

Fidelity's Turn (Diworsification)

In legendary investor Peter Lynch's first book, 'One Up On Wall Street', he coined the term diworsification. A potential client recently provided us with the worst case we have seen:

Symbol	Type	Asset	Category	Yield	Exp.	Load	M*	% Acc.
FIIIX	OEF	Equity	Foreign Large Growth	1.01%	0.98%		3	1.6%
FLCSX	OEF	Equity	Domestic Large Blend	1.03%	0.62%		3	4.8%
FDGRX	OEF	Equity	Domestic Large Growth	0.05%	0.77%		5	5.3%
FOSFX	OEF	Equity	Foreign Large Growth	1.44%	1.03%		4	2.3%
FVDFX	OEF	Equity	Domestic Large Value	1.03%	0.75%		3	5.4%
LVAEX	OEF	Equity	Domestic Large Value	1.67%	0.91%		2	3.1%
CEMVX	OEF	Equity	Emg Markets Large Value	0.97%	1.43%		3	2.5%
COFRX	OEF	Equity	Domestic Large Blend	0.85%	0.72%		4	4.2%
DODFX	OEF	Equity	Foreign Large Blend	1.81%	0.64%		3	2.6%
FKSCX	OEF	Equity	Foreign Mid Blend	0.94%	1.14%		4	0.3%
HLEMX	OEF	Equity	Emg Markets Large Growth	0.46%	1.42%		4	2.5%
OAKMX	OEF	Equity	Domestic Large Blend	0.90%	0.89%		5	7.1%
JAENX	OEF	Equity	Domestic Mid Growth	0.06%	0.93%		5	3.8%
LSGRX	OEF	Equity	Domestic Large Growth	0.43%	0.66%		4	2.6%
MGIAX	OEF	Equity	Foreign Large Growth	1.23%	1.01%	5.75%	5	1.3%
OIGIX	OEF	Equity	Foreign Large Growth	1.24%	0.70%		3	1.6%
TIDDX	OEF	Equity	Foreign Mid Growth	0.51%	1.08%		5	0.3%
TSWIX	OEF	Equity	Foreign Large Blend	1.38%	0.90%		5	2.8%
WFMDX	OEF	Equity	Domestic Mid Value	0.56%	1.12%		5	3.7%
FTABX	OEF	Fixed Inc.	Muni National Long	3.09%	0.25%		4	3.8%
FMNDX	OEF	Fixed Inc.	Muni National Short	0.92%	0.25%		2	0.8%
MDNLX	OEF	Fixed Inc.	Muni National Interm	2.93%	0.70%	4.25%	5	2.6%
SHMMX	OEF	Fixed Inc.	Muni National Long	3.90%	0.66%	4.25%	4	3.7%
MTBAX	OEF	Fixed Inc.	Muni National Long	3.04%	0.80%	4.50%	4	2.2%
MCNVX	OEF	Convertibles	Domestic Large Blend	1.61%	0.61%		4	2.0%
PATFX	OEF	Fixed Inc.	High Yield Muni	3.34%	0.99%		3	2.2%
TPINX	OEF	Fixed Inc.	World	2.63%	0.93%	4.25%	4	2.2%
WUSMX	OEF	Fixed Inc.	Muni National Short	0.71%	0.60%		2	3.6%
FDRXX	OEF	Cash	Money Market	0.73%	0.35%			0.6%
GUNR	ETF	Equity	World (36/64) Large Value Materials & Energy	2.03%	0.46%		3	1.6%
EFA	ETF	Equity	Foreign Large Blend	2.39%	0.33%		3	4.5%
IWF	ETF	Equity	Domesitc Large Growth	1.19%	0.20%		4	5.2%
IWB	ETF	Equity	Domestic Large Blend	1.73%	0.15%		4	3.0%
IJS	ETF	Equity	Domestic Small Value	1.36%	0.25%		4	1.2%
IJT	ETF	Equity	Domestic Small Growth	0.88%	0.25%		5	1.2%
IEMG	ETF	Equity	Emg Markets Large Blend	1.70%	0.14%		3	1.7%

She has 36 Funds and ETFs in her Fidelity account, with the Morningstar (M*) performance rating for each provided. This might be reasonable if each of these positions were individual stocks, but as they are funds each typically invested in hundreds of stocks, this “diversification” only serves to increase broker commissions. Further, many of these funds are in the same category. For example, she has 3 funds dedicated to Large Domestic Growth, and 4 dedicated to Large Foreign Growth. If one wanted to invest in Large Growth stocks

(which in itself is questionable), this could easily be accomplished by a maximum of 1 or 2 Funds, not 7. As detailed on our website, there is strong academic evidence that Value beats Growth over time. However, there is absolutely no justification for buying a bunch of Value, Growth and Blend Funds, when you can effectively buy the market with a single index Fund at much less **Exp.** For example, the iShares MSCI ACWI ETF tracks "the investment results of an index composed of large and mid-capitalization developed and emerging market equities" with an Expense Ratio of .33%. Want to be able to vary the allocation between Domestic, Foreign Developed and Emerging Markets? Three Funds can get the job done. As can be seen on our website under the Worth Sharing tab, we highly recommend International Diversification for all clients. That goal is currently being accomplished by no more than 4 Funds, and one of those is a Global Real Estate Fund, an Asset Class that is conspicuously missing from Fidelity's smorgasbord.

Bonds

Bond funds make up 21% of her portfolio. At 28 years old, they should make up 0%. In a rising interest rate environment, they provide "return-free risk." If you are concerned about reducing the Risk of your portfolio there are much better ways to do so. For example, QMNIX, whose Morningstar chart is shown below with the S&P 500 (yellow line) added, has outperformed the S&P 500 since inception (which we don't expect to continue) with 0 Risk when defined as relative Maximum Drawdown.

Load Fees

Five of the funds (MGIAX, MDNLX, SHMMX, MTBAX, and MTBAX), representing 12% of her portfolio, have load fees ranging from 4.25% to 5.75%. As I have written in a previous article (<https://medium.com/@DevinLHughes/when-is-it-time-to-shop-for-a-new-investment-advisor-f39776dbd729>):

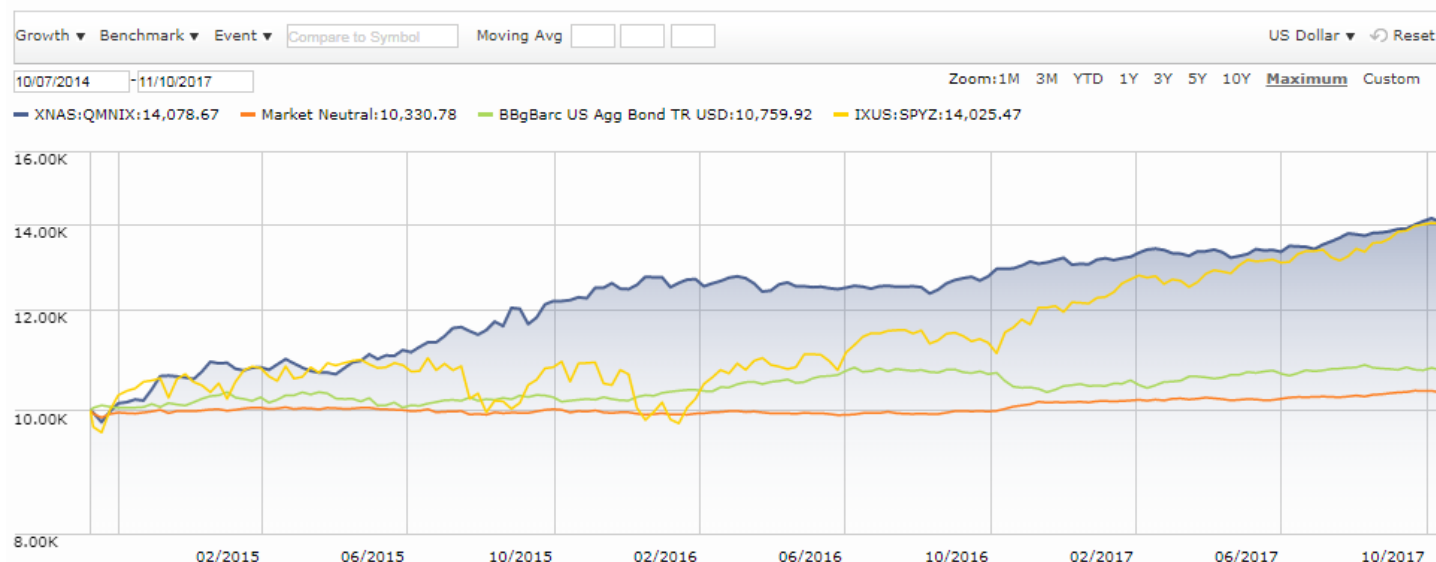
"In order to entice investment advisors and brokers to offer their vehicles to clients, mutual funds often offer a variety of share classes, many of which have Load fees. The idea behind the Load fee is for it to serve as a sort of sales charge, compensating the advisor and his firm for their expertise in assisting you in purchasing the fund shares. In practice however, the sole purpose of Load fees are to further enrich the advisor at the expense of the client."

There is never a good reason to be in shares with a load fee, as most Funds offer share classes with no Load. Take her MGIAX with its 5.75% load, an Open-end Fund (OEF) invested primarily in large foreign companies with an emphasis on growth. Within its Category it has a good track record, although both GPIIX, an actively managed OEF, and ISCF, a multifactor Exchange Traded Fund (ETF), the 2 Funds we are currently recommending for Foreign exposure, have outperformed it. MGIAX has multiple share classes, including Institutional Shares without a load. We always place our clients in the institutional shares when possible, which

Equity			76.36%
<i>Domestic</i>			50.54%
	Value	Large	8.54%
		Mid	3.74%
		Small	1.19%
	Growth	Large	13.06%
		Mid	3.80%
		Small	1.24%
	Blend	Large	18.97%
		Mid	
		Small	
<i>Foreign</i>			24.21%
	Value	Large	
		Mid	
		Small	
	Growth	Large	6.90%
		Mid	0.33%
		Small	
	Blend	Large	9.92%
		Mid	0.35%
		Small	
	Emg Markets		6.71%
<i>World</i>			1.61%
Fixed income			21.02%
	Bonds		2.24%
	Munis		18.77%
Convertibles			2.05%
Cash:			0.57%
Total:			100.00%

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NAV \$12.78	1-Day Total Return ↓ -0.16%	TTM Yield 1.41%	Load None	Total Assets \$ 2.2 bil	Expenses 1.39%	Fee Level Average	Turnover 227%	Status Limited	Min. Inv. \$ 5.0 mil
USD NAV as of 10 Nov 2017 1-Day Return as of 10 Nov 2017		30-Day SEC Yield --	Category Market Neutral		Investment Style Large Blend	Credit Quality/Interest Rate Sensitivity --			



also typically have lower expenses than the other share classes. Even the “A” share class that Fidelity placed her in has an option for its load fee to be waived.

The other four funds are focused on fixed income, meaning most (if not all) of their return will come in the form of interest. These funds have yields ranging from 2.6% to 3.9%. This means that with loads of 4.25-4.50%, and annual expense fees of 0.66-0.93%, it will take these positions more than a year (and for a couple of the funds more than two years) to break even.

Concluding thoughts

The academic evidence shows that over a sufficiently long time horizon, small stocks outperform large and value outperforms growth. The equity portion of her portfolio has 84% dedicated to large stock funds, and only 21% dedicated to value. This is not conducive to long term outperformance or even matching market returns before commissions, loads, expenses, and other fees, which will further dampen her return.

This certainly isn’t the worst portfolio I have seen, and much of it unfortunately appears to be standard practice among brokers, who do not have a fiduciary responsibility to their clients (meaning they don’t have to act in a client’s best interest, but instead meet a significantly lower “suitability” standard). That being said, the portfolio has several egregious elements that should never be acceptable.