SMART MONEY

Top 35 Mutual Funds

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Americans may be paying a lot more than they realize for the privilege of owning shares in a mutual fund.

Fund fees, of course, have gotten plenty of attention in recent years. But when funds trade excessively, or make moves that trigger capital-gains taxes, the investor takes another hit. Indeed, costs like these can siphon away thousands of dollars in returns over time -- and most of them never show up on fund statements.

SmartMoney weighed those hidden expenses in selecting a new list of 35 recommended stock funds.

According to a new, unpublished study, trading costs at the typical diversified U.S. stock fund add up to 1% to 1.25% of assets.

"The real question is whether the expenditures lead to better returns," says Gregory Kadlec, a professor at Pamplin College of Business at Virginia Tech and one of the study's authors. The answer? Generally, no. On average, funds recoup in gains only about half of what they spend on trades, says Mr. Kadlec.

Research based on data from fund tracker Morningstar suggests one way that the weight can get heavy. Over the past one, three, five and 10 years, funds that ranked in the lowest 25% in turnover, a rough measure of how often they trade, have earned two to three percentage points more on an annual basis than those in the highest quartile. Brokerage commissions on transactions are one factor that drives up costs.

Additionally, when a fund dumps or scoops up shares, its own transactions can move the stock price. That phenomenon, known as market impact, can make the trades less advantageous for shareholders. And capital gains from a fund can be taxed at up to 35%.

As we searched for the top funds, we discovered that many of the managers who trade best trade least. To track down our top 35, we started with funds from seven categories, each with great records and promising outlooks. Then we factored in the difference between returns before and after taxes.

We also looked for funds that minimize trading and tax costs by holding down turnover -- the percentage of the portfolio that gets replaced each year. Finally, we eliminated funds whose combination of expense ratios and 12b-1 marketing fees was too high. Most of our picks have no 12b-1 charges at all, so you may pay a transaction fee if you buy them from fund supermarkets like those at Fidelity or Charles Schwab. Buy them directly from the fund companies and you'll avoid that fee.

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