interests might not always be the same as their clients' interests, a significant number of investors are still unaware of the differences between RIAs and stockbrokers. (*Mentor Capital is an RIA.*)

TD Ameritrade conducted an Investor Perception Study in 2006, as a follow-up to their 2004 survey, to gauge whether the new disclosure rules have impacted investors' awareness of the differences between RIAs and stockbrokers. Unfortunately, these new rules have not had much of an impact:

- 43% of investors are still unaware that brokers and RIAs offer different levels of investor protection. (2004 survey: 41%)
- Only 26% of investors are aware that brokers are not required to disclose all conflicts of interest. (2004 survey: 32%)
- Only 26% of investors know that *only* RIAs have a fiduciary responsibility to act in investors' best interests. (2004 survey: 25%)

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Required Minimum Distributions from IRAs

Severe penalties may apply if you don't take IRA distributions when required

You are probably familiar with the tax benefits of putting money into a traditional IRA. And you may know about the 10% penalty for taking an early withdrawal. But did you know about the enormous penalty for not taking out required amounts?

Generally, you must begin withdrawals no later than April 1 of the year after you turn 70½. The required

amount is based on the value of the account on January 1 and on your age. The IRS publishes a table that is used to compute the actual dollar amount each year based on these factors.

Failure to take out sufficient money when required will result in a whopping 50% penalty.

Other rules will apply if you in-

herited the IRA, if you are the spouse of the decedent, and if the decedent had already started making withdrawals. The rules can be complex and the cost of an error can be huge. To be safe it's best to consult an expert. Mentor can help make sure you meet this requirement.

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Exchange-Traded Funds

ETFs are the hot new fund type. Their assets have grown rapidly in the last 10 years. They trade on exchanges like stocks and the price fluctuates throughout the day based on the value of the underlying securities. Most track established indexes, either broad-based such as the S&P 500 or narrowly based such as a particular industry sector. The management is thus largely passive and ETFs are known for having low expenses.

Unlike a closed-end fund, once an ETF is created no new shares are issued or existing ones redeemed.

Closed-End Funds

Like open-end funds, closed-end funds are a pool of invest-

ments that are generally actively managed. Like ETFs, they trade on exchanges. Thus, the price will fluctuate based on investor perception of the investments they contain. These funds can and do trade at either a premium or discount to their NAV.

In recent years they have lost popularity and only a few hundred exist.

Hedge Funds

These are for wealthy and experienced investors only – literally. Because hedge funds are not registered with the SEC they may only be offered to “accredited” investors. You must have a net worth of at least \$1,000,000 or annual income over \$200,000 (\$300,000 jointly if married). Hedge funds employ sophisticated and complex trading strategies to try to eke out additional gains from small inefficiencies in the markets. Fees are high, typically 2% or more plus the manager usually takes a cut of the growth and earnings above a certain amount.

Because of this and also the difficulty of obtaining reliable information about these funds, Mentor Capital does not recommend their use for even our wealthiest clients.

Next month: A discussion of mutual fund fees and expenses.

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Respondents to the 2006 survey made it clear that knowing the differences between RIAs and stock-brokers would impact their choice of financial advisor – 70% stated that they would not work with a broker if they knew about the differences in fiduciary and disclosure standards. However, unless the SEC adopts stronger rules that require stock-brokers to adhere to the same standards as RIAs, many investors will apparently remain unaware of these important differences.

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