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The Savvy Investor
Why Brokers Pitch The Worst Funds

The following was extracted from Timothy Middleton's July 23, 2002 article. It explains why house funds (proprietary funds) consistently underperform funds from independent fund families. The full article can be found at

Your broker's choices: Sell you a good mutual fund – or sell you a really lousy fund that carries his employer's name and makes him a lot more money.

Beginning in August 2002, American Express brokers, will be penalized if they sell funds other than Amex's own funds. Their commissions will be reduced. If the brokers sell the portfolios of the confusingly similarly named American Funds, which are among the best in the industry, the commission cut could actually cost the broker money.

The reason: American Express funds are lousy. Only three of the complex's 189 funds ranked in the top quarter of its Morningstar category over the three years ended June 30 2002, and only 27 ranked in the top half. An astonishing 86% were below average. Since the beginning of 2000, investors have yanked nearly \$3 billion from the complex.

American Express is not the only Homer Simpson among proprietary fund companies; they're all underachievers. Lipper compared all of them with independent mutual funds, both load and no-load. Among the most widely held funds, the performance of house funds trails them all.

This is no accident. While not designed to be as egregiously awful as those of American Express, house funds are intended to be

middle-of-the-road portfolios that never call attention to themselves, and thus invite brokerage clients to wonder why they own such dogs.

House funds (also called proprietary funds) have to be designed this way because they cannot attract the best managers. The companies don't have to be very good: They have thousands of brokers constantly flogging them.

"The standouts have tended to be few and far between from these firms," says Christine Benz, editor of the Morningstar Fund Investor newsletter. Financial giants such as Merrill Lynch and Morgan Stanley live and die on the strength of their core brokerage and investment banking businesses. **"Fund management is kind of an afterthought,"** Benz says.

Independent Funds Trounce Brokers

Proprietary mutual funds also charge big loads and fees that subtract from performance, but so do a host of independent fund complexes, notably Pimco and American Funds. **The most widely held funds, whether load or no-load, all tend to outperform house funds, both in equity and fixed-income portfolios.**

(Continued on Page 2)

10-Year Performance of Independent and Brokerage Funds

Fund Family	Equity (%)	Fixed Income (%)	Combined (%)
Pimco	11.32	7.21	9.76
American Funds	11.27	5.68	8.68
Fidelity	11.30	4.96	8.49
Vanguard	10.27	5.74	7.92
Oppenheimer	10.16	5.00	7.45
Franklin Templeton	9.68	5.42	7.07
Putnam	8.89	5.21	6.83
Smith Barney	8.32	5.56	6.60
American Express	7.33	5.52	6.42
Prudential	9.08	5.00	6.16
Merrill Lynch	8.54	4.59	5.80
Morgan Stanley	8.36	4.30	5.69

Notes: Proprietary fund companies in bold. 10-year period selected to include both bull and bear markets. Average annual performance of funds with 10-year records. Smith Barney is part of Citigroup. Performance is not load-adjusted. Period 06/30/92 – 06/30/02
Source: Lipper Inc.

Bottom Line

House funds don't have to sell themselves: They have a horde of hustling brokers to do that job.

Technically, it's illegal for brokerage firms to pay their workers more to sell their own funds than those of an outside organization. The National Association of Securities Dealers adopted this rule in 1999, because before that it was a routine industry practice.

American Express skirts the rule by punishing some of its brokers not with commissions, but with administrative fees. Called ticket charges, these are assessed on salespeople who are franchisees of Amex, rather than its own employees, which is the majority of Amex brokers.

Investors who use brokers face the possibility of being guided into bad funds on purpose. That's analogous to what used-car salesmen do, but you can be stuck with a financial lemon for life. Before you buy a fund on a salesman's say-so, look under the hood.

Sherwood Investment Services is completely independent and therefore does not have any pressure to sell products that are not in our client's best interest. Please contact us and visit our web site www.Sherwood-Investments.com for more information on successful investment strategies.