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Sticking to a Mutual-Fund Plan

When should you buy and sell funds? Here are eight rules to guide you.

Making money in mutual funds is not as easy as simply picking four- and five-star rated ones from Morningstar and mailing off a check to the fund company. You also have to know when to buy and sell them.

When the stock market tumbled to its low in March 2009 it didn't matter whether or not you held quality stock mutual funds - they all fell as global markets crashed. Droves of people dumped stock funds and loaded up on bond funds at exactly the wrong time. By doing so, many of those investors sold at a low price and missed the stock market's rally back to its former highs.

You can avoid such mistakes by having a long-range investment plan and sticking to it - no matter what's happening in the market. Here are some guidelines for planning your mutual-fund transactions.

I **DON'T TRY TO TIME THE MARKET** - It's a fool's game, one even professional money managers can't win at consistently. Don't buy or sell just because you think you know what the market is about to do. And it's especially important to keep your head and not panic when the market is in free fall. You'll avoid making rash decisions by dollar cost averaging, where you invest a set amount in regular increments the way you do in your 401(k) plan. If you're investing for a long-term goal such as retirement, your trades should be mostly limited to investing new money and rebalancing to keep your portfolio properly diversified. But even in that case, there are times when selling a fund makes sense.

2 **HARVEST YOUR LOSSES -** If a fund is a long-term poor performer or no longer fits in your portfolio, cut your losses and move on. If the fund is held in a taxable account and you sell it at a loss, you can use that loss to offset any taxable capital gains you might have. If there are no gains to offset or if losses exceed gains, the leftover losses can be used to offset ordinary income, up to $3,000 a year for most taxpayers. If you have additional losses, they can be carried forward to offset capital gains in future years. If you want to reinvest the proceeds from a fund sale in which you had a loss, be careful not to run afoul of the "wash-sale rule." That prevents you from taking a loss on an investment if you purchase a "substantially identical" investment 30 days before or after the sale. But it's easy to avoid that rule if you don't want to wait 30 days. "The investor can sell one fund at a loss, bank the tax deduction, and immediately buy a fund that tracks a different but similar index, thereby staying invested," says Andrew Millard, principal of Millard & Company in Tryon, N.C. For instance, if you sell a Standard & Poor's 500 index fund for a loss, you could reinvest the money in a fund that tracks the Russell 1000 index, a broader index of large-cap stocks than the S&P 500.

3 **REBALANCE YOUR INVESTMENTS -** In rebalancing, you want to sell part of your holdings in asset classes that have appreciated and reinvest that cash into lagging categories. Review your portfolio every few months, and rebalance at least annually. "Rebalancing can be difficult from an emotional perspective because it usually involves selling shares of a fund that is doing well and buying shares of another fund in the portfolio that is not performing as well," says Austin Brown, a financial planner in Chapel Hill, N.C. "However, when thought about rationally, what the individual is doing is selling high and buying low." Don't put off rebalancing because you're concerned about having to pay taxes on capital gains. "The market has had a great run recently, and it may be that you now have too much in stocks compared to your targets," says Robert Schmansky, founder of Clear Financial Advisors, a financial planning firm in Bloomfield Hills, Mich. "Just because you may incur a tax gain to rebalance, that isn't necessarily a bad thing. Gains are good."

4 **MONITOR THE MANAGERS -** Most mutual-fund managers can't beat the market for long stretches of time. "If you are attracted to a mutual fund's five-year and l0-year returns, it could be a mistake to buy shares of this fund if the manager has only been at the helm for one year," says George Kiraly, a certified financial planner in Short Hills, N.J. Take a look at your fund manager's tenure and performance. If you want more in-depth information, check out the analyst reports on Morningstar.com, which are available to subscribers to the site's Premium service ($22.95 a month; a free 14-day trial is available).

5 REDUCE COSTS - The easiest way to avoid worrying about a manager's performance is to avoid buying managed funds. Most investors are best served by index funds that have the lowest possible expense ratios and trading costs. Selling to get out of an expensive actively managed fund and into a less expensive index fund can be wise because differences in expenses can amount to significant drag on returns over time. Many investors and financial advisers are moving away from mutual funds in favor of exchange-traded funds. "Many ETFs are cheaper to own and to trade, represent broad indexes, and are more tax efficient than mutual funds," Millard says. "But they can be complex - and some are downright dangerous - so it's important to proceed with caution."

6 REDUCE YOUR RISK - An asset allocation that's appropriate for a 30-year-old might not be appropriate for someone nearing retirement One guideline, the "rule of 110," states that investors should subtract their age from 110 and put that percentage of their portfolio into stocks and the rest in bonds and cash. You might also be overly concentrated in certain sectors without knowing it. For instance, during the past couple of years many actively managed funds as well as S&P 500 index funds have been significantly overweight in Apple stock because of the size of the company. You'll probably want to pare back your risky funds as you near retirement and get more broadly diversified to weather the market's volatility.

7 AVOID DISTRIBUTIONS - Before you invest a large amount in a mutual fund in a taxable account, ask about the realized gains in its portfolio; funds usually release estimates in October. If they represent a significant portion of the fund's net asset value and the next capital gains distribution is near (typically November or December), you might want to delay your purchase until after the record date. Otherwise, you'll "buy the dividend" - that is, you'll pay a higher price for the shares and then receive a taxable distribution, after which the share price will drop.

8 SELL GRADUALLY

You'll probably need to liquidate some of your funds from time to time to cover college tuition or other expenses, or for retirement. That can be done as part of your rebalancing; you sell shares of funds from the overweighted asset classes to bring your allocations back into balance. "I will usually sell funds in a way to rebalance the portfolio and raise the necessary cash at the same time," says Chris Long of Long Financial Planning in Chicago. $

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