Mutual Funds: High Costs for Long Odds

Mutual funds were a breakthrough in the 1920s—but they may not be your best option today

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According to CNBC, in 2021 "about 85% of US large-cap stock funds underperformed the S&P 500…the (under-performance) share was 99% for large-cap growth funds relative to their benchmark. How big a bet would you make if you had a 1% chance of winning?

2021 was no outlier. According to S&P Dow Jones Indices, "Over the past 10 years, 82% of fund managers fell short of their S&P 500 benchmark, with 87% failing over 15 years. In our opinion, it seems that the longer one holds their mutual fund, the less likely it is to outperform its index–the stated goal of a great many actively managed mutual funds.

The high costs of mutual funds, both exposed and hidden, are a major contributor to this failure. But there are other factors investors should consider when investing in mutual funds, and they may also have a significant and negative impact on wealth protection and creation. Those things are tax inefficiency and the inherent conflicts that exist between fund managers and investors.

We begin with an essential premise: the performance of an investment is impacted by four factors: security selection (what you own), costs (what you pay to own your investments), taxes (how much you keep, not what you earn) and risk exposure (your ability to withstand the volatility of your investment).

Taken together, we refer to these things as controllables. They are in contrast with all the many other things that cannot be controlled: market direction, volatility, legislative and regulatory changes, interest rates, inflation, geopolitical events, the economy, natural disasters and the like. Those things are all real, of course, and can and do have meaningful impacts, but the investor has zero control over them and is best served by treating them as noise.

If we hold all other things equal, it's axiomatic that a lower cost investment is objectively better than one that costs more. That simple truth applies to all of the controllables, and we will apply it to our examination of mutual funds.

Mutual funds made perfect sense when they were first introduced in 1924, but it's important to ask if they still do. Modest investment amounts, diversification and professional management remain laudable goals, but are mutual funds the best way to achieve them? We argue that the answer is no, because costs, tax efficiency and transparency are not only non-trivial to an investor, they are key performance factors. In this white paper, we will examine the many and often little-known flaws of mutual funds, and contrast them with newer, more efficient investing products and solutions. Today's investor has many more choices, and may find that there are better, cheaper and more transparent ways to protect and grow their wealth.

Do you have questions about your mutual funds? Do they have hidden costs? Are they subjecting you to taxation needlessly? How much might they fall in a Bear market? Find out with our free report.

Costs — not the simple thing it seems

Mutual funds are more expensive than many investors realize. Costs are not limited to management and 12b-1 fees, which sometimes total less than half of the costs incurred by the fund–all of which are paid by the fund's investors.

According to the SEC: "As with any business, it costs money to run a mutual fund. There are certain costs associated with an investor's transactions (such as buying, selling, or exchanging mutual fund shares), which are commonly known as "shareholder fees," and ongoing fund operating costs (such as investment advisory fees for managing the fund's holdings, and marketing and distribution expenses, as well as custodial, transfer agency, legal, accounting, and other administrative expenses). Although these fees and expenses may not be listed individually as specific line items on your account statement, they can have a substantial impact on your investment over time."

Mutual funds are different from the vast majority of products Americans consume. A mutual fund that charges a sales load actually charges the buyer of that fund for the expenses of marketing the fund. It would be analogous to having your grocery store add twenty five cents to a six pack of Coca Cola to cover Coke's advertising costs.

The sales load is a commission paid to a stock broker for selling a particular fund. The broker therefore has an incentive structure that may be inherently in conflict with the best interests of the investor. Investors who work with fiduciaries, by contrast, do not have this potential problem, as the fiduciary is obligated always to do what is best for their client.

Sales loads, when present, average around 5% and may be charged when the fund purchase is made. Thus, the investor starts off at a practical disadvantage. For example, when an investor puts $10,000 into an S&P 500 ETF, virtually their entire $10,000 is working for them. But an investor buying $10,000 of a mutual fund with a 5% sales load will only have $9,500 in the fund.

Independent of a sales load, a fund may also charge a purchase fee to the investor. All types of acquisition fees have the same net effect of reducing the amount of money actually working for the investor.

Another category of mutual funds costs is known as a redemption fee. This fee creates a disincentive to sell the fund before a specific time interval as stipulated in the fund's prospectus. These fees are typically in the 0.5% to 2% range.

Both sales loads and redemption fees may dilute the importance of fund performance in making buy and sell decisions. An investor may want to wait until their fund has "paid back" its sales load with positive performance, or may choose to delay selling a fund to avoid the redemption fee. Neither of these is a rational economic decision.

Some mutual fund companies that offer multiple funds allow investors to swap their current fund for another in the same complex. When the fund company charges the investor for making the swap, this is called an exchange fee. Like sales loads and redemption fees, exchange fees are paid to the fund company and not shared by other investors in the fund.

Smaller investors may also be charged an account fee, assessed by the fund company if the investment falls below a certain, specified level.

All of the costs we've reviewed thus far are assessed on an individual basis, and favor the investor committing more time and money to the fund. There are many other costs, however, that are borne by all investors in the fund. Chief among these is the Expense Ratio, which comprises all the management fees and operating costs of the fund.

The incentive structure problem

We need to take a moment to bring up a potentially significant problem that is inherent to mutual funds, and that is the competing interests between the fund company and the investor. The fund company's overarching goal is to maximize its revenues, while the primary goal of the investor is performance.

Mutual fund managers and their companies are compensated by taking a percentage of the assets under management, which means that marketing is more valuable than performance. This can lead to prioritizing capacity, liquidity and index tracking, three objectives that support the manager, potentially to the detriment of the investors.

Capacity refers to the fund's ability to accept new inflows from investors, and that translates to a larger number of holdings. American Funds' Growth Fund of America (GFA) can provide a good example. As of May 18th, the fund had assets of over $217 billion spread across 398 holdings. This means that the average amount invested per holding is $545 million. Those massive positions have other implications for the fund, but certainly the fund has capacity.

Liquidity refers to the ease with which a manager can buy and sell the positions in the fund. There can be the very simple problem of finding enough stock to buy, or enough buyers for the stock the manager wants to sell. This can lead to avoiding less-liquid but very attractive securities, and, in the case of the GFA, can virtually eliminate opportunities to own small but high-flying companies.

Index tracking refers to the natural risk aversion of a fund manager. A rational fund manager knows that he or she must take on additional risk in order to out-perform the index they compete with–and they know that underperformance carries the risk of outflows. They have a strong incentive to be market-like: to have performance close to that of their benchmark. Again, we see competing incentives between investor and manager.

Whether or not the distribution fee should be considered a source of conflict is an eye-of-the-beholder thing. Some mutual funds charge this fee, known as a 12b-1 fee, as they deem marketing the fund to be an operational expense. It seems ironic to us that you would pay a salesperson to sell you something, especially something that has nothing to do with enhancing the performance

of the fund, but this is a very common practice. 12b-1 fees generally range between .25% and .75%.

Hidden costs

All the costs we have identified thus far are transparent, meaning they are disclosed to the investor in the prospectus and on popular investing websites. There are other costs that can be very significant that are hidden from view, but that can severely affect fund performance. All of these costs are borne by investors in the fund.

Trading commissions are estimated to cost 0.25% per year. When a fund manager receives an inflow, or an order to sell (outflow), he or she must promptly invest or divest positions in the portfolio. This means that a commission will be paid to the broker/dealer handling the trade. While not huge, 25 basis points is a performance haircut.

What can be more significant is the bid/ask spread. These spreads, between what a seller will accept and what a buyer will offer, grind away at performance. This will have a greater impact on funds that use more thinly traded stocks, and on funds with high turnover.

Where things can get really expensive is in something referred to as market impact costs. This can be a particularly meaningful cost for larger funds due to their massive position sizes. If that GFA manager decides to exit a given position, he or she may be putting a ton of stock up for sale. The law of supply and demand operates here, and experts have estimated that the market impact costs can be 1% to 3% per year.

This impact cost operates on the buy side, too. When the manager sells stock A to buy stock B, they will be likely to receive a discounted offer on A and create their own premium when they buy up a half billion dollars of B. If a manager makes the rational decision to take days or weeks to wind down or wind up a position, they lose nimbleness–the market may move against them.

By contrast, an investor could simply buy an S&P 500 ETF. Charles Schwab offers one with a 0.02% expense ratio…meaning the investor is charged $2 for every $10,000 invested. That ETF would have outperformed 99% of all large cap growth funds in 2021, and if held for the full year, would now be eligible for long-term capital gains taxation if sold for a profit. The investor would have absolute transparency, ultra-low costs and favorable tax status.

Taxes

Mutual Funds are ruled by the Investment Company Act of 1940. Among other things, the '40 Act decreed that mutual fund sales must be accompanied by a prospectus, and dictated that gains and losses must be distributed to the owners of the fund as of a certain date every year, known as the distribution date.

This can lead to an undesired outcome known as buying the distribution. This means that an investor may receive a tax bill for gains they did not receive. As an example, let's say a fund invested in Apple Computer years ago, and that Apple has gained 1000% since the original purchase. An investor buys shares of the fund, which then experiences a drop in price–the investor has lost money, at least on paper. If the fund realizes a gain by selling Apple, this new investor will receive a 1099 for the fund's gain. They lost money on their investment and got a bill for gains enjoyed by someone else.

Mutual funds are notoriously tax-inefficient. This is because the investor has zero control over the management of the fund. It's critical to remember that the investor does not own the securities in the fund–the investor owns a share of the fund itself.

Let's say a fund owns some stocks that pay dividends, and some that do not. In a separately managed account, as opposed to a mutual fund, the investor could own the underlying stocks. The investor could place the dividend payers in his or her IRA, where the dividends would not be taxed, and the non-dividend payers in their taxable account. That kind of flexibility simply doesn't exist with mutual funds. The advantage goes to the SMA.

The investor with their own portfolio could also harvest losses from stocks they want to own by selling them when they are down and buying them back 31 days later, locking in a realized loss but staying committed to the stock. They can use those harvested losses later against realized gains, a smart and low cost strategy to lower one's overall tax bill. Tax loss harvesting of this type is not available to mutual fund owners. Again: advantage SMA.

Exchange Traded Funds, or ETFs, possess a very real advantage over mutual funds, beyond the fact that they are by contrast very low cost and, as we've seen above, hard to beat. That is due to the fact that mutual funds must execute trades to manage inflows and outflows, while ETFs are allowed to use an in-kind creation and redemption mechanism, which has the effect of reducing and even eliminating the distribution of gains to holders of record.

For a detailed explanation of how this works, look here.

Best practices in tax management include low turnover (aiming for long-term gains), asset location (segregating individual securities in the most appropriate account) and loss harvesting. A separately managed account allows for all three, while mutual funds typically fail at all three.

Sins of commission

Previously we covered the conflicts that can be associated with incentive structures–when commissions can cause a misalignment of desired outcomes. When we say "sins of commission" now, we are referring to some nefarious activities that some mutual funds have gotten up to in the past. Not crimes, necessarily, but things we imagine most investors would not be happy about.

Any market that rakes in many billions a year and has thousands of competitors may be prone to spawn some very creative schemes. The prevalence of these schemes in the mutual funds industry has led us to conclude that fund performance reporting should not be trusted because it can be and has been intentionally inflated. Let's look at three questionable practices.

Incubation

Here's the scenario. You, a mutual fund company, open and privately fund a dozen new funds with diverse investment theses. One may focus on stocks of companies that sell red things while another focuses on companies that sell blue things and a third on the green thing business, and so on. You really can't be sure which color companies will do the best for the next three years, so you put $10M in each fund and, basically, wait to see what happens.

At the end of the three year period, you close all the poor performers and open the biggest winners to the public featuring your great performance.

A study published in The Journal of Finance found that incubated funds outperformed non-incubated funds by 3.5% on a risk-adjusted basis. In a world where 10% returns are the gold standard, 3.5% is huge. Naturally, incubated funds attract higher inflows. After incubation, however, the outperformance disappears because, in the end, the outperformance was the result of luck, and not skill.

Leaning on the tape

Earlier, we covered the topic of market impact costs–the impact of temporary spikes in the supply or demand of a given security. Leaning on the tape is an application of this phenomenon intended to inflate the performance of a mutual fund.

Let's say a manager has a large position in ABC, and highlights that position in their marketing. The manager enters a large order for ABC in the final minutes of the last trading day before he or she publishes their fund's performance. The big order drives up the price for the stock he or she is buying, yes, but it also raises the price of the stock they already own.

The amount they overpay for the new stock is dwarfed by the rise in the stock they previously owned. Will the market settle down shortly after the trade? More than likely, it will. But for purposes of performance reporting, the only thing that matters is the price at the market close on that last day.

A study (also in the Journal of Finance) showed that manager's have inflated quarter-end portfolio prices in just this way, and the impact of that price inflation ranges from 0.5% per year for large cap funds to well over 2% per year for small cap funds.

Excessive risk taking

We will start with the assertion that mutual fund managers are people, too. A key difference, however, is this: when a fund manager increases the risks in the portfolio–when they take a proverbial "long shot"--they are using other people's money.

When a fund makes a significant change to its risk levels, we refer to that as risk shifting. A study by the National Bureau of Economic Research examined the phenomenon of risk shifting among mutual fund managers, and concluded that "funds that increase risk perform worse than funds that keep stable risk levels over time, suggesting that risk shifting either is an indication of inferior ability or is motivated by agency issues."* Put plainly, it seems the manager was either bad at his or her job, or motivated by personal gain–or both.

If all of that wasn't bad enough…

Question: if you learned that your mutual fund company was affiliated with an investment bank, would that make you more or less likely to hire that company? Many investors might lick their chops, believing that they would gain access to initial public offerings (IPOs) and their cousins, seasoned equity offerings (SEOs).

However, it turns out that there is strong evidence that investment bank-affiliated funds underperform unaffiliated funds. In what may come as a surprise to no one, a comprehensive study of this subject found that affiliated funds hold disproportionately large amounts of IPO and SEO stock. They also found that worse performing IPO and SEO stocks were more likely to be held. The evidence was strong that investment banks use their affiliated funds to support their underwriting business–at the expense of the fund's shareholders.

Conclusion

We believe the evidence is clear and compelling that mutual funds are an expensive, tax-inefficient and sometimes deeply conflicted investment vehicle. Ample evidence also exists to suggest that holders of mutual funds are likely to underperform holders of ETFs and separately managed accounts.

**** Huang, J., Sialm, C., Zhang, H., & National Bureau of Economic Research. (2009). Risk shifting and mutual fund performance. Cambridge, Mass: National Bureau of Economic Research.***

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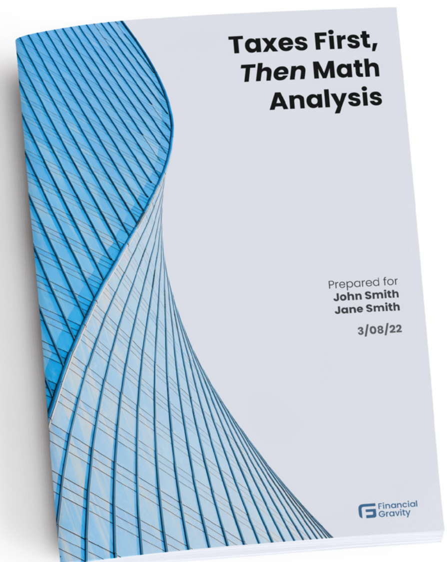

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Request the report from your Family Office Director's website or reach out to your Family Office Director for more information.

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