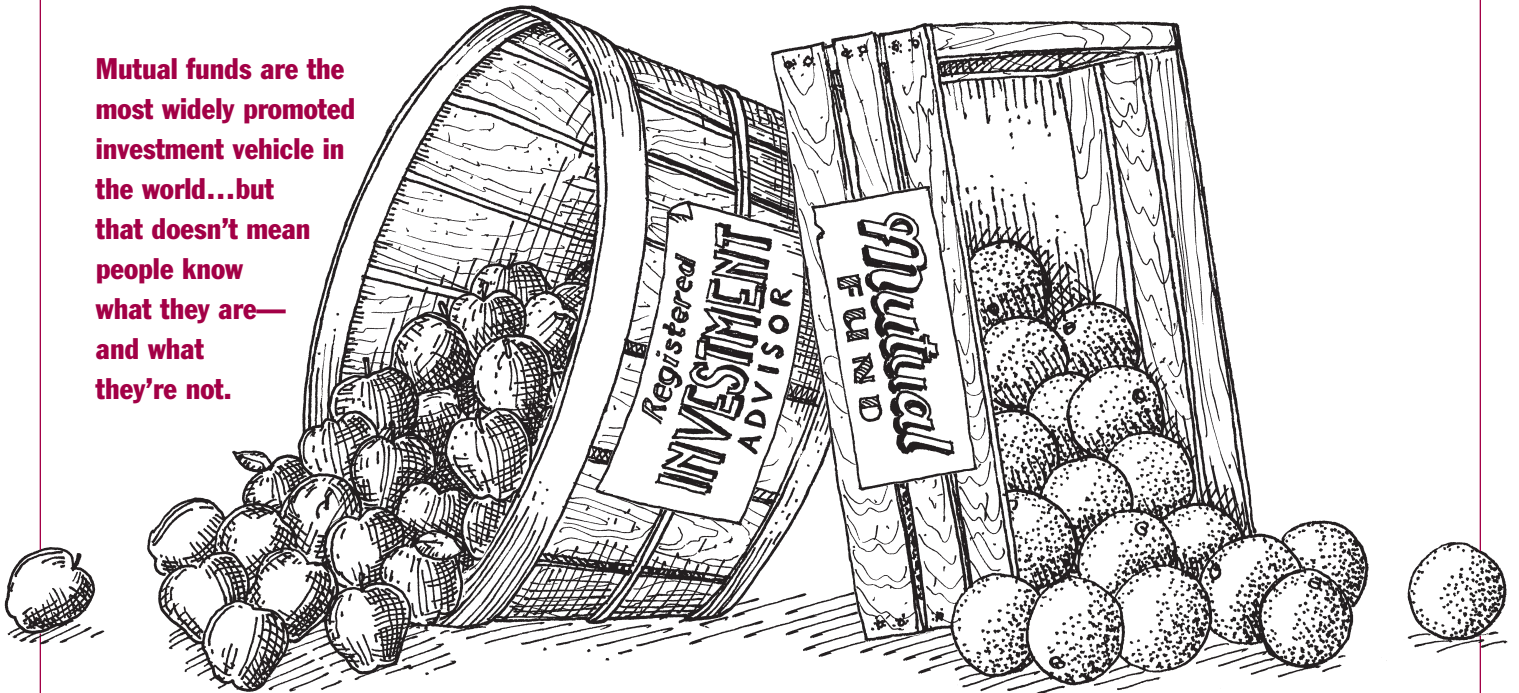


COMMENTARY

Alike—but, oh so different.

Mutual funds are the most widely promoted investment vehicle in the world...but that doesn't mean people know what they are—and what they're not.



Hats off to the mutual fund industry. It has done a wonderful job of promoting its product. In fact, mutual funds are easily the most widely promoted investment vehicle in the world – maybe the only investment vehicle that is so consistently hyped. You don't, for example, see advertisements from preeminent companies such as Microsoft or Johnson & Johnson saying, "Buy our stock."

McRae Capital Management is a Registered Investment Adviser specializing in individual account management. We are not a mutual fund company. In contrast to

mutual funds, we operate in a much different space within the investment world. But, through our close relationships with many clients over many years we have discovered that there's a lot of confusion about just what a mutual fund is, and even how mutual funds differ from a firm such as McRae.

That's why we decided to devote an issue of *Commentary* to this topic. We'll try to separate myth from reality in a simple and straightforward way. One could devote an entire book to this subject (many have). Our objective is simply to clear up a few miscon-

ceptions. Mutual funds and Registered Investment Advisers, such as McRae, are alike in that we are investment organizations. Other than that, we're as different as apples and oranges.

What's a mutual fund?

To get us on the same page, let's start with a definition. Mutual funds pool, or combine, many investors' money into a community portfolio to buy and manage assets of various types in the hope of securing financial gain, achieved through appreciation in the value of the underlying assets and/or dividend or interest income. Each

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investor in a mutual fund owns a small piece of the portfolio.

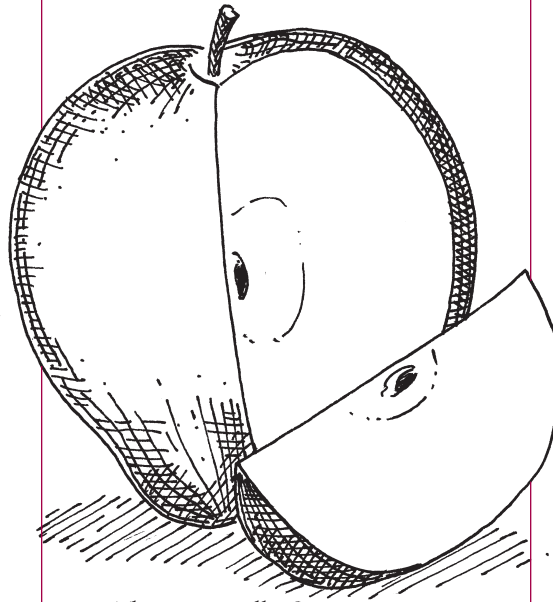
There are thousands of mutual funds in the U.S. that invest in a seemingly endless number of securities that may include stocks, bonds, commodities, real estate and foreign securities (to name a few). Some funds may target a specific industry, such as a technology fund, while other funds may attempt to replicate a particular index, such as the S&P 500. Recently, you may have read about Exchange Traded Funds, or ETFs, that are gaining popularity today. ETFs are similar to mutual funds, just traded in a different way. Bottom line: If it is something in which you can invest, some Wall Street firm has created a fund for it.

Whether you buy an ETF or a mutual fund, you are essentially buying a piece of an existing portfolio. At McRae, we think investors are better off creating their own customized portfolio.

Rationale for investing in mutual funds

The key question to ask is, Why invest in a mutual fund? Originally, mutual funds were a way for smaller investors to gain the benefits of professional money management and diversification, a universally recognized way of reducing risk. Most people do not have the time, knowledge and experience to make informed investment

choices, so they turn the task over to the manager who runs the mutual fund. As for diversification, a mutual fund holds the securities of numerous issuers, so that if any one of them encounters a problem the impact of loss will be limited.



Those are all good reasons – but they raise some questions. How does one know which mutual funds to buy? How many mutual funds should one own? How does one know when to sell a mutual fund? How do investors accommodate changes in their personal situation by wisely modifying their mutual fund holdings over time?

The answer, in part, is in an old investment industry adage: Mutual funds aren't bought, they are sold. They are sold through brokerage houses, financial planners, consultants and the mutual fund families themselves. There is a big distinc-

tion to point out. The person selling the fund is not actually managing the fund. Moreover, the people managing the fund itself are never talking directly to the clients who have invested in the fund. Whether investors are really being sold the mutual funds that are right for them and receiving objective, unbiased guidance in the process is definitely in question.

Rationale for individual portfolio management

If you have sufficient assets, however, you can gain the benefits of professional money management and diversification with a Registered Investment Adviser who specializes in individual portfolio management. Unlike mutual funds, investors' money is not pooled or combined with any other investor. Each account is separate and distinct and – importantly – custom designed for each client.

A Registered Investment Adviser, like McRae, doesn't sell anything. We receive no commission income. What we offer is investment advice and counsel based on each client's specific circumstances, needs and goals. We do not hold any client's assets, either. Those assets – stocks, bonds or cash – are all held by an independent, third-party custodian. We are compensated through a fee based on the assets we manage. This fee structure aligns our compensation with the best interests of the client.

COMMENTARY

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Table 2. McRae Capital Management vs. mutual funds: it's no contest

Investment	Fee	Fee on \$1,000,000 Account	McRae Savings	Fee on \$5,000,000 Account	McRae Savings
McRae	1% on first \$2M 0.5% above \$2M	\$10,000		\$35,000 0.7% Mgmt. Fee	
Stock Mutual Fund	1.40%	\$14,000	\$4,000	\$70,000	\$35,000
Bond Mutual Fund	1.10%	\$11,000	\$1,000	\$55,000	\$20,000
High Yield Bond Fund	1.40%	\$14,000	\$4,000	\$70,000	\$35,000
International Fund	1.72%	\$17,200	\$7,200	\$86,000	\$51,000

Note: Fund fees are average fees for each category - Sources Morningstar, MSN Money, SmartMoney.com

A look at specific points of differentiation

Let us turn now to some specific points of confusion. The tables in this *Commentary* are a quick way of comparing McRae Capital Management to a mutual fund. The comments that follow will provide a little more depth on selected points.

Access and accountability –

Table 1 indicates that both mutual funds and McRae offer access to professional investment managers. But that “access” is very different. As we pointed out earlier, mutual fund managers rarely interact with the clients who actually own the fund.

At McRae, you not only get our investment expertise, you can sit

down and talk with us in person. Unlike a mutual fund, you actually get to talk to the person making the investment decisions for your portfolio. This leads to greater accountability at McRae. If a client feels his or her investment objectives are not being met, they can contact us directly so we can address any concerns. Whom are you going to call to account at a mutual fund?

Fees – The fees charged by many mutual funds are significantly higher than the fees paid by McRae clients. It is our experience, though, that very few investors realize this. We believe the reason for this is simple. Mutual funds do not send a bill out to the fund

holders when it is time to pay for investment management. The fee is simply deducted from the fund and the price of the fund is adjusted down by the amount of the fee. To learn what the fee is, you need to either dig through a lengthy prospectus or make several clicks on a web site to get the information.

Conversely, McRae clients receive an actual quarterly invoice with our statements, as required by the Securities and Exchange Commission. Our clients are fully aware of what they are paying for our services, and that is fine with us. We believe that investors should know exactly what they are paying.

But take a moment to review Table 2 and you can see how

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expensive mutual funds can be. Using data on the average expense ratio of several types of funds, we show how much lower the McRae fee is. Moreover, as your account gets bigger, the savings get even larger. Further, this data only deals with the management fees that funds charge. It doesn't include any sales loads or extra commissions that can be levied when someone buys or sells a fund.

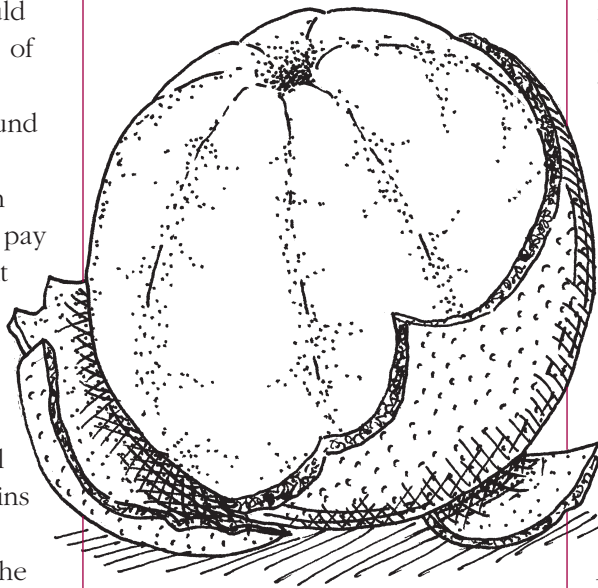
Tax Impact – The tax impact is much different as well. Your individual tax status is of no concern to the fund manager. How could it be since there are thousands of individual owners of the fund? So how does this impact the fund holder?

Just like a stock, if you own a fund and the price rises you pay a capital gains tax on the profit when you sell it. If you sell the fund at a loss, you can deduct the loss against other gains. But there is another tax issue a fund holder has to deal with, and that is the capital gains distribution.

Over the course of a year, the fund manager is buying and selling stocks, some for gains and some at losses. But the fund itself does not pay taxes. Instead, it distributes the gains to you, the fund holder, and you pay the tax. So, once a year fund holders receive a tax statement report for their share of the net gains the manager realized during the year. These gains

are something you have no control over, and have little idea of how large they might be.

This sets up an unusual situation: You can buy a fund and see the value of the fund drop, but due to the trading activity of the money manager still get socked with a tax bill at the end of the year. The real kicker: Mutual funds only distribute the gains for you to pay tax on. Should the fund take a net loss, they cannot distribute that to you as a fund holder, but keep it for the following year.



OK, you're asking, if firms like McRae offer so many advantages, why isn't everyone investing with a Registered Investment Advisor who specializes in individual account management? One reason we readily admit: The mutual fund industry has done a far superior promotional job. Firms such as McRae generally don't advertise or

promote themselves because we spend so much time and energy managing our clients' accounts. So, we remain a well-kept secret.

Actually, while we have pointed out many differences between mutual funds and firms such as McRae, it wouldn't be entirely incorrect for our clients to think of their investment with us as a mutual fund – a mutual fund of one where you own the entire fund. Client portfolios are well diversified and clients receive professional investment management. But their portfolio is designed, built and managed for them – and no one else.

In sum, in one regard, mutual funds and McRae are alike in that we both invest financial assets. But for everything else, well, it's like comparing apples and oranges.



For additional copies of this issue of Commentary, please write: McRae Capital Management, Inc., 100 Campus Drive, Florham Park, NJ 07932, or telephone 973-966-2700. Past issues of Commentary are available upon request.

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Table 1. Summary checklist of differences between mutual funds and McRae Capital Management

Attribute	Mutual funds	McRae
Access to professional investment managers	Yes	Yes
Able to meet with the individual or team managing your money	No	Yes
Investment manager knows you and your personal situation	No	Yes
Diversified portfolio	Yes	Yes
Personally customized portfolio	No	Yes
Management may change without notification	Investors must rely on prospectus to learn of substantive changes	Management in place since 1981
Account service	Toll-free telephone or online	Personal service from management and staff
Consider the effects of taxes when managing the portfolio	No	Yes
Costs	The average actively managed mutual fund fee is in the range of 1% to 2% of assets but it is “unseen” because it is deducted from your assets	1% on first \$2 million, 0.5% thereafter; more apparent because clients receive an invoice
Other costs	12b-1 fees, sales loads, redemption fees and others	Cost of buying or selling a security, generally averaging a few cents per share

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