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Five Reasons Your Mutual Fund Probably Underperforms the Market

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Before investors blindly turn over precious hard earned money to money managers perhaps a little due diligence is in order. According to SPIVA (S&P Indices Versus Active Funds), the statistical "bible" on such arcana, actively managed domestic mutual funds have a rather dismal record when compared against investing in passive indexes. In 2012, 66.08 percent of all domestic equity mutual funds underperformed when matched against the S&P 1500. In 2011 a swollen 84.07 percent were laggards, while in 2010 "only" 57.63 did worse than the averages. The S&P 1500 includes the value of 90 percent of all exchange traded stocks. SPIVA slices and dices and parses the data into thirteen different categories from the Small Cap Core Funds which are measured against the S&P Small Cap 600 to the Large Cap Funds which do battle with the S&P 500. For the past three calendar years through 2012, every single category, all thirteen of them, on average had returns worse than their respective benchmarks. Of the thirty nine data points (13 x 3 years) only Large Cap Value funds beat (one time) their benchmark. In 2010 an impressive 65.33 percent of this class of funds exceeded their hurdle which is the S&P 500 Value Index. But alas, in 2012 they gave it all back and more when a whopping 85.06 percent of these funds once again underperformed their benchmark. Enough numbers….In this article I will explain five major reasons why on average, year in and year out, passive equity indexes outperform professional money managers.

1) **Diversification**: More accurately, I should have said too much of it. Most mutual funds may hold sixty, seventy, or more positions in different equities. Some funds may have over a hundred different holdings. Statistics say if you throw a dart thirty five times against a wall containing all S&P 500 (or S&P 1500, it doesn't matter) listed stocks and held that portfolio, that the returns on that portfolio would over time track the S&P 500 within 3 percent. To be specific, if the S&P 500 gains 9 percent annually over eight years then the dart portfolio will return between 8.73 and 9.27 percent per year during the same period. So statistically, for a fund manager to outperform the market (S&P 500) in general or his particular benchmark in particular, then she or he either must hold fewer positions or be radically overweight in a few particular stocks or in a sector, like the financials or technology. Go have a look at a particular fund and then look at its sector weightings. If that fund has more than fifty holdings and its sector weights are very close to those in the index it measures itself against (i.e. a Mid Cap Core Funds compares to S&P Midcap 400) then this fund more than likely is a laggard. A fund with this profile is almost by definition, mimicking the very index it is trying

to beat. Diversification is a valid investment axiom, but when trying to achieve excess returns or *alpha,* there is such thing as too much of a good thing.

2) **The Fees**: Mutual Fund fees range across the board. According to data from industry trade group ICI (Investment Company Institute) the average fees charged by actively managed equity mutual funds are 1.44 percent annually. On the low end there are some that are under 1 percent while others can easily be over 2.5 percent. Due to economies of scale a fund with $10 billion in assets can be run more efficiently than a $300 million pool of money, and therefore may carry a lower price tag. Although sales of these types of mutual funds are on the decline, there are still funds with “front end” loads as well as “back end” loads, often referred to as redemption fees. Redemption fees have some merit as they are often designed to stop traders from moving in and out of the fund attempting to make a quick speculation profit. These fees often decline over time and may go to zero after a few years. There are 12-b1 fees to consider. If you purchase your mutual fund through a retail broker, there is likely a 25 basis point (.25 percent) recurring annual fee tacked on. There is no reason ever to buy a fund through a broker when you can pick up the phone and call Schwab or Fidelity and do it for free. Assume an all in cost for your fund purchase is 1.5% per year and we pick an investment horizon of ten, fifteen and twenty years. Next let’s postulate that before fees this fund has a total return of nine percent per annum. Now let’s compare returns before and after fees….9 percent vs. 7.5 percent. For ten years at 9 percent a $1,000 investment becomes $2,370 but when the expenses are deducted you are return diminishes to $2,060. As more time passes the effects of compounding further exacerbate the differences. For fifteen years 9 percent returns $3,640 while the 7.5 percent investment yields only $2,950. 20 year totals are $5,600 versus $4,250. Unless you have a super manager these are long odds to overcome indeed. If an investor purchased the Vanguard S&P 500 ETF (VOO) the expense ratio is only 5 basis points (five hundredths of one percent) or one thirtieth of the actively managed fund. The Blackrock (BLK) iShares S&P 500 Index Fund (IVV) has costs only slightly higher at 7 basis points. With either of these options an investor comes much closer to realizing the actual market returns.

3) **Cash On Hand**: Fund Managers, by definition, have to keep some portion of the fund assets in cash for normal course of business redemptions or for buying opportunities as market dips inevitably occur. On average the cash amount may be as low as three percent and as high as seven percent. This is dead money, especially in today’s zero interest rate environment that earns no return. So for every $1,000 invested, at any given time, maybe only $950 is working for you. It represents just one more weight mutual fund investors must shoulder. Further, because human psychology over millennia never changes, the really large fund redemptions will come at the worst of times. Fear and greed are universal emotions that seem genetically encoded. People very frequently make panic sales when the market crashes. To meet larger than normal redemptions may force a manager to sell stocks often precisely at the worst moments to satisfy a person’s craving for safety. After the dust has settled and the scare now in the past, those same equities may now have to be repurchased at higher prices. This may adversely affect returns as well.

4) **Money Manager Psychology**: Fund manager's often have one eye on the market, one eye on the indexes, and one eye on other managers competing in the same space. By my count the main focus of investing may not perhaps be receiving all the attentions due. Take a listen to Barron's on April 8: "Yet with stocks up 23% since June, money managers can't afford to fall to far behind surging indexes. Concerns are mounting corporate profits aren't rising fast enough. So buyers are piled into sectors with more stable revenues like health care, consumer staples, and utilities…… " Many managers therefore exhibit similar qualities to lemmings. They will follow each other off the cliff rather than risk being different and thinking independently. The inference of the above quote is that everybody bought the same stocks. Next, managers may be compensated on how they perform relative to their benchmark. Or perhaps their bonus is based on being in the top quarter or decile of all managers. There is ample incentive to be a follower rather than having both eyes on the ball…..research and picking the best securities. While empirically I don't know if there are statistics to prove this, I believe fund managers returns are impaired by these attitudes.

5) **Taxes and Phantom Income**: All of the computations by SPIVA are done on a pre-tax basis. If you consider the tax implications the numbers may get downright draconian. Many funds turn over 70, 80 or even 100 percent of portfolios annually. This makes for a lot more short term gains than occur in index funds. Also, trading costs are greatly increased by this large turnover and trading costs are not included in fund expense ratios. Second, perhaps more pernicious, are potential phantom gains. Mutual funds can make capital gains distributions, often toward year end in October or November. Say an investor puts money in a fund on October 15 and Microsoft is trading at $31 per share at date of fund purchase. The fund has owned the stock for a few years and has a basis of $22 per share. At the end of October the manager elects to sell Microsoft at the market price of say $30 per share. Despite having only been in the fund for two weeks the newbie investor gets an $8 per gain even though the stock has actually fallen a dollar. Funds have differing amounts of these "unrealized" gains in the portfolios. It should be a consideration if you choose to invest in mutual funds and may be wise to consult a tax advisor to fully acquaint with these ramifications.

Taking these formidable obstacles cumulatively, even with all the brains in the world, it is hard for managers to beat the markets. As mentioned, the ones that do often take more concentrated positions and may have fewer holdings. Why, given the abysmal performance of the industry as a whole, do investors continue to come back for more punishment? It is a strange phenomenon to me. Perhaps there is comfort, however fallacious, that a "professional" is watching over your money.

Savvy investors should look at fund expenses, historical portfolio turnover and sector weightings to before deciding if their manager has a chance at beating the market after taxes or is really just a closet indexer charging excessive management fees. Do what you will, but don't say you didn't have the facts.