Mutual Funds Reality Check: Are You Really Diversified?

You might be invested in multiple mutual funds, but they might be invested in the same stocks. Here's how to go about fixing that.

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Mutual funds were created to give the individual investor a broad-range, diversified portfolio. Is that true? The vast majority of today's retirees and pre-retirees own mutual funds. Chances are good that you may not be getting the diversification you expected.

Though mutual funds can offer access to a wide range of investments, it's easier than you might think to end up with a portfolio that's unintentionally concentrated. Even if you own multiple funds, you may be invested in securities that are similar or exactly the same. And that could put your money at risk — especially if you're near or in retirement.

Here's an example:

A few weeks ago, a prospective client came to me for a second opinion on his holdings. He believed his portfolio was adequately diversified because he owned seven different funds from one well-known investment group.

MANY OF THE SAME TOP STOCKS HELD IN MUTUAL FUNDS

But when I took a look, I found that $400,000 of his $500,000 portfolio was concentrated in four of that group's flagship funds. Interestingly, the holdings in those four funds looked amazingly similar.

- Fund A's top holdings included Microsoft, Apple and Alphabet (aka Google)
- Fund B's top holdings at that time were Apple, Microsoft and Amazon
- Fund C's top investments were Apple, Microsoft and Facebook
- Fund D's top holdings were Microsoft, Apple and Alphabet

The overlap didn't end there. The other funds' holdings were also strikingly similar. Even more concerning is the fact that the top positions represent a disproportionately large percentage of the fund's assets.

Here was a guy who thought he was playing it safe by investing in several mutual funds. Instead, he owned stock in mostly the same few companies across his funds. Not to mention that such a heavy investment in one sector could also have put him at risk. If there had been, hypothetically, a prolonged sell-off of those tech stocks, it could have crashed his retirement.

BETTER ALTERNATIVE STRATEGIES AVAILABLE

The thing is, I actually liked the companies this gentleman's funds were holding. But with that much to invest, if he wanted those or any stocks that much, he could have just purchased them on his own and avoided the high costs often associated with mutual funds. And he wouldn't be looking at his statements each month believing his funds were providing the diversification he needed to safeguard his nest egg. There are potentially better alternative strategies available that could be utilized to achieve his goals.

OK, I know what you're thinking: What are you supposed to do if most or all of your money is sitting in your 401(k), and you have a limited menu of stock-and-bond mutual funds?

My first recommendation would be to learn enough about investment basics so you can evaluate the funds you're offered and make good choices, keeping true diversification in mind. Or you could hire a financial professional to help you review and assess the performance, costs and other aspects of each available option.

If you're a do-it-yourselfer and you like the simplicity of a target-date fund, you should be careful and investigate the fund's actual holdings and track record. You might find there is more risk in target funds than you realize.

If you left behind a 401(k) with a former employer, you might consider transferring that money into a traditional rollover or Roth IRA. You will likely be given access to more and often better investment options.

A financial professional can help you check across all your different accounts — including your spouse's — to be sure you're avoiding an overlap. Or you can use the U.S. Securities and Exchange Commission's EDGAR search tool to view company prospectuses and get more information about investing in mutual funds.

WHAT TO DO IF YOU FIND YOU'RE OVERLY CONCENTRATED

If you find you have some duplicates in your holdings, or you're overly concentrated in a certain sector, you can decide whether it makes sense to sell and invest in an area where you don't have as much exposure. (Make sure you understand the tax consequences of selling if you're working with holdings in a taxable account, though. It might be better to make necessary adjustments in a tax-deferred retirement plan rather than an account that's taxable.)

An experienced financial adviser can also help you decide on an appropriate level of exposure to a certain stock or sector based on your age, risk tolerance and other factors, no matter where you're keeping your money.

He or she can keep you up to date, as well, on what's happening in the U.S. and international markets, and with the U.S. and world economies, and explain how those changes might affect the balance of the investments in your accounts.

Keep in mind that portfolio diversification can be especially important for older savers, who don't have as much time to recover from an investing error or oversight. Mutual funds have a reputation for having built-in diversification — but that's not always true. If you don't pay attention to your fund's specific portfolio, you could actually end up limiting your gains, increasing your risk and potentially blowing up your retirement!

SOURCES

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