



WHY WE USE MUTUAL FUNDS

We believe that our core competencies include identifying excellent investment managers and combining them skillfully in portfolios. Using this expertise, we select mutual funds managed by what we call “genius” managers and combine them so their unique approaches to investing complement one another.

Occasionally, we are asked why we use mutual funds, rather than some other investment vehicle, in the construction of our portfolios. There are many good separate account and hedge fund managers. Why don't we use any of them?

Our goal is to build and manage portfolios that give our clients the best chance of meeting their long-term investment goals. We do not approach this task with a bias in favor of any particular investment vehicle. No single investment vehicle is right for every situation and every investment vehicle has its time and place. We simply want to construct the best portfolios we can. Our years of experience tell us that mutual funds usually work best for our clients. Here is a summary of why we believe this.

Mutual funds give us access to a variety of the world's best managers. There are thousands of mutual funds available today. Some great managers are only available to the public through the mutual funds they manage. The universes of separate account and hedge fund managers that are available to most investors are much smaller. We believe that more choice means more opportunity to find skillful managers who can add value to our clients' portfolios.

Mutual funds allow us to achieve better diversification for our clients.

Because there are so many mutual funds available we can easily find funds that cover every major asset class and investment style, even those that have traditionally been viewed as alternative asset classes and strategies like real estate, commodities and absolute return. These funds use many different investment approaches, giving us great flexibility in creating diversified portfolios for our clients. We cannot get anywhere near the breadth of investment styles or approaches and have far less flexibility using separate accounts or hedge funds.

Mutual funds allow us access to great managers at reasonable minimums.

The vast majority of mutual funds have relatively low minimum investment requirements. We can easily build well-diversified portfolios for our clients without any concern about these requirements. Minimum investment requirements for separate accounts and hedge funds are usually significantly higher, making it more difficult to build well-diversified portfolios. For example, using mutual funds we can construct a fully diversified portfolio for an investor with \$100,000. Such an investor might have access to only one or two separate account managers through a retail separate account program and could not even meet the minimums for most hedge funds or institutional separate accounts.

Mutual funds are highly liquid and can be traded quickly and efficiently.

We can buy or sell mutual fund shares easily through the custodial platforms we work with. This allows us to put a client's assets to work, reposition a client's portfolio or provide a client with needed funds quickly and efficiently. Deploying assets quickly, repositioning portfolios and generating cash are all more difficult with separate accounts and hedge funds. Based on our own experience and conversations with others in the industry, the vast majority of separate accounts are not rebalanced on

a regular basis and hedge fund investments are almost never rebalanced, due largely to the difficulties in moving these types of assets among accounts. The ability to react quickly to volatile markets or client requests is important to us and, we believe, to advisors and their clients, as well.

Mutual funds make excellent managers available at a reasonable cost.

The costs associated with mutual funds vary widely as do the costs associated with separate accounts and hedge funds. There are many factors to consider in determining the total cost of using different types of investments. Taking these into account, we believe that mutual fund costs are reasonable, relative to the costs of other types of investments, given the many benefits that funds provide. We pay great attention to the fees charged by the funds we use and tend to use funds with lower expenses, like institutional class funds, whenever practicable.

Mutual funds provide the opportunity for solid investment performance.

There have been attempts to determine the relative superiority of different types of investment vehicles from a performance perspective. None have been conclusive. We have even done some of our own research in this area and have not reached any definitive results. The bottom line is that there does not appear to be any inherent performance advantage of one type of investment vehicle over another. We believe that portfolios of mutual funds provide at least as good an opportunity for superior long-term performance as any other investment vehicle.

The quantity and quality of analytical material on mutual funds is excellent.

Mutual funds are subject to a high degree of scrutiny from government regulators, data providers and the financial press. There is a tremendous amount of information available about virtually every mutual fund and the integrity of that information is relatively high. Quality data regarding mutual funds is far more available than for separate accounts or hedge funds.

Mutual funds can be an excellent investment vehicle for taxable investors.

We have developed many ways of helping taxable investors using mutual funds. These include the use of tax sensitive funds, avoiding short-term trading gains, tax-loss harvesting, avoiding funds with large imbedded gains and buying funds with large imbedded losses, monitoring anticipated capital gains distributions and trading accounts on a “specific lot” basis to maximize tax benefits.

Mutual funds are highly regulated and provide a high degree of safety.

One of the major benefits of mutual funds is that they are highly regulated by the federal government. From performance calculations to corporate governance, mutual funds are subject to a detailed regulatory scheme designed specifically to protect investors. Regulation of separate accounts and hedge funds is far less rigorous. We believe that the regulatory framework applicable to mutual funds provides an added element of protection and safety for our clients.

A Final Word About “Snob Appeal”

The truth is, certain types of investments like separate accounts and hedge funds have an element of “snob appeal” that is attractive to some investors. Mutual funds, on the other hand, are viewed as an investment for the “masses” by such investors. We think this kind of thinking is silly and misses the point.

The snob appeal of separate accounts and hedge funds derives primarily from their higher minimum account requirements. Many retail separate account programs require a minimum investment of

\$100,000 per account and some hedge funds and institutional separate accounts have minimums as high as \$10 million or more. Many hedge funds are open only to “qualified purchasers,” which further contributes to their snob appeal. The fact that separate accounts can be “customized” to meet individual investor needs and preferences also enhances the snob appeal of separate accounts.

First of all, the factors that give separate accounts and hedge funds a sense of exclusivity do not appear to translate directly into any sort of performance advantage. In fact, as discussed above, they may actually make it more difficult to create and efficiently manage well diversified portfolios.

In addition, “being a member of the club” often has a fairly high cost. Hedge funds, in particular, tend to have very high fees and lack transparency and liquidity. They also tend to have relatively high turnover and engage in short-term trading strategies that make them “tax inefficient” for taxable investors.

Separate accounts, on the other hand, are sometimes promoted as superior to mutual funds, from a tax perspective. This claim is based on two facts. First, separate account investors get their own basis in the securities bought for their accounts (i.e. they do not inherit “imbedded capital gains” like some mutual fund investors do). Second, some separate account managers will work with a client’s financial advisor to engage in tax-loss harvesting on behalf of the client.

We think these advantages are overstated. First, these purported advantages only apply to taxable investors. They provide no benefit at all to non-taxable investors such as IRAs or other employee benefit plan accounts. Moreover, the imbedded capital gains “problem” is sometimes not a problem at all, even for taxable mutual fund investors. For example, there are often periods when many mutual funds actually have imbedded losses that mutual fund investors can buy into, thus creating a tax *benefit* for the investor. Even during periods when funds do have imbedded capital gains we can and do minimize their impact by monitoring the size and timing of capital gains distributions.

The tax loss harvesting benefits of separate accounts are also overstated, since relatively few taxable investors actually utilize this potential benefit. This results from the fact that most separate account managers do not initiate tax loss harvesting without some prompting from a client’s financial advisor. All too often that prompting never comes. The potential benefit is simply lost. At Frontier, we engage in a program of ongoing tax-loss harvesting for clients who utilize our tax-sensitive portfolios without the need for any prompting at all.

Separate accounts generate some of their snob appeal from the fact that can be customized. That is, a client can request that a manager not buy specific stocks or certain types of securities like “sin stocks.” Again, this potential benefit is usually not used by separate account investors and there is no hard evidence that customization contributes to long-term investment performance, in any case. In our view, letting “genius” managers do what they do best, without interference, is the approach most likely to produce good long-term results.

As mentioned above, both separate accounts and hedge funds are subject to less regulatory oversight than mutual funds making them, in our view, less safe than funds. In the hedge fund world there have been numerous high visibility cases of malfeasance and even outright fraud that suggest that our concerns are justified. We don’t think sacrificing safety for exclusivity is a good trade-off.

This brings us back to what we think is the most important point of all. Many of the most talented investment managers in the world manage mutual funds. Bill Gross manages mutual funds (his separate account minimums are \$75 million).

Jeremy Grantham *only* manages mutual funds (he is not available through separate accounts or hedge funds). The list goes on. If high minimums and exclusivity are still important to you or your clients, then consider that over 1,000 mutual funds have minimum account requirements of \$1 million or more.

Mutual funds are a relatively safe, liquid, flexible and cost effective way to access a wide range of “genius” managers. More asset classes and investing styles can be accessed via mutual funds than ever before—far more than most investors can access through separate accounts or hedge funds. From our perspective, mutual funds give our clients the best shot at prudently reaching their long-term goals. We think that is more important than being a member of “the club.”