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Top 5 Worries of Mutual Fund Investors

By John Smartt, CPA, MBA

Most individual investors in the United States are mutual fund investors. Funds form the backbone of many 401(k) and similar defined contribution retirement pension plans. Here is a listing of what are, or should be, the issues/worries facing mutual fund investors.

Fund operating expenses

According to Morningstar Inc., a leading fund information provider, the average U.S. stock-based mutual fund now charges its investors 1.46 percent per year for fund operations.¹ A major study of returns from the U.S. stock market over the last 200 years calculated the after-inflation return of stocks to be 6.9 percent per year.² The average mutual fund, thus, takes more than 20 percent of the anticipated after-inflation return of an investor wishing to own a portfolio of U.S. stocks.

The effect of the drag of expenses on investment performance is best grasped in the long term. Your \$3,000 contribution to your IRA this year would grow to \$11,394 in 20 years at 6.9 percent per year. If the rate of the return was reduced by 1.46 percent, the investment would grow to \$8,572, a difference of \$2,822 (more than 94 percent of your original investment).

In a study requested by the Wall Street Journal, Morningstar found that the distinguishing factor of top stock, bond and money market funds is "modest annual expenses, usually well below one percent a year." A broad hint to the findings is contained in the title of the article: "Hint: Managers Are Only as Smart as the Expenses They Charge."³

What to do? Choose funds with low or very low fund operating expenses. Expenses are listed in the fund's prospectus, annual report or online (e.g. Morningstar.com).

Portfolio turnover

Financial news brings favor to some stocks and disfavor to others. Most stock mutual funds make changes within their investment portfolios. The "portfolio turnover rate" is the rate of this change. Several costs are involved. Although it purchases stocks in lots of 10,000 shares per transaction, there are brokerage costs, which a mutual fund bears. In addition, there is a difference (known as "the spread") between the price at which a stock can be purchased and the price at which it can be sold at any given point in time.

Finally, the very size of the transactions of the fund operates to move the market price, lower if the fund is selling a stock and higher if the fund is purchasing. Several studies have estimated the cost of portfolio turnover. One estimated that the cost to sell one stock and to purchase a replacement was 0.95 percent. If each stock were replaced once each year (a 100 percent turnover rate), the cost would be almost one percent.⁴ The Plexus Group, a management consulting firm that assists mutual fund managers to increase the efficiency of their security trading activities, estimates that a 100 percent turnover of stocks in a fund costs 1.16 percent (1.01 percent for stocks with a market capitalization of more than one billion dollars, and a whopping 4.49 percent for smaller capital stocks).⁵

What to do? Choose funds with low/very low portfolio turnover rates, as listed in the fund's prospectus, annual report or online.

"Style Drift"

Modern Portfolio Theory (MPT) is a body of academic work now 50 years old. Here are a couple of principles of MPT of prime importance to investors:

"Riskier asset classes, such as [the stocks of] smaller companies and value companies, will produce higher returns as compensation for their higher risk ...diversification across asset classes can increase returns and reduce risk. For any given level of risk, a portfolio can be constructed that will produce the highest expected return. There is no right portfolio for every investor. Each investor must choose an asset allocation that results in a portfolio with an acceptable level of risk."⁶

The prospectus provides basic information about a fund, including the range of securities in which it is permitted to invest. Some funds invest in a broad range of securities, stocks and bonds ("hybrid" or "balanced" funds). Others funds are specialized, e.g. small capitalization value stocks, or healthcare industry stocks. In constructing a portfolio, the investor (or investor's advisor) must be concerned with whether the fund that has been chosen (e.g. small stocks) will continue to invest in small stocks or will it "drift" into investing in medium or larger cap stocks.

What to do? In its basic, one page per fund report, the Morningstar mutual fund reporting service provides a summary of the investment style of the fund (growth, value or blend; large capital, medium or small) over a 10-year history. If you are to remain highly diversified, your fund should stay put.

Taxable distributions

Your 401(k) provides deferral of income taxes on your investments until you begin withdrawing money from the account, generally in retirement. Individuals with stock mutual fund investments in currently taxable accounts must worry about the effect fund ownership has on their income tax bill. *The Morningstar FundInvestor*, a monthly publication providing information on 500 selected funds, estimates that the large capital funds it follows (more than 120) cost individuals in the highest federal tax bracket, between 0.3 percent and 4.1 percent per year in income taxes.⁷

What to do? Seek funds with histories of lower rates of portfolio turnover since net capital gains realized by the fund must be distributed to shareholders as taxable distributions, whether the shareholder accepts the distribution in cash or merely reinvests in more shares of the fund. Low turnover doesn't guarantee freedom from taxable capital gains distributions, but is a reliable indicator.

Fund performance histories

All of us seek to use experience as a basis for our actions; it's a natural response to life. We use evidence. We are planners. Most investors believe that the past performance record of a mutual fund is a predictor of future performance. But more closely considered, the evidence is that history is of no assistance. Here is Fortune magazine's advice:

"Despite the solemn import that fund companies attribute to past performance, there is no evidence that the four percent who beat the [S&P 500] index over a 15-year period owe their record to anything other than random statistical variation. ...Despite volumes of research attesting to the meaninglessness of past returns, most investors (and personal finance magazines) seek tomorrow's winners among yesterday's [winners]. Forget it... The truth is, much as you wish you could know which funds will be hot, you can't and neither can the legions of advisers and publications that claim they can."8

Jonathan Clements writes the "Get-ting Going" basic investment advice in the *Wall Street Journal*. He doesn't believe that history is worth searching, let alone relying upon: "I believe the search for top-performing stock funds is an intellectually discredited exercise that will come to be viewed as one of the great financial follies of the late 20th century."9

Even more dangerous, the historically "hot" fund of today has a higher than average chance of under-performing in the future. John Bogle, a founder of the Vanguard Group of mutual funds and a proponent of low-cost, indexed mutual fund investing, devotes an entire chapter in his book, *Common Sense on Mutual Funds, New Imperatives for the Intelligent Investor*, to the principal of reversion to the mean:

"But in the very long run, there is a profound tendency for the returns of high-performing funds to come down to earth, and almost as inevitably, for the returns of low-performing funds to come up to earth...Reversion toward the market mean is the dominant factor in long-term mutual fund returns."10

What to do? Morningstar reports that if "good funds" are purchased in "out of favor" (e.g. under-performing) industries, held several years and sold, the investment result will be better than just holding a diversified list of stock funds. Nerves of steel are a requirement because this means purchasing funds, which are currently out of favor. For example, it might mean purchasing stock funds currently invested in Japanese stocks. Few individuals can stomach this approach. However, there is another solution.

What To Do — Another Solution

Indexed mutual funds do not choose Ford stock over General Motors or IBM over Dell. Instead, such funds (also known as "passively managed") merely seek to own the same stocks as are included within an index, often the S&P 500, an index of the stocks of the 500 largest public U.S. companies. Because this strategy can be implemented by computer software, fund operating expenses are lower than paying an investment manager. Typical index fund operating expenses are less than .5% per year, and many are less than .25%.

Stocks in the index change, but only occasionally, much less often than the investments within an actively managed fund. If properly implemented, the strategy of tying fund investments to an index reduces both the possibility of style drift and the level of taxable capital gains distributions.

An index fund seeks to perform at the same level as the index of its portion of financial markets, minus the lower operating expenses of the fund and of portfolio trading. Institutional investors responsible for pension and endowment funds are learning this lesson faster than individual investors. It is estimated that 40% of all institutional funds are indexed or passively managed.¹¹ Rather than being beguiled by historical claims of excellence, the investor ought to investigate this now 25-year-old investment vehicle — the indexed mutual fund.

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- 11 Swedroe, 7.

About the author

John Smartt, CPA, MBA, with the firm Financial Counseling & Administration, is a Tennessee Registered Investment Advisor and a Financial Industry Affiliate Member of the National Association of Personal Financial Advisors. A frequent speaker on investment topics, he offers investment management affiliations to CPAs. He may be reached at 865/588-4159 or by e-mail at johnsmarttcpa@yahoo.com.