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The Changing Face of Fund of Funds

By Julie Crawshaw

Funds of funds (FoF), which essentially hold a portfolio of other investment funds that represent various asset classes and market sectors instead of holding equities, bonds, and other securities directly, are becoming increasingly differentiated to deliver more specialized services to investors.

"There's a whole series of issues going on now in the market around transparency: risk, performance, quality of the firms, and even the fees," says Wayne Cutler, managing director at Novantas LLC based in New York City. "That's good news for investors."

The idea behind FoF investing is that a fund of funds is able to move money between the best funds in the industry, thereby increasing shareholders' returns with more diversification than a single fund offers.

Funds of funds usually are organized in a fund family of their own. They offer funds that specialize in the entire universe of investments, including those in Europe and other mature markets, emerging markets, fixed income, aggressive growth, hedge funds, and private equity.

Though fund-of-funds investing was very popular in the 1960s, it faded substantially when a scandal involving FoF Equity Funding surfaced in the 1970s. Today, the funds clearly are making a comeback, and new models are appearing that use multiple investing strategies, including edge funds, private equity, and index investing.

In the past, fund-of-funds investing relied on active fund management, but there now are some exceptions from which investors can choose.

For example, take the ones that Mark Matson, CEO of Matson Money, advises about. "We're rare in the fund-of-funds space," Matson says. "We subscribe to market efficiency and the modern portfolio theory [MPT], so we do our best to eliminate stock picking and market timing and track record investing from the process."

Matson manages more than $3.1 billion for investors across the country. His funds have thousands of stocks in them and include large-, mid-, small-, and micro-cap stocks from more than 40 countries.

Another benefit of relying on market efficiency and MPT is reducing overall fees to the client. "For example, our U.S. portfolio we have 99 basis points including our fee and the fund fee," Matson says. "That's very unusual. Even the usual mutual fund fee at Morningstar is 135 basis points. We're cheaper than most mutual funds that aren't even funds of funds."

Matson Money offers three funds: a free market international fund, a free market U.S. fund, and free market fixed income fund. "We use the model to create diversified portfolios," he says. "For example, our U.S. fund has U.S. large, micro, small value, and within that one portfolio we might have 4,000 stocks at any one time in the different categories we build."

Benefits of FoF Investing To Consider

One-stop shop: Paul Jacobs, CFP, a financial planner with Palisades Hudson, believes that the main benefit of FoF investing is that these funds serve as a one-stop shop that can let investors put their portfolios on autopilot.

"This, of course, is assuming that the fund is managed by a quality manager," Jacobs says. "For an investor who does not have the time and interest to monitor several mutual funds and periodically rebalance a portfolio, funds of funds provide a way to delegate that responsibility to a fund manager."

However, even though some may think FoFs advertise themselves as a way to put your portfolio on robopilot, Jacobs believes that any investor needs to track the fund and all the underlying investments. "Unless you know what the underlying investments are, you could have a rude awakening later," he says. "We saw this in 2008, when people thought that their funds of funds were safer than they actually were."

Access to investments that otherwise might be out of reach: Saif Mansour, managing partner of Breakwater Investment Management LLC and US Capital Partners, sees many benefits to FoF investing. The first is that top-tier funds of funds are able to access a best-in-class subset of fund managers, including hedge fund and private equity, that might not be available to the individual investor otherwise.

FoFs frequently are used to invest in hedge funds and private equity funds, which typically have higher minimum investment requirements. Cutler says that, although large pension funds and university endowments continue to invest directly in hedge funds and private equity, many smaller ones that haven't been getting the returns they need to support their capital requirements are turning to fund-of-funds investing to boost their yields.

"Everyone's saying, 'We can't keep our money in these 1 or 2 percent return investments. We need to take a little more risk,'" Cutler says. "They don't have access to hedge funds, so they put 5 percent into a Fund of Funds. They don't have access, or the time and resources to research it, so they invest in a fund of funds."

Potential ease of creating portfolio diversification: Taken together, the three Matson funds of funds include 18 different asset categories in 44 different countries with more than 12,000 different stocks in the portfolio. "It's very difficult for any investor, even one with a billion dollars, to create that kind of diversification inside a portfolio without the fund-of-funds structure," Matson says.

"For an investor who does not have the time and interest to monitor several mutual funds and periodically rebalance a portfolio, funds of funds provide a way to delegate that responsibility to a fund manager."

— Paul Jacob

In addition, building a balanced and diversified portfolio of fund managers across a variety of investment strategies and targeted returns reduces the aggregate portfolio risk.

"If one particular fund manager has a poor performing year or one individual investment sector has a negative growth period and an investor is concentrated in that particular fund, there is the potential for substantial capital loss," Mansour says.

So, with a carefully constructed portfolio of fund strategies and investments, managed through a fund of funds, the entire portfolio should not be at great risk if one fund manager or strategy has negative performance.

FoF diversification can open additional money-making opportunities as well. For example, after the recent tsunami, Japan's market dropped 11 percent. "Because we have over 45 countries in our international fund and new cash coming in every day, we were able to buy Japan on the dip," Matson says. "Without a fund-of-funds structure, the average investor is not going to be able to achieve that."

Years ago, Matson says, a diversified portfolio might have had eight different mutual funds. "It was very difficult to manage because you had to juggle eight pieces, and every time you made a transaction, there were tax implications," he says. "Tracking all these moving parts within one client's portfolio made tracking on a daily basis a nightmare."

Then, at the end of the quarter, when it's time to rebalance, perhaps three or four different investment categories were off 1 or 2 percent. The manager had to generate five or six transactions, which can be expensive from both a tax and trading standpoint. "It makes rebalancing a client's portfolio very difficult," Matson says.

In contrast, Matson's FoF portfolios have only three moving pieces: U.S., international, and fixed income. Within each one of those funds of funds, there might be anywhere from five to eight funds. "On a quarterly basis at the client level, all I have to do is rebalance those three pieces," Matson says. "On a daily basis, I keep the fund of funds balanced to its specific target."

Assuming there are eight different pieces in each portfolio, as new cash comes in on a daily basis, Matson keeps those different categories rebalanced at the fund level, thereby gaining more control over risk.

U.S. Equity Fund	
US Micro Cap Portfolio	15.0%
US Small Cap Portfolio	15.0%
US Small Cap Value Portfolio	25.0%
US Large Cap Value Portfolio	30.0%
US Large Company Portfolio	15.0%

International Equity Fund	
Continental Small Co.	4.0%
Japanese Small Co.	2.0%
Asia Pacific Small Co.	2.0%
United Kingdom Small Co.	2.0%
Int'l Small Cap Value Portfolio	40.0%
Int'l Value Portfolio III	30.0%
Int'l Large Cap	5.0%
Emerging Markets Small Cap Portfolio	4.88%
Emerging Markets Value Portfolio	4.88%
Emerging Markets	5.25%

Source: Matson Money

Professional management: A professional manager does due diligence on the underlying investments for you. "You always have to do some due diligence. but as opposed to doing it around 10 different hedge funds, you just do it around one manager who puts 10 funds together for you," Cutler says. "What you have to do is select the right fund of funds manager."

"Frankly, I'd be pretty nervous buying into a fund of funds without some type of third-party research such as Morningstar," Cutler says. "Basically, you need to either be very conservative or say 'this is my very, very high-risk money.' It's less of a gamble because you're doing funds of funds, but I'd still rely on research."

Mansour stresses the importance of thoroughly understanding the investment strategies both the top-tier manager and managers for the underlying assets use. "Make sure that the portfolio of funds has diversified focus and the individual funds within the portfolio continue that diversification mindset to mitigate risk even further," he says.

"You do not want concentration within one fund or within an asset class as a whole," Mansour says.

Drawbacks to Keep In Mind, Too

High Fees: Though the Securities and Exchange Commission now limits the total amount of fees investors can be required to pay to a fund of funds, fees remain a problem for many of these investments.

Traditionally, most funds of funds have been managed actively, with management fees paid to the FoF manager and to each manager of the underlying funds. Such high fee funds include actively managed funds, foreign funds, and exotic funds.

"Typically, you're not only paying the fees on the underlying mutual funds, you're also paying the manager a fee for expertise," Jacobs says. "With an index portfolio, you could have a much lower expense ratio with similar market exposure."

In fact, many of these funds work on 2/20, which means the fund charges 2 percent of assets under management, plus 20 percent of profit. "This is fine so long as they are doing well," Cutler says. "If you're earning 30 percent return, who cares? The problem is, that's difficult to do over time, and so the fees will just kill you."

"There's a big range here," Cutler warns. "You have to do the math and calculate the net amount that would be taken away."

There are, of course, some notable exceptions, including Matson's market-efficient, MPT FoFs.

"With some FoF funds, the fees are not onerous," Jacobs says. "VanGuard offers both target-date funds and funds of funds, and I would not classify those fees as excessive, but there are some funds of funds out there for which the aggregate expense ratio is well over 2 percent."

One fund Jacobs has recommended is the VanGuard Star Fund, which has an allocation target of 60 percent equities and 40 percent fixed income. "With this fund, investors do pay fees for the fund and for the underlying funds, but the aggregate fees aren't very high, probably less than 1 percent," Jacobs says.

Increased distance from the investments: Because a fund of funds has a top-tier manager who manages the underlying investment funds, investors are at least once removed from control over their investments. Such funds just don't work well for investors who take a hands-on approach.

Jacobs says he rarely uses target date or other funds of funds because most of Palisades Hudson's clients want more direct control over their portfolio allocations.

"These funds can be very difficult to include as part of a portfolio, because you have no control over the underlying assets allocations within them," he says. "If you have an asset allocation you're trying to stick to, it can be very difficult to do so if you're using one of these funds."

However, sometimes these clients have friends or relatives who are just starting out as investors to whom these funds are more useful in setting up a diversified portfolio using a small number of funds, he says.

Poor or unethical management: The safety of investing in FoFs came under fire when Bernie Madoff's Ponzi scheme was uncovered, because many FoFs invested heavily with him. Eventually, it became clear that one reason for these buy-ins was that Madoff didn't charge high fees, which helped investors believe he was performing well. Now, of course, we know that the reason he didn't charge much was that he wasn't doing anything except stealing investors' money.

> **"Evaluate your investment performance reports beyond simply looking at returns performance . . ."**
>
> — *Saif Mansour*

Additionally, during 2008 and 2009, the media and investors battered FoF investing because of false claims that ambitious FoF marketers made about the strength of their due diligence processes.

Mansour warns investors to check for ethical management and best practices in reporting. "Lately, there's been a plethora of Ponzi schemes and dirty practices. It is essential that individual investors check the performance record and backgrounds of the fund managers they are investing with," he says.

Had Madoff's investors done this, they would have seen the red flags and pulled their money out before Madoff spent most of it.

"Also, evaluate your investment performance reports beyond simply looking at returns performance, but ensure the fund manager has provided third-party reviews and audits from a reputable institution that confirm their internal record keeping."

FoF investors should do detailed due diligence before investing, looking carefully at the fund manager's ability to allocate capital in a balanced fashion and whenever possible evaluate the individual funds that make up the underlying

Fixed Income Fund

One Year Fixed Income	4.0%
Two Year Global Fixed Income	2.0%
Intermediate Government Fixed Income	2.0%
Inflation Protected Securities	2.0%
Five Year Government	40.0%
Five Year Global Fixed Income	30.0%

Source: Matson Money

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investments, Mansour says. "Do your research with diligence. Look at the investment criteria, and hold managers accountable. Check the track record behind fund managers, look for specialized expertise, and if they are an asset," he says.

Jacobs concurs, adding that the track record for the manager of a fund of funds is important. But that he believes that the track records for the managers of the underlying funds are even more important.

"A lot of times with these funds, you'll see a core portfolio," Jacobs says. "I saw one with an underlying fund that made up 2 percent of the fund. That doesn't require as much tracking as an underlying fund that makes up 20 percent of the fund."

ETFs: Alternative to Traditional FoF?

Jacobs points out that it's easy to understand the growth of alternative investments such as exchange-traded funds (ETFs), which come with trade costs only.

"You trade online for $10, and that's not even a basis point if you make money when you sell it," he says. "The ETFs that are being created are a challenge for the funds of funds, at least for the equity markets."

Matson is a less optimistic about ETFs, especially funds-of-funds models. "As ETFs become more popular, we're seeing more people opening funds of funds with ETFs," he says. "Unfortunately, there's a lot of speculation and gambling going on. Usually they're investing in bubbles, buying whatever has been hot lately."

So you've decided to invest in a fund of funds, how do you go about choosing a good one?

Here are Matson's recommendations:

• **Low cost and high quality**: Aim for a fun with total fees of 1 percent or less. Look for funds that are institutional quality that are not available to the public but must be purchased through an adviser.

When you buy the more readily available funds of funds, public ones are more likely to suffer massive redemptions if the market crashes.

• **Avoid hot shots and "gurus"**: Look for a FoF that eliminates stock picking, market timing, and track record investing. That way, you'll know exactly what the mix of assets is in the fund you're buying.

• **Low turnover**: Choose a fund of funds with less than 19 percent turnover of the stock internally in the fund.

"The average Morningstar mutual fund has 100 percent turnover of its holdings every year," says Matson. "All that turnover means commissions, bid/ask spread costs, and market impact costs. All of these are very profitable for the brokerage firm but destructive to the investor." ■

Making Money in a Slow Economy

Investing in a slow-growth economy calls for a lot more than employing classic asset allocation and buying index funds, advisers say. The answer to making money today lies in switching to a more flexible, absolute-return strategy.

Here are six tactics advisers recommend that investors use to boost returns and avoid losses in their portfolios:

Index funds have been a failed strategy for 10 years, says Richard Leader, president and chief investment officer of First Houston Capital. Because they are capitalization weighted, indexes tend to get people into the most popular — and, therefore, the most risky — stocks.

"It's not that the stock market has failed people or that stocks have failed people," Leader says. "Indexes and index funds have failed people."

The reason is that companies that are overvalued and risky frequently dominate the indexes, Leader says. "Ten years ago, most investors put most of their assets in the S&P 500 index, where companies like Enron and WorldCom imploded," he explains.

However, simply because a few companies tanked does not mean that savvy investors should avoid the stock market altogether, Leader says. High-quality, profitable companies can still be found.

"When people say, 'You can't make money in the stock market', it really means they themselves haven't made money there yet," he says. "Just don't buy when you feel euphoric or sell when you feel panicky."

Wealth coach Deborah Owens concurs. "The fact is, now is when you need to be investing, when markets are down," says Owens, founder and CEO of Owens Media Group. "Invest in companies that are going to weather and profit from downturns in the economy. Companies like Wal-Mart, Costco, BJ's Wholesale Club," companies that make products and offer services people have to buy regardless of whether the economy is up or down.

Seek Absolute Returns

High government debt levels in the United States, Europe, and Japan are a drag on economic growth, says J. Michael Martin, president and chief investment officer of Financial Advantage. Investors need to focus on getting an absolute return, he says.

"I don't think we'll have for a long time the kind of environment in which someone can get high returns and make up for the years they should have been saving," Martin says, adding that the whole world is enormously more unstable and much more prone to provide us with big surprises now.

"Embrace the opportunities this market presents instead of worrying over what it doesn't offer. Try not to over-focus on the short term."

— J. Michael Martin

"You need to have a portfolio that can adapt quickly to unpleasant surprises, whether those be from terrorists, regulators, or cross-border currency moves," he says.

Developing such a portfolio means being out of sync with indexes much of the time, Martin says. It also could mean lower average annual returns because reducing the downside volatility means giving up something on the upside.

Choosing companies agile enough to respond quickly to crises is essential, Martin observes, adding: "If you want growth, you've got to find it in the character of the companies you invest in."

"Google, for example, has had to deal with some pretty wild global issues, but it looks to me like management understands this is a volatile world, and they'll figure it out as they go along.

"I think Con-Agra is figuring out the value grocery game with product innovation. Panera Bread has a great balance sheet and a menu that's different," Martin says.

Bypass Bonds, Preserve Capital

With bond interest rates where they are now, you're not getting compensated for the risk.

"A 30-year Treasury yielding 4 percent is awful," notes Matthew Tuttle, CFP, CEO of Tuttle Wealth Management. Tuttle says his portfolios are mostly in cash now.

"Preserve your capital," Tuttle advises. "The whole idea of being tactical is that you avoid the large, long-term loss when everyone else is getting creamed."

The fact that we've been in a 30-year bull bond market means that people who jump onto the bond bandwagon are getting in on the tail end — and that is never the best place to be, Leader says.

Don't flock into bonds today just because they're popular, he advises.

"Start thinking about buying quality things when they're cheap. Find good quality common stock, profitable companies paying good dividends, and buy them when they're not popular. If your time horizon is two or three years, chances are you'll make money."

Martin also says that buying shares makes more sense than holding a lot of bonds. "About 40 percent of our portfolio is bonds now, but they're pretty short term, very high quality, and mostly corporate."

Lending money is more dangerous than it used to be. But having too much in low-yield government bonds will expose you to inflation risk."

Increase Emerging Market Holdings

Besides buying companies that are able to adapt and be resilient to negative surprises in their industries, Martin says his firm is being defensive by gradually overweighting emerging markets.

Emerging markets have numerous advantages over the OECD world now, including complete access to all the technologies that developed countries have, Martin says. So many advantages, in fact, that Martin's firm is increasing its stake in emerging markets by 1 percent a quarter.

"They have a huge standard-of-living gap to be filled, an enormous labor cost advantage, a debt/credit advantage because their potential consumers are not burdened with debt the way they are in Europe and the U.S., and their companies and governments have great cash flow," he says.

"Generally, the P/Es in developed and emerging countries aren't all that different now, but you have the growth advantage."

The big question is: Can emerging markets develop as fast as they have been when the developed countries that are their markets are flattening out?

"I don't know," Martin says. "But if we can buy all their advantages for the same P/E as developed market stocks, we would rather do that, and since we can't have any idea of the volatility, we'll do it with dollar-cost averaging."

Historically, dividends have accounted for about half of the total return on stocks, Martin notes. "With less top-line growth, that will be true again," he says. "Making investing in companies with the financial and market strength to boost their payouts over time is a smart move now."

Dividend payers offer the additional advantage of providing capital for additional investments when investors elect to reinvest dividends instead of spend them, even though dividend investment is a long-term strategy.

Leave the Follow-the-Pack Mentality Behind

All too often, investors are unduly influenced by what their friends are doing, Leader says. "Several years ago, everyone was buying and flipping rentals. But did most people get into that when it was cheap and out of favor? No."

It may take courage when discussing investing strategies with friends and colleagues who've fled from stocks to bonds, to say, "I know everybody thinks I am fool to invest in the stock market now, but Coca-Cola's not a bad company at 12 times earnings." But Leader says, "It's better to be a lone wolf than a pack member now."

Owens echoes that belief. "Develop a wealthy mind-set and don't follow the herd. The fact is, now is when you need to be investing, when markets are down. Even though people are calling this a slow-growth economy, the fact is that markets are cyclical, and we're in a downturn. Look at companies that are going to profit in this environment."

Finally, embrace the opportunities this market presents instead of worrying over what it doesn't offer. Try not to focus too much on the short term. Instead, think more about what you're paying and about the prospective earnings power of what you're buying, Martin advises.

"Regardless of whether you inherited or saved your nest egg, or sold a business, you should get the highest risk-adjusted return you can get," he says. ■

Tax Audits Slated to Rise Dramatically

Even though the top 40 percent of all U.S. taxpayers pay 86 percent of all federal tax liabilities (not just income tax), the IRS appears to think that well-off taxpayers have an unlimited amount of money stashed somewhere that they're ready to hand over to the government.

In fact, the IRS itself reports that the percentage of taxpayers who were audited in the fiscal year ended Sept. 30, 2010, increased in every category of adjusted gross income above $500,000, compared with a year earlier.

The biggest audit increases were at the top income levels — 18 percent of taxpayers earning at least $10 million were audited in fiscal 2010, 1 percent more than in fiscal 2009, according to the IRS. For those earning $500,000 to $1 million, the audit rate rose from 2.8 percent to 3.4 percent.

"The government decided the IRS needed a more global view of the revenue stream of high net worth taxpayers," says Stephen Colella, CPA at Dicicco, Gulman & Company. "Because the taxes of high net worth people are more complex, the government also decided IRS agents needed more sophistication."

So, during the latter part of 2009, the IRS ramped up its efforts to target high-wealth individuals aggressively with a new Global High Wealth Industry Group. Even though the IRS has not defined specifically what "high-wealth" individuals means, the agency has indicated that it will focus on individuals and families with "tens of millions of dollars" in assets or income.

The IRS Goes Fishing

The IRS has hired flow-through specialists and international examiners and is considering hiring economists, appraisal experts, and industry specialists who will review not only taxpayers' individual returns but also the returns for their related entities, including trusts, private foundations, partnerships, equity-sharing arrangements, and privately held and related entities in which the taxpayer may have actual or beneficial ownership, Colella says.

"The general premise is that they're going after people with large amounts of wealth, sometimes using what we refer to as 'fishing expeditions' where they in effect 'drop a line' to see if anything comes up," Colella says. "State taxing authorities are also increasing efforts to collect tax dollars."

Such increased tax-gathering efforts demand that taxpayers be particularly vigilant in keeping complete, accurate supporting documentation for the deductions they claim, says David A. Lifson, CPA at Crowe Horwath. This is especially true because the number of correspondence audits, which tend to target one or two items on a taxpayer's return, undoubtedly will increase. If you don't have documentation supporting the deductions you took, then the IRS probably will order a full-blown, in-person audit.

Audit letters requesting proof for deductions for charitable contributions and interest on mortgage payments are two that Lifson sees increasing.

When the IRS started auditing returns for charitable deductions, the agency discovered that most people were lying, perhaps deducting the cost of a case of wine won at a charity auction as a charitable contribution because the check that paid for the wine was written to a charity, Lifson says.

"If you contribute more than $250 to a charity, you need a letter from the charity that substantiates this and details anything you received in return," he says.

The rules for mortgage interest are quite complicated, Lifson warns. "You want to make sure you follow the law," he says. "You can only deduct interest expense on $1.1 million in mortgage debt, so if you're carrying a $2.2 million mortgage on your fancy house at the beach, you can deduct only half the mortgage interest you're paying."

Moreover, if you deduct more than $50,000 to $60,000 a year in mortgage interest, there's a good chance the government will want you to provide proof.

However scary all the above may sound, Lifson advises that good record-keeping easily defuses. "If you keep good records, the audit will go away fast," he says. "You make the necessary copies, send them to the IRS, and you're done."

"If you worry when you get audited, you waited too long to worry," he says. "Keep good records, and you should have zero fear of an audit." ■