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Think twice before putting your savings into Mutual Funds.

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Intended Audience

For those of you deciding where to put excess cash or retirement savings.

Summary Points to Take Away

- Three points to consider on why market index funds will outperform actively managed mutual funds: (1) Strong performance by a mutual fund will see an influx of cash that increases the asset base – bringing down the return in terms of %; (2) Options for fund managers with new influxes of cash are sparse - Higher cash can be invested in current well performing asset positions would push them into being overvalued; or could invest it into stocks that were not deemed strong enough investments in the first place. (3) SEC limits the % ownership a mutual fund can have in a stock; thus, with more cash, more positions in more stocks have to be taken; thus, the fund becomes more representative of the market.
- Actively managed mutual funds become glorified index funds, which charge higher fees; thus, fail to beat market index benchmarks (ex. S&P 500).
- Investing in market index funds gives you growth and diversification, which most actively managed mutual funds promise you in the first place, so might as well skip the middle man (i.e. the highly paid investment team hired to manage your money).

Analysis

Common saying on Wall Street is that “most mutual fund managers can’t outperform the market” –measured by comparing the fund return to representative benchmarks (ex. S&P 500). Looking into the logic of this statement – there appears to be some truth to it.

Before we go on, please note the two investing options being compared within this article: (1) Actively managed mutual funds have well qualified (and expensive) professionals making investment decisions usually with specific themes (i.e. specializing in base metals or Asian Pacific stocks), because of this – the management fee to the investor is typically 2% of the total asset base given the highly skilled investment team that are managing the assets. (2) Passively managed mutual funds or ETFs –have the mandate of tracking the performance of the general movement in the market (ex. If Citigroup presents 2% of the S&P500, then the passively managed fund that is tracking the index would hold 2% of Citigroup). Since there is no detailed financial analysis, etc – the fund is run by a skeleton team; thus, a lower fee is charged to investors (ranging from 0 to 1% of total assets).

Why it is that mutual fund manager can’t outperform the market?

- (1) Strong performance by a mutual fund will see an influx of cash that increases the asset base. This appears to be a logical conclusion since as mutual fund posts a gain higher than the market it’ll catch the average investors attention, which will flood the fund with excess cash with the hopes that history will repeat itself. More cash equals a larger asset base. Let’s assume that the fund receives additional cash that doubles their current asset base; thus, the team will have to identify enough investment opportunities to bring double the prior year gains incurred in order to provide the same performance year over year. If the cash isn’t invested – then the return would be cut in half as the gain in terms of dollars stays the same but the asset based used to generate that gain has doubled – this puts mutual fund managers into a tough position.

- (2) With the new founded cash – what options do the fund managers have, they can either take the cash and invest it in the funds current holdings, which have performed well over the year; thus, pushing these stocks to levels where they'll be considered overvalued; or they could take the new cash and invest it in stocks that were not deemed strong enough investments in the first place. Similar to the point above – opportunities are a finite constraint; thus, with more cash – less optimal opportunities have to be utilized as the fund eventually runs out of investment options with further increases in cash to play with.
- (3) SEC limits the % ownership a mutual fund can have in a stock; thus, with more cash, more positions in more stocks have to be taken. Given that funds can only invest so much into each stock identified, more worthy investments would need to be identified in order to put the new cash into play. Eventually with enough influxes in cash – the fund must purchase a large basket of diverse stocks, which will essentially track the market; thus, becoming a glorified index funds them.

Given that the pre-fee return of passively and actively managed funds is expected to be the same, passively managed funds (i.e. market index funds or ETFs) will outperform actively managed funds due to the lower management fees. This is assumed in the long run as for every year the fund outperforms the market it will see an increase in cash from investors flowing into the funds, which will continue to lead the fund into purchasing numerous holdings resulting in a diverse basket of funds; thus, becoming an overpriced index fund inadvertently.

Where to go from here?

For those of you with RRSP, 401K's or discretionary saving plans or if you're planning on starting up a savings fund – consider moving from actively managed mutual funds to ETF's or passively managed index funds that track the market or passively managed index funds with your local asset management firm or financial institution. Market index funds will prove to be the winner.

Would love to hear your feedback – contact thatstockguy.NET@gmail.com .

Thanks,

Simon

Simon Giannakis is the founder and creator of thatstockguy.NET. He currently is a Senior Accountant within the Assurance and Advisory group at Deloitte & Touche LLP in Toronto, Ontario. He has a BBA degree from Wilfrid Laurier University and is currently pursuing both CA and CFA designations. Simon can be contacted through thatstockguy.net@gmail.com

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