How Many Mutual Funds Should You Have in Your Investment Portfolio?

Time to take an inventory of your mutual funds. How many are there? What are their investment styles? Is your portfolio of mutual funds cluttered just like your closet? Have you owned some mutual funds so long that you have forgotten why you bought them? Are there some mutual funds on the top shelf, way in the back of your financial closet you haven't even looked at in a while?

Adding new mutual funds to your portfolio is far easier than reorganizing your fund portfolio and discarding inappropriate, redundant, or simply poor-performing mutual funds. The answer to the question of how many mutual funds you should have in your portfolio is not just a number. But if you have many more than eight mutual funds in your closet, chances are you need to do some serious portfolio cleaning. Here's why.

First, in order to be well-diversified, your mutual fund portfolio should be invested in domestic and foreign stock mutual funds and in fixed-income mutual funds or income fund equivalents. Within the domestic stock market, your mutual funds should cover large stocks, small stocks, and stocks in-between.

Foreign investments should cover established firms in industrialized countries and stocks of countries that would be considered emerging markets. While geographic diversification domestically is relatively unimportant, diversification by region for foreign investments is. Representation in Europe for large stock international mutual funds is important, and investments in Latin America and the Pacific Rim are crucial when considering emerging stock mutual funds. Global mutual funds that invest domestically and abroad sound like a one-fund answer, but it is too much geography for one portfolio manager to cover and global funds tend to change domestic/foreign portfolio weights as world conditions change, neutralizing some diversification benefits.

Counting the Mutual Funds

Let's stop and take a count: one large stock domestic fund, one small stock domestic fund, one international large stock fund, one emerging market stock fund—so far, four mutual funds. Have we missed the mid-sized domestic stocks? Well, check your large-cap stock fund and your small-cap stock fund to see what they include. Usually, large stock funds leak down into the mid-size range and small stock funds push up into the mid-size range. If not, add a mid-size mutual fund to avoid any portfolio gaps. Now we may be up to five, all of which are stock mutual funds at this point.

If you want income and the diversification benefit of a fixed-income fund, then a simple choice would be to consider intermediate U.S. government bond mutual funds. The intermediate maturity—in other words, a three- to 10-year weighted average maturity of the bonds in the portfolio—captures most of the yield of longer-term mutual funds with much less volatility when interest rates change. If you are in a high federal tax bracket, a municipal bond fund might be a better choice. And if you live in a state with high state and local taxes such as California or New York, you may want to consider substituting a state-specific municipal bond fund to minimize federal, state and local taxes on the bond income. Aggressive investors can reach to high-yield corporate bond funds and if they are in a high tax bracket, hold the fund in a tax-sheltered account. While high-yield (junk) bond funds invest in lower-quality corporate debt that pays high income, the individual default risk of the bonds in the portfolio is softened through diversification and the high income dampens portfolio volatility. Furthermore, high-yield bonds tend to be sensitive to the economic cycle, acting more like stocks than government bonds.

One bond mutual fund in a portfolio may make sense, but it is difficult to imagine the value of more than two bond mutual funds. For high-tax bracket individuals, a municipal bond fund and perhaps a high-yield bond fund in a retirement account may make sense, but high-tax-bracket investors often prefer growth through common stock mutual funds rather than income from any source.

So, if we add one to our fund count for a fixed-income fund we have a total of six mutual funds; two bond funds would push it to seven.

Other Categories of Mutual Funds

What about all those other categories of mutual funds? Do you need a gold fund, mortgage-backed bond fund, international bond fund, sector fund, index fund?

Let’s take them one at a time.

- Gold mutual funds are concentrated sector funds holding gold mining stocks primarily in North America, South Africa, and Australia. They are extremely volatile, as gold price changes are magnified by the operating cost breakeven points of gold mining firms. Do you need a gold fund in your portfolio? No. Most investors use gold funds as a store of value, a hedge against inflation. Over the last decade, however, they have been neither. When stocks are roaring up, you would like your gold fund to behave like a stock, but it tends to act like gold bullion. When the stock market collapses, you hope your gold fund behaves like gold bullion, but unfortunately, it tends to act more like a stock.
- Should you consider mortgage-backed bond mutual funds for your portfolio? Probably not. A

diversified portfolio of mortgages that promise higher returns than a U.S. government bond portfolio of similar maturity does have some appeal. However, mortgage-backed funds have at times behaved as badly as gold funds. When interest rates rise, bond prices fall and the share prices of bond mutual funds also fall. So, as an investor, when rates rise, you want a mortgage-backed bond fund to act contrary to a bond, but it doesn't. When interest rates fall, the prices of bonds and bond mutual funds rise, but a mortgage-backed bond fund will respond more to the mortgage market. When mortgage rates fall along with interest rates, mortgages are refinanced and part of your investment is essentially handed back to you to be reinvested at lower rates.

- International bond mutual funds often promise higher yields, but the difference in yields is usually due to differences in currency strength. A country with high interest rates is likely to be protecting a weak currency. When rates are high, investors buy the currency to buy the bonds and support the currency in the process. If the currency in which the foreign bonds are denominated weakens, the differences in yield may evaporate or even fall below domestic yields. Currency speculation is not a game most investors should play.
- Sector mutual funds concentrate on one industry or a few closely related industries. Because they are concentrated in an industry, they are not well diversified. Beyond the additional risk, the trick to master is just which sector funds to invest in. At the top of most "best-performing mutual funds" lists will be some sector funds, but they'll also appear on the "worst-performing mutual funds" lists—it's just a question of when. Most aggressively managed stock mutual funds concentrate in some industries and might be viewed as a combination of sector funds. Few investors are willing and able to place sector bets unless they have particular experience in a sector through their education, work experience or vocation, and if they do have the expertise, selecting individual stocks may be more rewarding.
- Do index mutual funds have a place in your portfolio? Yes, but they don't add to the number of funds. They simply are another way of managing your assets in one of the fund categories necessary for a rational, well-diversified, non-redundant mutual fund portfolio. Index mutual funds should be employed in a situation where even the brightest and best of portfolio managers using superior timing and stock selection decisions would have difficulty overcoming the cost advantage of an index fund. Areas of the markets that are efficient, have readily available information, are well-researched and followed closely by the investment community, or are simply not susceptible to very profitable analysis are candidates for indexing. The market for large domestic stocks and the U.S. government bond market fit the index fund criteria. Small domestic stocks and emerging foreign markets do not. These markets have attributes that make intelligent, thorough analysis more likely to contribute returns that can overcome the cost of active fund management.

Style Diversification in a Portfolio of Mutual Funds

An added classification for domestic stock funds is investment style—mutual funds can be categorized as growth or value, or both. Growth mutual funds would typically invest in stocks with high earnings growth expectations; value mutual funds would invest in stocks with low prices relative to earnings and net asset values. The style label should be based not on what the fund says it is or what it says it will do, but on what it does. Investment style classification should serve to help investors avoid redundancies and coverage gaps. But they also beg the question, "Should a portfolio of stock mutual funds be diversified by style as well as the size of stocks?" Size, yes. Style, perhaps.

Many mutual funds operate in more than one stock size range and many use approaches that are classified as both growth and value. Do you need a value and growth fund in each stock size category? No. One value fund, and it might be the large stock fund, and one growth fund covering the mid-sized and small stock area provide coverage of size and style. A large stock index fund will be both growth and value, and more extensive indexes will cover value and growth for more stocks and stock size ranges.

Eight Is Enough…

Understanding the style and stock size characteristics of mutual funds will help prevent duplications and an unnecessary run-up in the number of mutual funds in your portfolio. Now, back to our count of mutual funds: We left off at six with one fixed-income fund, or seven funds with two fixed-income funds. Add a money market fund and the counter clicks to eight. Be sure you can justify adding mutual funds to your portfolio beyond eight. Make certain you need them, that they truly cover new ground in asset type, geography, or investment style, and that the addition is meaningful.

Taking the time to create an organized, understandable, appropriate and efficient portfolio of mutual funds may be your most important investment.