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Why wealthy investors don't own mutual funds - MarketWatch

Monday, September 17, 2012
8:55 AM

By Mitch Tuchman

Mutual fund fees too high? Any product has to sell itself on being different, better, and worth paying for. You'd never pay extra to a driver who might — or might not — get you where you need to go.

Yet most mutual funds do exactly that. They start at Point A and, too often, never get to Point B. It's a big world with lots of detours, after all.

Mutual funds are interesting creations. They trade a bit like individual stocks. You can buy or sell them using a ticker symbol. And, much like stocks, your investment performance relies on the expertise of a small group of people.

In the case of common stocks, you are betting that the board, CEO, and other top managers understand the business well enough to grow sales and profitability. Whether anyone else agrees with your assessment is another question, but there is a compelling evidence that rising sales supports a stock's price.

At the very least, strong revenue growth and serious cost controls provide room for safe dividend payments or, failing that, reinvestment in the business itself.

With mutual funds, the problem is the same. You have to find and bet on a small group of people, namely the fund manager and his or her research team. Their expertise should remove some of your personal uncertainty about stock investing. After all, you now have a manager to make stock bets for you, even with mutual fund fees too high.

But why are mutual fund fees too high? Consider that selecting a fund is not enough. You have added the complexity of having to "guess right" the future performance of the manager. As we know from finance research — and see printed at the bottom of every mutual fund prospectus — past performance is no guarantee of future results.

Now, data from Lipper shows that investors who feel somewhat safer in the hands of a professional stock picker face a significant, but poorly understood, "meta" risk: Their own inability to pick the right picker.

From *Financial Times* , [via CNBC]:

"Mutual funds are not performing as badly as last year, when just 27 percent offered better returns than the benchmark they choose to track, according to research group Lipper. But, again, the majority still trail in 2012."

Stretch out the numbers, as [Reuters' Felix Salmon suggests], and things don't improve:

"This is pretty much in line with the latest Spiva analysis, as of year-end 2011, which shows just 16% of equity funds outperforming the S&P Composite 1500 over 1 year to end-2011, 43% outperforming over three years, and 38% outperforming over five years."

Inserted from <http://www.marketwatch.com/story/why-wealthy-investors-dont-own-mutual-funds-2012-09-14>

Over a decade, things get worse, never exceeding 35% of funds outperforming, and over 30 years the number is 31.5%, Salmon notes.

Mutual fund fees too high: solutions

Are your mutual fund fees too high? How much would you pay for a 30% chance of beating the benchmark? Or a 70% chance of failing? Remember, second prize is not matching the index. It's probably underpeforming at some measurable level.

If you think of matching the market as your minimum goal, understand that seven out of 10 fund managers are going to get lost along the way and likely drive you down some aimless back roads. They might eventually match their benchmark — but never once you subtract their fees.

Along the way, of course, the meter is running: The average mutual fund charges between 1.3% and 1.5% and some charge up to 2%. Meanwhile, index funds charge as low as 0.2%. Some ETFs are even cheaper.

You might conclude, rightly, that the premium for underperformance should be negative, as in "You couldn't pay me to ride with that guy!" Yet millions of investors happily pay the premium, oblivious to just how lost they will get.