Summer 2005

BWFA Advisor

Baltimore–Washington Financial Advisors, Inc.

Fee-Only Retirement & Estate Planning, Investment Management, & Tax Services

Whatever Happened to the Fidelity Magellan Fund?

By Saxon Birdsong, MBA

Fidelity Magellan grew to be the largest mutual fund ever, and has also declined in size more than any other fund. The story of how this came about may help our readers see what went wrong.

The Fidelity Magellan Fund started in 1963, and was originally named the Fidelity International Fund. The SEC eventually made Fidelity change the name, because the fund didn't actually own any foreign assets. Peter Lynch began running the fund in 1977 and invested very successfully in growth stocks until he left the fund in 1990. The fund was turned over to Morris Smith, who had a short but successful 2-year run. Jeff Vinik was the next manager in '92 and promptly altered the character of the fund. At the end of 1995, instead of owning growth stocks, Mr. Vinik had invested 32% of the fund's assets in bonds and cash. Mr. Vinik's strategy was not successful, and in 1996 Fidelity replaced Vinik with the current manager, Bob Stansky. Mr. Stansky has also not kept pace with the market, and now the fund is on the lemon list, having under-performed the market over 1, 3, and 5 years.

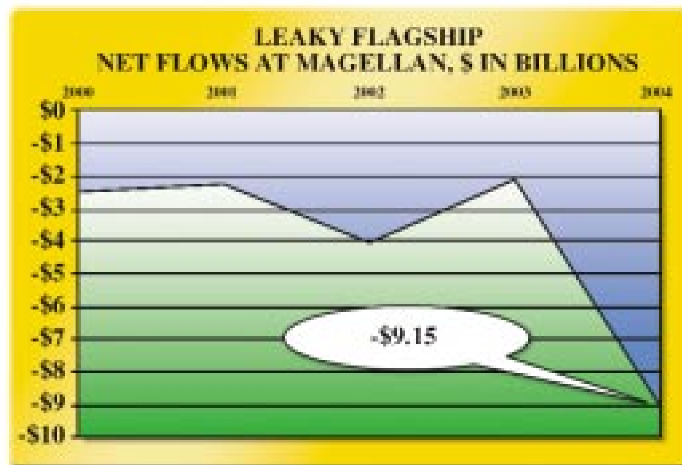
After peaking at $106 billion in early 2000, the famed Fidelity Magellan Fund now stands at about half that value: $55 billion. What happened to $51 billion (equivalent to $175 per US resident) of investors' money? Part of it evaporated in losses; the remainder went elsewhere.

Last year, when the market returned about 10%, $9.15 billion left the Magellan Fund. And in 2003, when the market returned a blazing 26%, $2.4 billion left Magellan. In an attempt to stem outflows and improve performance, the fund took aggressive positions in several stocks, including AIG (the big insurance company with serious governance problems) and Viacom, the entertainment company. So far this year, AIG is down 16% and Viacom has lost 8%.

When investors flee funds, the funds are forced to sell assets and pass taxable gains on to investors. That hurts, particularly when the funds are also losing value.

Very large size is a disadvantage to mutual fund investors. In 1995 the Magellan Fund owned 5% or more of 266 companies! This places a staggering responsibility on the fund and severely limits what a fund manager can do. The fund manager must move very slowly, and quietly, (how quiet can an elephant be?) when you have such a large position in so many large firms. Even small trades or irrelevant comments by anyone connected with the fund about the fund's holdings are quickly reflected in the price of the fund's holdings.

As Fidelity Magellan illustrates, size oftentimes has little to do with success, and good funds don't necessarily stay that way. Other large funds are subject to these same risks. The important thing for investors to do is learn as much as they can about their investments, or, hire someone who will do it for them. Your investments are too important to you and your family to ignore.



What's Happening at BWFA?

We're sorry to say that our Director of Client Services, Jesse Sternberger, has decided to leave BWFA. We're happy to announce that he has taken a full-time position as the Director of the Montgomery General Hospital Foundation, where he will be running the foundation and overseeing its efforts to raise funds for Montgomery General Hospital. With all the contacts Jesse has, he's sure to be outrageously successful.

We're thankful for the 8 months he spent with us and wish him the best of success in the future.

Fee FO Only ™

Contracts, Fees and Refunds—Oh My!—Continuing Care Retirement Communities

By Mark Stinson, CPA

Mr. and Mrs. Client are very excited; they have found a cottage in a retirement community and everything seems perfect! The only things standing between them and their dream retirement home are contracts, fees and refunds. Oh my! They've been handed three types of contracts, multiple monthly fee choices, and "entrance" fee and refund options. They're overwhelmed and have come to BWFA for help.

The Clients have chosen a cottage in a continuing care retirement community (CCRC). A CCRC provides a continuum of housing options—from independent living to assisted living to skilled nursing—all in one community. The Clients are assured of housing and healthcare services for the rest of their lives.

In most cases, residents of these communities are required to pay a substantial entrance fee as well as a monthly fee. The amount of each of those fees is based on the type of housing and the level of care and amenities chosen. For example, a resident who chooses a three-bedroom cottage will pay both a higher entrance fee and a higher monthly fee than a resident who chooses a one-bedroom apartment. A resident needing assisted living services may have a higher monthly fee than a resident requiring no assistance.

Generally, there are three types of contracts:

Extensive Contract – This contract offers unlimited long-term nursing care with little or no increase in monthly fees.

Modified Contract – This contract includes a specified amount of health care or long-term nursing care.

Fee-for-service – This contract requires that residents pay separately for all health and medical services and long-term care.

Entrance Fee

Entrance fees are substantial. Some communities offer entrance fee options that include refunds when you leave. Choosing among these options is a daunting task. Read the contract carefully to determine if the entrance fees are refundable, refundable on a declining basis over time, or partially refundable on a percentage basis.

The Clients have asked us to evaluate entrance fees options at a local community. The entrance fee options are:

1. **90% Refund** – Purchase a cottage for $602,665 and your estate receives a 90% refund of the purchase price.
2. **50% Refund** – Purchase a cottage for $433,267 and your estate receives a 50% refund.
3. **0% Refund** – Purchase a cottage for $325,765 and your estate receives no refund.

Using a net present value analysis, we conclude that if our clients stay at the community for more than eleven years the 0% refund option is best. Key factors we considered in the analysis are:

- A life expectancy of 13 years for him and 19 years for her
- Their health, which is good
- A 6% investment return
- A 3% inflation rate

Conclusion

CCRCs are growing in popularity, because they offer lifetime housing and a range of services. However, choosing among the range of services, the fee options, and the contract types is daunting. Do your homework, visit several communities, prepare a list of questions in advance, and read the fine print. As with all financial planning issues, we will be happy to assist you in evaluating your choices.

We Share Good Ideas and Discounts!

From time to time, our clients offer to share ideas or opportunities with the rest of our clients and friends. Here's one we'd like to tell you about.

One of our Client Advisory Board members has offered a discount (ranging from 5% to 35%) on IBM computer products. He is permitted to purchase up to 25 new IBM computer products each year. He doesn't receive any "cut" on the discount. He's passing it along as a "perk" for being a client or friend of BWFA.

BWFA has already bought two IBM Notebook computers through this offer. Of course, it's possible that there may be better offers available, so do your homework.

If you'd like to take advantage of this offer, just give Lisa a call at our office and she'll help you with the details.

Investment Management

By Rob Williams

How to Select a Mutual Fund

Mutual funds offer small investors a way to participate in the financial markets. But, in order to earn a fair return, investors need to do their homework. Evidence shows that most investors do poorly because they select inappropriate funds and trade them at the wrong times. To help you avoid this fate, we offer you some pointers for selecting funds and earning a competitive return.

1. Determine your portfolio strategy first; then select funds to build your portfolio. These funds should provide wide diversification across different categories of stocks, bonds and other securities. Your strategy should consider:

   a. How long will you hold the investments (that is, how long it will be before you will need the cash),

   b. How much you will need to draw, and

   c. How much risk you can tolerate and still sleep at night.

   Your strategy should not be to find the "hot" fund that had the highest return last year—the one everyone is talking about. Such funds are not likely to remain at the top for long.

2. Stick to your strategy through thick and thin. John Vogel, the founder of Vanguard Mutual Funds, has noted for years that the average investor earns much less than the average mutual fund. The reason for this poor performance is that the average investor buys hot funds when the market is high, then sells when the market is low. The best strategy is not to change course in midstream.

3. Select funds with low costs. Over the long run, the costs of mutual funds add up, and research has shown that expensive funds perform worse than less expensive ones. Make sure your funds are "no-load funds," which have no front-end loads (commissions paid when you buy a fund) or back-end loads (commissions paid when you sell a fund). Make sure the funds' operating expenses are less than 1.4% per year, the average cost of all mutual funds.

4. Pick funds with clear, consistent investment styles that fit your investment strategy. Make sure the fund really owns securities consistent with its stated style. Often the name of a fund gives a poor description of how a fund really invests your money. Watch out for "style drift." Sometimes a fund will start out with one style, but then the types of investments it holds gradually drift to a different style. The Fidelity Magellan Fund was a classic example: it changed from a growth stock fund to a balanced fund holding both stocks and bonds.

5. Select funds from well-established and respected fund families.

6. Select funds that have managers with at least 3 years of tenure.

7. Choose funds that have been in the top 25% of their peer groups over 5 years. If the fund is a small-cap growth stock fund, you should see how its rate of return compares with those of other small-cap growth stock funds.

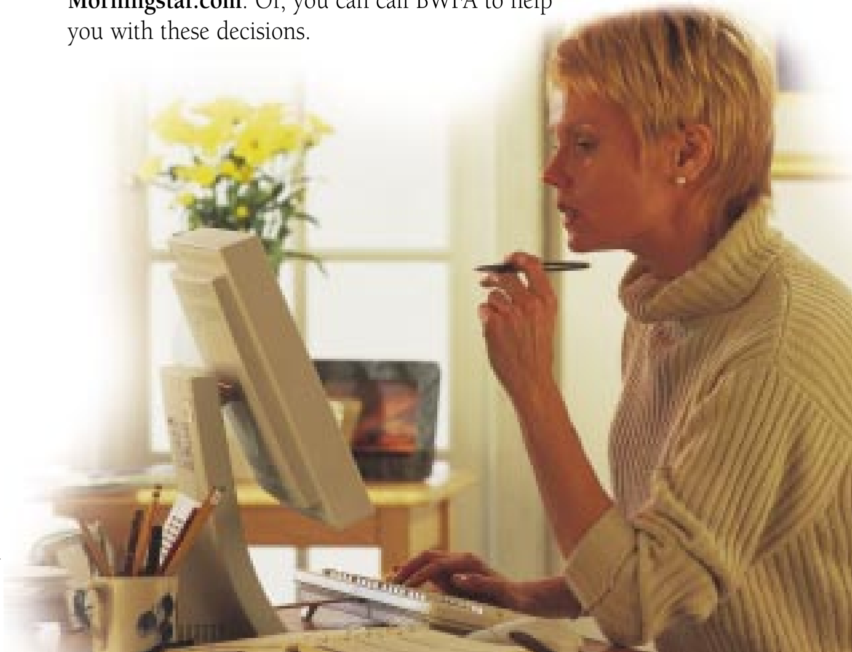
8. Watch out for high cash balances. Mutual funds often keep cash balances so they will be prepared for investor withdrawals. The problem is that not all of your money is working for you.

9. Avoid funds that have "high turnover rates," which means they buy and sell often. Trading stocks rapidly increases costs and causes more taxable gains in taxable accounts.

10. Minimize portfolio overlap. Often mutual funds buy the same stocks. This means you may not be as diversified as you think you are.

11. Avoid the largest funds: funds over $10 billion.

To gather these facts, do not depend on the prospectus alone. Often the description in the prospectus is purposely vague, which allows the managers to do almost anything they want. Therefore, you should also contact the mutual fund company or look the fund up on **Morningstar.com**. Or, you can call BWFA to help you with these decisions.



Tax Services

What Are the Tax Consequences of Selling Your Home?

By Bob Cassel, EA,

Our planning article in this issue addresses options you face when you consider moving into a retirement community. But first you have to sell your home. What are the tax consequences of that sale?

Yes, you may have taxes to pay. But, due to a very generous tax law change in 1997, you can avoid paying taxes on $500,000 worth of gain ($250,000 if you're single). In today's housing market, we often see people selling homes that have appreciated greatly. If you understand the new law, you can use it to your advantage.

To avoid paying tax, you must have:

1. Owned and used the home as your principal residence for at least 2 of the 5 years before the sale (the 2-year period does not have to be consecutive),
2. Not sold another principal residence for at least 2 years and 1 day before the sale, and
3. Filed a joint tax return in the year of the sale if you're married. **Your spouse doesn't have to have owned the house, only to have lived in it for 2 of the 5 years.**

Do You Owe Any Capital Gains Tax?

Calculating the gain isn't very hard. Here's an example:

1.	You (an unmarried person) sell your principal home in July of 2005 for	$400,000
2.	You purchased the home in July 1975 for	$92,500
3.	Over the years you made improvements totaling	$25,000
4.	You refinanced the mortgage once and incurred settlement and legal fees of	$1,000
5.	At the time of the sale, you pay broker's fees and settlement costs of	$24,000
6.	Your total investment in your home is the total of lines 2 through 5	$142,500
7.	Before the exclusion you have taxable gains of the sale price (line 1) less your investment (line 6)	$257,500
8.	You can now take the exclusion allowed by law (up to a maximum of $250,000)	–$250,000
9.	Your taxable gain is	$7,500
10.	Your federal capital gains tax is 15% of line 9	$1,125

Most states will also tax these capital gains. Having a mortgage does not affect your taxable gain.

The Old Rules

Under the old rules you could avoid paying tax on the sale of your home if you bought a new home more expensive than the old one. After age 55 you could take a one-time exclusion of $125,000. **Forget these rules;** the new ones are more beneficial.

Selling Two Homes

As usual with tax law, the fine print is more complicated. This is especially true if you remarry at or near the time you plan to move to a retirement community. If you both own homes, you need to do some careful planning so that you don't sell both homes within a 2-year time period and end up paying taxes on one of the sales.

Before any life transition it's always a good idea to seek the advice of a fee-only financial advisor. BWFA is ready to help you take advantage of tax laws and avoid common mistakes.

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