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A Few Extra Thoughts on Mutual Funds

Edited by John Mauldin

This week we are going to look at one aspect of the future of investing. A few weeks ago, I was with good friend Doug Fabian in LA. I spent a session or two on his weekend radio show and then we went out to dinner. Not surprisingly, we began to compare notes on investing. While I generally spend my time focused on the hedge fund world, Doug is a true expert on mutual funds.

I wrote in my book that I think the day will come when hedge funds will be available to the public and as an industry will be as large as or larger than mutual funds. Doug, however, looks at a different end of the investing spectrum. He thinks the world of mutual funds will shrink for entirely different reasons. I found his thinking quite interesting and asked him to do an article so I could share it with you while I am out on vacation. I will be back next week, but I am glad to be able to share these thoughts from Doug.

The Endgame For Mutual Funds

By Doug Fabian, Editor, Successful Investing

" The Britain that is going to be forged in the white heat of this revolution will be no place for restrictive practices or outdated methods on either side of industry."
---Prime Minister Harold Wilson

History is replete with examples of good ideas that have outlived their usefulness. For example, the horse and buggy, the homing pigeon and the hourglass are just a few that instantly pop into my head. Indeed, even such a relatively recent invention as the typewriter has given way to the vastly superior word processing powers of the personal computer. Someday the keyboard and the personal computer will seem quaint. All of these inventions served their purpose well in their time, but they were all eventually relegated to the scrapheap of history in favor of better, more efficient forms of technology.

But technological development isn't the only area where ideas outlive their usefulness. The principle of constant change holds true in most walks of life, and the investment arena is no exception. Remember what life was like trying to invest before the existence of mutual funds? What about those exorbitant government-mandated commissions charged by brokers in the 1970s? How about not being able to look at your account online or make a trade instantly using the Internet? Yes, my friends, change is constant in the investment world too, and in my opinion, we are about to experience another big change with respect to what kind of investment vehicles we'll be using.

Until recently, I always recommended no-load mutual funds as the "weapon of choice" in the battle for market-beating investment returns to subscribers of my Successful Investing newsletter. In fact, for over 27 years I've been one of the staunchest proponents of no-load funds as the primary investment choice for the individual investor. But times change, innovations arise, and what were once good ideas begin to outlive their usefulness. So it is with mutual funds. The once favorite sons of investment portfolios worldwide are now in danger of going the way of the typewriter.

Now I know what you might be thinking about now. How can an investment vehicle with over $6 trillion in assets, 40 million shareholders, and over 10,000 choices now be obsolete? Well, the answer is that while mutual funds are not quite dead yet, they are starting to become out of favor with investors, and for a number of very good reasons. First let's examine some of those reasons, and then we'll take a look at my new favorite alternative to mutual funds

The Best Place To Be Until Now

For several decades no-load mutual funds were by far the best way to get broad-based exposure to the market at a reasonable cost. In fact, when the ability to make changes to your mutual fund holdings via telephone first came about in the mid-1970s, my father saw this as a way for the individual investor to become empowered and take control over their own portfolio. He felt so strongly about this new potential for personal investor empowerment that he started the Telephone Switch Newsletter, the predecessor to what is now Successful Investing. Back then the no-load fund, and the ability to switch your holdings with a simple phone call were the state-of-the-art investment tools for investors. Now, most of us use the computer and the Internet to accomplish this task, however, we're largely still using the same type of fund structure we did in the 70s.

The question now is, why are mutual funds no longer the place to be? What's different now? Why are funds no longer the darlings of the investment world? Let's take a look at a few of the answers.

Scandals: A funny thing happened about 10 months ago. The public caught wind of the secret after-hours deals available only to favored mutual fund investors that cheated long-term shareholders out of profits. "The world changed on Sept. 3, 2003," said Jay Baris, an attorney who works with the mutual fund industry in a recent Wall Street Journal article. He was speaking of the day New York Attorney General Eliot Spitzer unveiled his investigation into improper mutual fund share trading.

Since news of the fund scandal broke, investors have been questioning the trading practices of many of the most prominent mutual fund companies. They've seen many of their favorite fund companies come under attack and be fined and reprimanded by the SEC for improper trading practices. Until the scandal no one really realized that their personal net worth was being negatively impacted by the behind-the-scenes privileges of a few big players that the fund companies were eager to please at individual investor expense. The scandal got people to question what the fund companies were doing in their name. During this period of questioning people began to look at what they were getting for their money. Over the past five years, investors realized what they were getting wasn't very much at all.

Underperformance: A great number of investors have come to realize that although their portfolios haven't made a great deal of money over the past five or so years, the fees they have consistently paid for the privilege of that underperformance have been omnipresent. We'll get to those outrageous fees in a moment, but let's first stick with underperformance.

It is my contention that the mutual fund industry as a whole does a terrible job of managing money in a bear market. One reason for this is obvious. The fund companies want you to buy and hold their funds, and therefore they won't ever tell you to sell! Think about it, when was the last time you heard of a mutual fund company advocating the sale of one of their funds because the market was just not the place to be? I can't recall ever hearing that. Now there may be a few talented brokers out there who will try to get you to rotate from one market sector to another given conditions in a specific market segment, but brokerages and fund companies don't want you to sell. They want you to continue to blindly pump your dollars into their company so that they can grow their assets. Most of the time, growing your assets is not their first concern. And of course, the last thing they want is to lose your assets via a sale of one of their funds.

Now before any of John's learned readership takes me to task about the difficulty for virtually everyone over the past five years to make a profit in this market, let me first say that I agree that these past five years have been challenging for all of us in this business, myself included. But here's the rub, the fund companies are making money by charging high management fees despite bad performance results. Think about that in your own profession, or any other profession. If a salesman were to fail to meet his goals over a five year period, would he still receive the same fees and commission than if he were to double his quotas? Not likely, unless of course he was a mutual fund.

As part of my Successful Investing service I publish a list of funds I call The Lemon List. This quarterly list flushes out the funds that have underperformed their peer averages for the past 1, 3 and 5 year periods. It's kind of a who's who of fund industry losers, underachievers and over chargers. The worst of the worst as it were. This is where you'll find some of the most egregious violators of the high-fee for underperformance school of thought. You can get this list for free by registering at http://www.fabianlive.com/register.jsp.

Now, speaking of fees, that brings us back to just how much investors are paying for the privilege of that underperformance.

Fees: Now for the real killer, and what I think will ultimately bring about the obsolescence of mutual funds, high management fees. In the bull market of the late 1990s, people tended to pay only modest attention to the fees levied by mutual fund companies. After all, what difference did it make if you gained 20% in a fund and paid a 2% management fee? You were still ahead of the game by a whopping 18%. For a couple of years there, those kinds of returns were the norm. But as we've already mentioned, change is a constant. What was once commonplace is no longer the norm, and so it is with double-digit mutual fund returns. Let's face it, in a bull market virtually anyone with a pulse can make money, and even average fund managers were able to do very well for a lot of shareholders.

So far in 2004 nearly all fund categories are down for the year. Of course, that hasn't stopped fund companies from continuing to charge their management fees. According to Morningstar, the average actively managed mutual fund charges expenses of 1.56%. That fee is rain or shine, up or down market, win or lose at the end of the year. While this may not seem like much on its face, consider that when you purchase an average fund you are already in nearly a 2% hole that you have to then climb out of in order to be positive at the end of the year. With performance so far in 2004 largely in the red, that near 2% starting deficit could mean the difference between a profit and a loss.

The problem of high fees gets even greater if you are buying B-shares from a fund company or brokerage. B-shares are a class of mutual fund shares that charge investors a commission only when the shares are sold. Unsuspecting investors fall for this fee structure by being told that they can put all of their money to work right away, with no up front fees. What fund companies don't tell you is that they then charge higher continuing fees to cover the cost of advancing the commission to the broker or agent that sold you the B-shares originally. Because of these higher fees, investors can end up earning far less money on their investments than they would have if they had just paid the management fee up front when they originally bought the fund.

It should be clear to you by now that I think investors have been taken advantage of by advisors advocating a buy-and-hold strategy, charging exorbitant management fees and delivering weak fund performance. All of this has helped make mutual funds yesterday's investment of choice. So where should the smart investor go now? My choice is Exchange Traded Funds, or ETFs.

The ETF Revolution

Like the automobile, the clock and the personal computer, Exchange Traded Funds or ETFs, are an idea whose time has come. Indeed, it is often said that there is no force so powerful as an idea whose time has come, and that's precisely how I feel about ETFs.

What are ETFs? For those of you still not familiar with them, ETFs are sort of the best of both worlds. They offer you the exposure to both broad market indices (such as the Dow and S&P 500) as well targeted market sectors like energy and basic materials, yet they trade like a stock on an exchange (most trade on the American Stock Exchange or AMEX), which means you can buy and sell them anytime during market hours. With mutual funds there is a one-day delay when you buy or sell, and then you are forced to accept the closing NAV of the fund as your buy or sell price. Using ETFs your decision is automatic and you know what price you've bought or sold at moments after you execute your order.

This is particularly important in a tough market when each day could mean the difference between a gain and a loss for the year. Currently there are over 120 ETFs to choose from, including ETFs that cover the bond market.

Recently I recommended that subscribers to my service move 100% of their portfolios into cash. Because I am what is known as a trend follower, I am in the market when the trend is up, and out of the market when the trend is down. I base my decisions on the price movement of a proprietary market indicator that represents a cross section of the entire market. My indicators told me that it was time to play it safe, wait on the sidelines until conditions merit a return into equities. Because I may get these "Buy and Sell" signals several times in a year, I only recommend to my readers investment options with low fees and few holding period penalties. ETFs offer all of these benefits, and at a fee structure far more attractive than mutual funds.

While the average mutual fund's management fee is 1.56%, ETF fees can be as low as 0.1%. In fact, the average ETF's management fee is just slightly higher at 0.36%. Compare 1.56% to 0.36% and that's a real, in your wallet difference at the end of the year, especially when you're dealing with big numbers.

Another thing I like about ETFs is that they are objectively managed. For the most part, ETFs are tied to the indices in the major markets. As the Dow goes, so go the Diamonds. As the S&P 500 goes, so go the Spyders. [The ticker symbol for the Dow ETF is DIA, the S&P 500 is SPY and therefore explain the nicknames Diamonds and Spyders - John] This makes it easy for anyone to keep track of their investments simply by checking up on the major market indices. You can invest in country indexes, specific industry indexes and more. Simplification and savings, two ideas that will never go out of style.

Remember that scandal we talked about earlier? Well, one pernicious effect it has had on mutual funds, and in particular for trend followers like me, is that fund companies are now waging an aggressive campaign to lock investors into buying and holding all mutual funds. Most mutual funds are now levying very stiff redemption fees if you take your money out within a given time frame. This new fee is just another reason why I'm convinced mutual funds are headed for a fall.

You can track ETFs, and learn more about them at http://finance.yahoo.com/etf and at www.amex.com.

The good news here is that everything beneficial about a mutual fund can be obtained by using an ETF, and with virtually none of the downside. Significantly lower fees, no trading restrictions, instant trade execution and objective management tied to the market itself. It's a powerful idea whose time has come. Now lest you think I am the only one out there touting the benefits of ETFs, don't take it from me, take it from the fund companies themselves. I recently read a story in the Wall Street Journal that talked about how more and more fund managers were buying ETFs to get exposure to different market sectors. If fund managers are using ETFs to bolster their funds, why can't the individual investor just bypass the fund manager and buy ETFs on their own?

In my opinion the likely outcome of everything I've touched on here is that investors are likely to move into ETFs in greater and greater numbers in the years ahead. Many more ETFs are being registered each year, and their growing popularity is an unstoppable trend in the investment world. I think that what you'll likely see is massive mutual fund redemptions with a re-allocation into ETFs. I also think there will be a move into the less regulated field of hedge funds by high-net worth investors in the years ahead as well. I will defer to the hedge fund expertise of this site's host for more on that subject however.

Finally, I would like to thank John for allowing me to present my "thoughts from the frontline." I've been a big fan of John's work for years, and I really appreciate this opportunity. Also, big congrats on the stellar New York Times book review. I know first hand how good it feels to get a positive review on your book. When I wrote my book, Maverick Investing, the best part was reading the positive feedback I got from critics. So congratulations once again on a very well deserved positive review.

(Doug Fabian is the Editor of the Successful Investing and VIP Investor newsletters. He can be heard every Saturday afternoon on his nationally syndicated radio show, Making Money with Doug Fabian.)

A Few Extra Thoughts on Mutual Funds

Let me add a few more thoughts. I agree with Doug that ETFs are a coming force which will relegate many mutual funds to a marginal sideline.

But not all, some for the right reasons and some for the wrong reasons. Many mutual funds will continue simply because ETFs will generate less income to those that market them. Why is there a need for scores of S&P 500 index funds? The answer is the fee income and who is selling what to whom. Mutual funds will continue because they generate the on going fees, called a trail or 12B-1 fee, to pay the salesman.

One other advantage of the no-load mutual fund over ETFs is that a commission is not charged to buy it. ETFs trade like stocks and a trade commission will be charged for each additional investment. The smaller investor, or 401-K investor, who wants to add $50 or $150 a month, will have lower costs in a mutual fund.

But the model will change over time. Investment advisors and brokers who charge a management fee for over-seeing client portfolios will gravitate toward ETFs and mix them in with specialty funds to create a portfolio that is more fee sensitive.

However, there are some mutual fund managers whose active style or niche market knowledge simply adds value. There are some funds and desirable management styles which simply will not work as an ETF.

That being said, the data suggests these managers and funds are less than 20% of the industry. Good management will always be able to attract investors and charge higher fees. But for the majority of funds who are simply tracking indexes or managers who under-perform their peers, the future is one of dwindling assets under management. They will be competing with ETFs on the low cost end of the investment spectrum and hedge funds on the active end. Not a business model I would want for my business. The next recession, which we talked about last week, will just accelerate these trends.

Moosehead Lake, San Francisco, and Bermuda

As you read this, my bride and I are at an Inn on Moosehead Lake in northern Maine. I really hope she can see some actual moose, as that will give her a thrill. After seven days of internet and business withdrawal, I am sure I will be regretting having to return home next Wednesday.

I will be speaking at the annual MAR Hedge Fund conference (maybe the largest such conference of the many in the industry). You can find out more by going to www.marhedge.com click on conferences.

I am speaking three times at the next Money Show event in San Francisco on September 22-24, 2004, at the San Francisco Marriott. They asked me to pass on the following note: Attend over 150 FREE educational workshops, 14 panel discussions, and general sessions focusing on economic and investment presentations and browse over 100 exhibits... all FREE. For complete details or to register online click the link below or call 800/970-4355 today. Don't forget mention me (John Mauldin) and Thoughts From The Frontline, along with priority code 003336.
http://www.moneyshow.com/main/main.asp?site=sfms04i&cid=default&sCode=003336

Next week, I will be back in the office and writing. Perhaps a relaxed mind will give us a fresh perspective to meditate upon.

Your trying to figure out how to stay one more day analyst,

John Mauldin