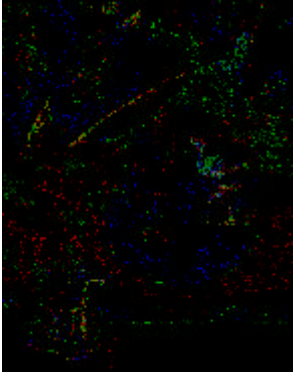


What Went Wrong In Mutual Fund America?

The triumph of salesmanship over stewardship

by: John C. Bogle

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An excerpt from John Bogle's new book, The Battle for the Soul of Capitalism, Yale University Press, 2006. (Note: The excerpt has been edited to be internally complete.)

America's mutual fund industry has lost its way. Dominated by the interests of its managers, fund organizations have focused on salesmanship over stewardship, abandoning traditional investment committees in favor of flashy portfolio managers. Engaging in ever more risky investment policies, managers increasingly provide new funds to meet the fads of the day, only to quickly dispatch them when they have outlived their usefulness.

What is more, by virtue of its own perverse governance structure, the fund industry itself presents the most extreme example of the triumph of managers' capitalism over owners' capitalism in corporate America.

Using an organizational design that would amaze (and delight!) the oligarchs of corporate America, the managers of mutual funds have enjoyed virtually free rein to place their interests ahead of the interests of the owners of their funds. While the policy promulgated in the preamble of the Investment Company Act of 1940 clearly ordains that funds must be "organized, operated, and managed" in the interests of their shareholders, "rather than in the interests of their managers and distributors," that sound policy has been honored far more in its breach than in its observance. [\[1\]](#)

Given the power held by fund managers over the owners of the funds that they supervise, it would have been miraculous if the mutual fund industry had been immune to the kinds of scandals that have faced corporate America and Wall Street. For in no other line of business endeavor is the conflict between owners' capitalism and managers' capitalism more institutionalized by tradition, and therefore more widely accepted. The conflict arises from a structure in which the fund itself, typically a corporation with its own directors but with no employees, begins its existence as a creature of its management company, a separate corporation with its own separate financial objectives. It is that very structure that gives managers near-total dominion over fund shareowners. As a result, it was almost preordained that fund managers, for all of their proclamations about their dedication to Main Street investors, would abuse their power, resulting in the profound conflicts that ultimately came to light.

Rocked By Scandal

Industry leaders, of course, denied that significant conflicts existed. Indeed, in his remarks at the Investment Company Institute's General Membership Meeting in May 2003, Matthew Fink, the president of the fund industry's trade association, pointed with pride at the industry's rock-solid reputation, citing Securities and Exchange Commission (SEC) commissioner Harvey Goldschmidt's glowing tribute just a few months earlier: "The mutual fund industry has been blessed—and blessed is the only word—by being relatively free of scandal." [\[2\]](#) As he read those words, giant images depicting the quotation were displayed on both sides of the dais. Fink then added: "The record is no accident. . . . We have succeeded because the interests of those who manage funds are well-aligned with the interests of those whose invest in mutual funds."

Less than four months later, on September 3, 2003, the mutual fund scandals exploded, epitomized in an eerie parallel to the corporate scandals that first came to light with Enron in 2001 and the Wall Street scandals that came to light in 2002. Widespread wrongdoing was exposed when New York's crusading attorney general Eliot L. Spitzer brought civil actions against four major mutual fund management companies, charging that they had conspired with, and even aided and abetted, preferred investors (including hedge funds that identified their strategy as "mutual fund market timing") to undertake illegal acts. These investors would buy and sell fund shares at closing prices based on late-breaking events that had taken place well after the market had closed, and trade international funds in the United States at values set in foreign markets hours before the trades took place. Spitzer accurately compared these practices to allowing favored investors to bet on a horse race after the horses have crossed the finish line.

The attorney general's seemingly airtight case was built not only on covert practices, but on readily discernable motives—the receipt of payola, for the want of a better word. The managers received that payola in the form of side banking deals, earning high interest rates on their loans to the traders, requiring as a quid pro quo large investments in other funds on which the manager earns high fees—"sticky assets" in the vernacular of the trade—and the like.

One manager's e-mail could hardly have made the motivation clearer. "I have no interest in building a business around market timers, but at the same time I do not want to turn away \$10-\$20m[illion]!" [\[3\]](#) (Yes, the exclamation point was there.) The writer emphasized that allowing the timing trades would be in the manager's "best interests." Lest his colleagues be complete nincompoops who failed to get the point, he explained in a parenthetical aside what that meant: "increased profitability to the firm." Another e-mail (God bless e-mail) discovered during Attorney General Spitzer's investigation and made public in his September 3, 2003, complaint against Canary Capital Partners, also told the truth: "Market timers are a big problem . . . it's very disruptive to the operation of the funds. [But] obviously, your call from the sales side."

The industry's response to the market timing scandals can be best characterized by paraphrasing the classic line spoken by police captain Louis Renault, played by Claude Rains in the film Casablanca, as he was confronted by the Nazis in a bar well known for the gambling that took place inside: "I am shocked, shocked to find timing [in the movie, gambling] going on here." The public was told that the misdeeds were akin to "parking at a meter and not paying. Nobody is being bankrupted by this." [\[4\]](#) We've also been told that these breaches of fiduciary duty are attributable to only a "few bad apples," although as these scandals continued to come to light the definition of "few" had to be liberalized. [\[5\]](#)

As the trading scandals grew, other scandals surfaced. Brokerage firms, it turned out, were often selling higher-priced "B shares" (with the sales load spread over five or six years) rather than less expensive (but still costly) A shares (with front-end loads), as well as selling their own proprietary funds without disclosing the conflict of interest. It also turned out that some fund managers were directing brokerage commissions and other payments to firms that sold the shares of their funds without disclosure, and often in violation of SEC rules. The wide-ranging scandals were the starkest example of the triumph of managers' capitalism over owners' capitalism in mutual fund America, a dispiriting echo of the old baneful warning: "When we have strong managers, weak directors, and passive owners, it's only a matter of time until the looting begins."

The Emperor's Clothes

How can it be that the fund industry takes its bizarre governance structure as the natural order of things? How is it that its leaders couldn't see that this structure was an accident waiting to happen?

As Descartes said in 1650: "A man is incapable of comprehending any argument that interferes with his revenue."

Even as the spotlight that shined on the specific acts that brought notoriety to corporate America's bad apples—the Ken Lay's, the Dennis Kozlowski's and the Sam Waksal's—the spotlight that shined on the mutual fund industry brought notoriety to the bad apples of the industry. Even more important, the scandals illuminated all the nibbling around the edges of proper and ethical conduct that, absent that intrusive spotlight, could otherwise have persisted for another decade or more, and demonstrated the frequent willingness—nay, the eagerness—of fund managers to build their own profits at the expense of the fund owners whom they are honor-bound to serve.

Some Notable Examples

As in corporate America, and in investment America, there were some particularly bad apples in the giant barrel that represents the fund industry:

Gary Pilgrim and Harold Baxter

These two fund executives not only allowed certain preferred hedge funds to engage in market-timing schemes, but, through a hedge fund in which they held personal interests, even did so themselves. Since the inception of the PBHG (Pilgrim Baxter Holding Group) funds in 1985, their funds had operated under frankly speculative policies. They engaged in aggressive short-term trading tactics, and provided volatile returns, both up and down. But however spasmodic the eye-catching returns periodically achieved by their funds were, the firm hyped them in opportunistic advertising and drew huge investor capital to their funds after their good performance had been achieved, and almost inevitably just before it turned sour. Result: investors in the PBHG funds incurred literally billions of dollars of losses, while Pilgrim and Baxter earned at least \$1 billion of profits at their expense. In addition to some \$457 million of management fees paid by the funds for the services of their firm during the 1990s alone, they capitalized on these profits by selling their management company to a publicly held company created for the sole purpose of reaping a share of the huge profits earned by fund managers. The extra profits the two managers earned through the trading schemes represented but a minor addition to the staggering financial wealth they had accumulated. Their settlement with the SEC and Attorney General Spitzer included fines and reimbursements to the funds totaling \$160 million, a virtual drop in the bucket that was filled to the brim with their ill-gotten gains. (In settling the civil charges they neither admitted nor denied guilt.)

Richard Strong

Richard Strong was principal owner of Strong Capital Management, a management company that countenanced and encouraged market timing in its own Strong-branded mutual funds; Strong also did such timing for himself and for his friends and family members. While criminal charges were considered but never brought against Strong, he was barred from the industry for life (without his admitting or denying guilt to the civil charges). His firm's monetary penalty of \$175 million was among the largest assessed against any fund manager. He was well compensated for his efforts, however, including \$217 million of fees paid to the manager by the funds during the 1992–2002 decade, and an additional reward estimated at \$400 million when the management company was sold to Wells Fargo Bank a year after the scandal.[\[6\]](#)

As in corporate America, the names of many other bad apples could easily be added to this list. Executives from more than a score of major mutual fund management companies—including some of the oldest, largest, and once-most-respected firms in the field—have been implicated in the scandals and disciplined, often severely, by regulators. Similarly, the fund misconduct went far beyond a few isolated incidents involving a handful of wrongdoers. The problems are far more systemic, for the barrel of mutual fund capitalism is itself riddled with conflicts, reflected not only in the scandals involving market timing, brokerage payments, and overcharging for sales loads, but in excessive management fees and fund expenses and over-zealous marketing of speculative funds, where the financial losses inflicted on fund owners by fund managers were far greater.

From Stewardship To Salesmanship

Just as a pathological mutation transformed corporate America from owners' capitalism to managers' capitalism, so a similar mutation occurred in mutual fund America—a mutation from the industry's traditional focus on the stewardship of shareholder investments to salesmanship and asset gathering. Building a giant asset base is the easy way to produce higher fees and larger profits for the manager, who regularly collects its cut as a percentage of the asset pool. But high fees come at the direct expense of the investors who own the funds. Just as it took the scandals at Enron et al. to illustrate the broader problems of corporate America, so it took the whole series of timing, distribution, and brokerage commission scandals to call attention to the broader problems that afflicted mutual fund America.

The market-timing scandals are estimated to have cost long-term fund investors something like \$3 billion in the dilution of their returns. That dollar-for-dollar loss, of course, exactly matched the gains made by the short-term speculators in fund shares.ⁱ But the penalties

paid by fund shareholders in the form of excessive expenses, and by the unwillingness of fund managers to share with fund shareowners the staggering economies of scale involved in fund operations as fund asset levels soared, can be counted in the tens of billions, year after year.

Even more damaging were the losses incurred by fund investors as a result of the overbearing interest by fund managers in marketing and promotion. In the recent market boom and bust alone, investor losses totaled in the hundreds of billions of dollars. Capitalizing on the stock market fads and fashions of the recent stock market bubble, fund managers sold fully a half-trillion dollars in “new economy” funds to investors. In short, it turns out that the scandals that were initially publicized in the press were but a small tip of the giant iceberg that represents the enormous price paid by investors as the industry moved away from stewardship and placing shareowner interests front and center, to salesmanship and placing manager interests first.

The truth: most mutual fund managers were far more alert to improving their own financial welfare than to improving the financial welfare of those who entrusted them with their hard-earned assets. Managers used far more energy, creativity, and intelligence—and infinitely more resources—in the development of clever and opportunistic marketing schemes than in the fulfillment of their duties as responsible corporate citizens. Gathering assets and maximizing advisory fees are the sine qua non of most management companies, and it is their quest for higher profits that must bear heavy responsibility for the illegal late-trading scandals, the unethical time-zone trading scandals, and (though it has received almost no attention) the heavy waste of investor resources engendered simply by creating opportunities for garden-variety market timing—too many investors moving too much money among too many funds at too fast a rate.

Market Timing To The Fore

The market timing issue is but one obvious example of that conflict of interest, and, from a financial standpoint, probably the least important example. The most obvious timing problem was reflected in the “late trading” scandal, the brazenness of which deserves a place in the financial cronyism hall of fame. That ploy is simple and straightforward. While the closing prices of funds are established at the stock market’s close each day, “market-moving” events often occur after the close. When some sort of good news comes and is anticipated to cause stock prices to rise the next day, for example, preferred investors were allowed to buy shares at the presumably lower value set earlier. They could then redeem the shares the next day, turning a profit, but only at the expense of their fellow shareholders, whose profits, in turn, were diluted.

But late trading was only one form of timing abuse. “Time-zone trading” was likely even larger in its negative impact on fund shareholders. This tactic, too, is simple. Here a favored speculator is allowed to take advantage of a free (to the timer!) arbitrage between an international fund net asset value calculated at 4 p.m. in New York but based on closing prices across the Pacific 14 hours earlier. The shocking truth about time-zone trading is that it went on for so long without significant defenses being erected by managers. It has hardly been a secret. Academics have been publishing papers about it at least since the late-1990s.

In 2002, well before the scandal struck, an article in the *Financial Analysts Journal* carefully described the time-zone trading strategy, quantified its effectiveness, presented specific examples of how easy it was to make money by gaming the system. It also berated the industry for its benign neglect of the market-timing issue: “When the gains from these strategies are matched by offsetting losses incurred by buy-and-hold investors in these funds . . . why haven’t more funds taken stronger actions to restrict short term trading?”^[7] What is more, the authors cited fourteen other academic studies on the same point. Especially prescient in light of Spitzer’s later discovery of market timing by the Canary hedge fund, this article noted that 30 hedge funds had openly defined their investment strategy as “mutual fund timing.”ⁱⁱ If, however unlikely, industry participants had been fast asleep before that article was published, surely its publication would set the alarms ringing.

But it didn’t. The sole published response to the revelation was a letter to the editor from a senior executive of a manager whose funds were mentioned in the story. The letter lamented that a publication aimed solely at financial professionals should never have published such a piece. It described the article as a bad idea in the best of times, but abhorrent when investor confidence was already shaken by corporate greed.^[8] Nonetheless, just nine months later, the very firm that employed the respondent initiated a 2 percent redemption fee on its international funds, seemingly belatedly acting on the advice of the article to “take stronger action to restrict short-term trading.”^[9] (The firm states that the action was not engendered by the article.)

Market Timing Is Omnipresent

The soaring use of market timing by the average fund owner—not only the illegal late trader and the unethical time-zone trader—indicated that ordinary investors, using the finest vehicle for long-term investing ever designed, were engaging in excessive short-term speculation in fund shares.

There’s a lot of money sloshing around the mutual fund system. How much market timing is there? We simply don’t know. But we do know a great deal about what is going on. First, there is much more timing activity than the industry acknowledges. One indication of how long fund owners hold their shares is the redemption rate—the annual amount of redemptions by shareholders as a percentage of a fund’s average assets. By failing to acknowledge that redemptions whose proceeds are invested in another fund within the same family—“exchanges out”—are actually, well, redemptions, the ICI substantially understated the fund redemption rates it regularly published. Such intra-family redemptions are the clearest—though hardly the only—example of a market timing investment strategy; for example, frequent moves back and forth between a stock fund and a money market fund in the same family. While the ICI reported an equity fund redemption rate equal to 29 percent of assets in 2002, the actual rate, including exchanges out, was 41 percent, almost half again higher. The average fund investor, who during the 1950–1975 era held his fund shares for an average of about twelve years (proxy for an 8 percent redemption rate), was holding shares for only about two-and-a-half years (proxy for a 41 percent redemption rate).ⁱⁱⁱ

What is more, the annual report of each mutual fund is required to report total redemptions, including these exchanges. For the funds involved in one aspect or another of the timing scandals, the numbers approached the brazen. The Alger equity funds, with total assets of \$2.3 billion in 2002, reported redemptions for the year totaling \$9.3 billion—a 400 percent redemption rate, suggesting a three-month average holding period. Bank of America’s Emerging Markets Fund experienced annual redemptions equal to 295 percent of assets, and Janus Adviser International Growth fund experienced redemptions equal to 372 percent of assets.

With the dollar amount of redemptions clearly set out in each fund's financial statements and reported to shareholders without comment, we must assume that the figures were read by fund directors as well. The obvious market-timing activity, then, was happening not only with the tacit knowledge of the managers, directors, and regulators, but right under the noses of the shareholders, the press, and the public, fully disclosed for anyone who cared to look. Yet the record is virtually devoid of questions or challenges regarding the soaring market timing of fund owners.

Further, even if it doesn't entail market timing as such, nor reach the threshold for illegality, long-term fund investors pay a heavy penalty for investor activity by short-term owners. When equity funds hold extra cash as a redemption reserve, long-term returns are diluted. When such a reserve is not held, fund investors incur the cost of portfolio purchases on inflows of money, and the cost of portfolio sales all over again when the cash flows out, and perhaps tax costs as well.

In Mutual Funds, You Get What You Don't Pay For

Nowhere in mutual fund America is the conflict between owners' capitalism and managers' capitalism more severe than in the costs assessed against fund shareholders. This general rule puts it bluntly: The more the manager takes, the less the owner makes. Yet despite the obvious and documented inverse relationship that clearly links mutual fund costs and mutual fund returns, costs have risen all through the industry's modern history. In the 54 years that I have been part of this industry, for example, the costs directly incurred by equity fund investors alone—largely management fees and operating expenses—have increased from a mere \$15 million in 1950 to \$37 billion in 2004.^{iv} (Including direct costs of bond and money market funds last year, the total was \$58 billion.) That 2,400-fold increase far surpassed the nearly 1,600-fold growth in equity fund assets, from \$2.5 billion to \$4.0 trillion.

Thus, equity fund direct costs rose one-and-a-half times as fast as assets, an astonishing result in an industry in which the economies of scale in investment management are little short of staggering. (There is no evidence, for example, that it takes any more security analysts and portfolio managers to run a fund with, say, \$5 billion of assets than a fund with \$1 billion of assets.) Reflecting this increase, the expense ratio of the average equity fund (unweighted by assets) actually rose from 0.77 percent to 1.56 percent during that long half-century—an increase of more than 100 percent.^v

The Investment Company Institute (ICI) of course strongly objects to measuring fund costs in dollars. (They're enormous.) It prefers ratios. (They're tiny.) When measured against aggregate fund assets, the largest possible denominator, almost any numerator looks small. Using asset-weighted data, incorporating sales charges, and basing its ratio on the cash flows of funds rather than their assets, the ICI concludes that the costs of equity fund ownership came to 1.25 percent of assets in 2003, compared to the 1.56 percent expense ratio for the average fund shown above.

It is difficult to take seriously the fund industry's allegation that the costs of fund ownership have steadily declined. Any decline, if such it be, arises only from the fact that investors are increasingly choosing funds with lower expense ratios, and not from substantial management fee reductions. When the ICI alleges that these lower costs are the result of vigorous price competition in the fund industry, it fails to recognize that price competition is measured, not by the decisions made by fund buyers, but by the pricing decisions made by fund sellers. Major fee cuts, however, have been conspicuous by their absence.

But the management fees and operating costs included in expense ratios are by no means the only cost entailed in the ownership of fund shares. Mutual funds have become active—indeed, hyperactive—traders of the securities in their portfolios. The annual impact of these costs can be fairly estimated to come to another 0.8 percent to 1 percent of equity fund assets. On that basis, the costs of portfolio transactions may have grown by more than a thousandfold from 1950 to 2004— from an aggregate of, say, \$25 million to perhaps \$25 billion.

And that's only part—if the largest part—of the fund expense picture. In addition to operating costs (\$37 billion) and transaction costs (\$25 billion) incurred by equity funds, at least another \$10 billion comes in the form of front-end sales charges, penalties on early redemptions of shares, out-of-pocket costs, fees paid by investors to independent investment advisers who provide asset allocation and fund selection services, and opportunity costs.^{vi} Equity fund investors paid costs estimated at \$72 billion in 2004 alone, and as much as \$300 billion over the past five years. That is what investors paid for, and it is therefore what they didn't get in terms of the net returns that were available in the stock market. When we add these costs up, it's fair to estimate that the all-in annual costs of equity fund ownership now run in the range of 2.5 percent to 3 percent of assets.

The Arithmetic Of Investing

To understand the impact of all of these costs on mutual fund investors, it is necessary only to understand the eternal arithmetic of the investment equation. Gross return in the financial markets, minus all of the costs of financial intermediation, equals the net return actually delivered to investors.

Whatever returns the financial markets are generous enough to deliver, please don't make the mistake of thinking that investors as a group actually earn those returns. To explain why this is the case we need only to understand the simple mathematics of investing: All investors as a group must necessarily earn precisely the market return, but only before the costs of investing are deducted. After all the costs of financial intermediation are deducted—the management fees, the transaction costs, the distribution costs, the advertising and marketing costs, the operating costs, and the hidden costs of financial intermediation—the returns of investors must, and will, and do, fall short of the market return by an amount precisely equal to the aggregate amount of those costs.

For all investors as a group, then, beating the market before costs is a zero-sum game; beating the market after costs is a loser's game.^{vii} It is inevitable that the returns earned by investors in the aggregate will fall well short of the returns that are realized in our financial markets. The great paradox of investing is that you don't get what you pay for. The fact is quite the opposite: You get what you don't pay for.

Of course it's possible that our professional mutual fund managers and pension fund managers as a group could somehow beat the

market, but only at the dollar-for-dollar detriment of amateur individual investors. But there is not a scintilla of evidence that such is the case. (Most studies of the returns of individual investors, in fact, show that they fall short of the market by the amount of their trading costs, an unsurprising finding.) Time and again, the average mutual fund manager has proven to be, well, average before costs are deducted, and below average thereafter. In fact, costs of fund ownership represent the approximate amount by which actively managed equity mutual funds lag the stock market over time. In the recent era, as we will soon see, equity funds lagged the market by an amount approximately equal to the level of their all-in costs of some 2 percent to 3 percent per year. So yes, costs matter.

How Much Do Costs Matter?

How much do costs matter? A ton! Indeed, the record is crystal clear that fund costs have played the determinative role in explaining why funds lag the market's return. During the 1985–2004 period, for example, the annual return on the average mutual fund averaged 10.4 percent when the return on the stock market itself averaged 13.2 percent. That 2.8 percentage-point differential is almost exactly just what one might expect, given our rough estimate of fund costs. (Never forget: Market return minus cost equals investor return.) Simply put, fund managers have arrogated to themselves an excessive share of the financial markets' returns, and left fund owners with a commensurately inferior share.

There is little doubt that, in nearly all cases, a fund's independent directors and its management company share a common interest in providing good returns to the fund shareholders. But when it comes to how good, their interests diverge. Why? Simply because the higher the management fees and other fund expenses incurred by the fund, the lower the fund's return.

In some types of funds, this relationship exists on a virtual dollar-for-dollar basis. For example, the correlation coefficient between the yields that money market funds deliver to their shareholders and the expense ratios of these funds is -0.98 , perilously close to a perfect negative correlation of -1.00 . Each percentage point of increase in cost results in a reduction in return of almost exactly one percentage point. When money market yields are 3 percent, for example, a high-cost fund will deliver as little as 1.75 percent to its owners; a low-cost fund will deliver as much as 2.75 percent, or 50 percent more. Indeed, whenever fund gross returns are commodity-like (for example, in stock index funds and bond index funds), the same kind of locked-in relationship prevails in which each extra dollar of costs entails a reduction of almost exactly the same dollar in returns.

Costs, Returns And Risks

While in the short term the relationship between the costs and the returns of managed equity funds is more tenuous than over the long run, costs clearly differentiate the superior performers from the inferior performers. An examination of the total costs and net returns of all 942 diversified U.S. equity funds in the Morningstar database showed that for the decade ended February 28, 2005, the total costs for this select group of funds that were in existence over the full ten-year period came to 1.9 percent per year. (Average expense ratio of 1.2 percent plus average portfolio transaction costs estimated at 0.7 percent. The study conservatively assumed that transaction costs totaled 1 percent of turnover, equal to only 0.5 percent on each side of the trade. It did not take sales charges or other out-of-pocket costs into account.)

Conclusion: the high-cost quartile of funds, with all-in expenses of 3.0 percent, provided an average annual return of 9.0 percent.^{viii} The low-cost quartile, with expenses of 0.9 percent, provided an average annual return of 11.7 percent, an advantage of 2.7 percentage points per year, an advantage that was even larger than its average cost advantage of 2.1 percentage points. (On a fund-by-fund basis, the inverse correlation between cost and return was remarkable: -0.42 percent.) The low-cost funds enjoyed a premium of 30 percent per year in annual return over the high-cost funds, confirming the thesis that the higher the cost, the lower the total return.

What's more, the funds with the highest costs also assumed the highest risks. The high-cost quartile carried a risk that was an amazing 34 percent higher than the risk carried by the lowest-cost quartile. (The standard deviation of their returns—a widely accepted norm—was used to measure volatility, the customary measure of the amount of risk assumed by a fund.) The high-cost funds also generated vastly higher annual portfolio turnover versus the lowest-cost group, 152 percent versus 19 percent. In all, the low-cost funds had an even greater advantage—3.8 percentage points per year—in risk-adjusted return. The investor who simply sought out low-cost funds, then, enjoyed an amazing increase on annual risk-adjusted return from 8.1 percent to 11.9 percent, an enhancement of nearly 50 percent per year.

Compounding these returns made a good situation better for the low-cost funds. For their high-cost cousins, compounding costs made a bad situation worse. Each dollar initially invested in the low-cost group would have grown by \$2.07—to \$3.07—during that ten-year period, compared to the growth of only \$1.18—to \$2.18—for the high-cost group. Investing on the basis of relative costs alone, then, fund investors would have improved their ten-year profit by 75 percent, simply by doing their fishing in the low-cost pond and avoiding like the plague the high-cost pond. It's hard to imagine a more persuasive case regarding the relation between fund costs and fund returns.

The Real-World Consequences Of High Costs

These conclusions on the impact of fund costs on fund returns may seem like an interesting theory, no more, no less. But a comparison of the long-term returns achieved by mutual funds with the returns earned in the stock market itself confirms the reality that the returns actually earned by mutual funds have lagged stock market returns by the amount of costs incurred. When you think about it, how could it be otherwise? When a mutual fund manager buys a stock, he is usually buying it from another manager of a mutual fund or pension fund. When he sells a stock, he is also usually selling it to another professional. On each trade, one manager is right; one is wrong. That might look like a zero-sum game, but it isn't. After an intermediary broker takes his commission, it becomes a loser's game on balance. So the return of the average fund ought to equal the return of the market before costs, and ought to lag the market by the amount of fees paid to its manager plus the aggregate costs of portfolio trading.

And it does. During the period 1985–2004, as noted earlier, the U.S. stock market, as measured by the Standard & Poor's 500 Stock Index, provided an annual rate of return of 13.2 percent. The return on the average equity mutual fund was 10.4 percent. The reason for that 2.8 percentage-point lag is not very complicated: As the trained, experienced investment professionals employed by the

industry’s managers competed with one another to pick the best stocks, their results averaged out. Before costs are deducted, the average mutual fund should earn the market’s return. Since all-in fund costs can be estimated at something like 2.5 percent to 3 percent per year, the annual lag of 2.8 percent in after-cost return simply validates our eminently reasonable hypothesis.

When these returns are compounded over the years, the gap between the return earned by the stock market and the return earned by the average mutual fund reaches staggering proportions.

Over as short a period as 20 years—the expected investment lifetime of a new investor today is at least 60 years—fund costs consumed more than 40 percent of the return provided by the stock market itself. Put another way, an initial investment of \$10,000, simply invested in the stock market in 1985, would have produced a profit of \$109,800. The profit on the same investment in the average mutual fund would have come to \$62,900.

Looked at from yet another perspective, the investor put up 100 percent of the capital and assumed 100 percent of the risk, but collected only 57 percent of the profit. The mutual fund management and distribution system put up zero percent of the capital and assumed zero percent of the risk, but collected 43 percent of the return. If this example does not represent the paradigm of the triumph of managers’ capitalism over owners’ capitalism in mutual fund America, it is hard to imagine what would. Almost half of the fund owners’ money was siphoned away by those who quite literally had everything to gain and nothing to lose.

A Marketing Business—We Make What Will Sell

It gets worse. While the conflict of interest between fund managers and fund owners explains the large cost-driven gap in long-term performance between the average fund and the stock market itself, there is another major conflict that has cost fund investors even more. Fund managers have moved away from being prudent guardians of their shareholders’ resources and toward being imprudent promoters of their own wares. They have learned to pander to the public taste by capitalizing on each new market fad, promoting existing funds and forming new funds, and then magnifying the problem by heavily advertising the returns earned by their “hottest” funds, usually highly speculative funds that have delivered eye-catching past returns. This focus on marketing has had a profoundly negative impact on fund investors, who have paid a huge penalty both in the timing of their fund purchases and in the selection of funds they purchased. As a result, mutual fund shareowners have fared far worse than have the funds themselves.

The fund industry has become a business-school case study in marketing—packaging new ancillary products in order to increase its penetration of existing markets and to expand into new markets. Modern marketing has played a major role in the exponential growth in mutual fund assets. But while it has enriched fund managers, it has cut deeply into the returns earned by fund owners.

Figure 1

Total Return On Initial Investment Of \$10,000 1985-2004			
	Annual Return	Final Value	Profit
Stock Market	13.2%	\$119,800	\$109,800
Average Fund	10.4%	\$72,900	\$62,900
Average Fund Investor	7.1%	\$39,700	\$29,700
Shortfall To Fund	3.3%	\$33,200	\$33,200
Shortfall To Market	6.1%	\$80,100	\$80,100
Share Of Market Return Consumed By Average Fund	46%	67%	73%

Note: During the 1993–2003 decade, based on a study of the two hundred largest equity mutual funds accounting for about 85 percent of all equity fund assets, the dollar-weighted return earned by fund shareholders was 6.8 percent, which lagged the 9.8 percent time-weighted return of the average fund by 3.3 percentage points per year. As shown in above, if we assume that a similar lag also applied over the two decades ended 2004, the dollar-weighted return earned by the typical fund investor averaged 7.1 percent per year.

In this ever-market-sensitive industry, firms are content to hide their light under a bushel in bearish times when stocks are depressed and unsought. But when stocks suddenly burst into the spotlight in bullish times, the managers create hundreds of funds—described as “new products”—focused on the hottest sectors of the market, seeking attention, wallowing in press coverage, identifying their managers as “star” performers, and engaging in vigorous advertising campaigns.

Rather than focusing on the sound investment choices that were once the industry's hallmark, fund managers worshiped at the altar of the Great God Market Share, creating funds that the investing public would be willing, if not eager, to buy. In the late bull market, what the public wanted to buy was the hottest idea of the day—"new economy" funds that focused on the Internet, on technology, and on telecommunications, and aggressive growth funds that concentrated in those market sectors. Indeed, these risky sectors came to dominate the portfolios of even the more diversified traditional growth funds. The industry cooperated to the fullest, creating these risky new funds, promoting them, and selling them to a covetous public that had little interest in the more sedate value funds that were to provide a haven in the oncoming storm.

The Penalties Of Timing And Selection

All of that marketing helped to enrich fund managers, who were rewarded by fees measured at more than \$250 billion for all stock, bond, and money market funds during the six-year boom and bust of 1997–2002 alone. But it cost fund owners far more than those onerous fees. By jumping into the market late in its bull run when stocks were at their highest levels rather than regularly investing in good times and bad, investors paid a huge timing penalty. By picking the wrong funds at the wrong time, they paid an even larger selection penalty.

First, consider the timing penalty. With the Standard and Poor's 500 Index generally languishing under the 300 level during 1984–1991, investors purchased equity funds at a \$15 billion annual rate. But after the index rose above 1,200 in 1998, on the way to its high of 1,527 in 2000, investors poured money into equity funds at a \$230 billion annual rate—15 times as many dollars. Putting so little of their money into equity funds when stocks were cheap during the early years and then acting on the apparently irresistible impulse to invest so much of their money when stocks were dear has also cost fund investors hundreds of billions of dollars.

Next, consider the selection penalty. Here the industry's responsibility is far greater. During the bubble, we created and promoted growth funds and sector funds that favored overpriced Nasdaq stocks—the "new economy," technology, and the Internet. At precisely the wrong time, investors poured over \$460 billion into these highly risky funds and withdrew nearly \$100 billion from the conservative value funds favoring NYSE stocks—"old economy" stocks that, bless them, both lagged the market as the bubble inflated and held fairly steady as it burst.

Fund owners, of course, must accept a large part of the responsibility for their own costly foolishness. Nonetheless, fund managers, too, must accept their own substantial share of the responsibility for those counterproductive patterns of adverse timing and selection that played havoc with the returns earned by the very investors that they had a duty to serve.

Adding Up The Score

When we combine the penalty that fund owners paid as a result of the cost-induced performance lag of the average fund, and then leverage that penalty with the timing and the selection penalties paid by the average fund investor, shareholder losses reached truly stunning proportions. While it is not possible to calculate with precision the amount by which the returns earned by fund owners have lagged the returns reported by the funds themselves, it is possible to estimate that lag. The best way to do so is by comparing the dollar-weighted returns earned by fund shareholders as a group with the time-weighted returns reported on a per-share basis, the conventional way of calculating fund returns. As Figure 1 shows, the average fund investor lagged the average fund by 3.3 percentage points per year.^{ix}

When this shortfall is added to the 2.8 percentage-point shortfall of the average fund to the stock market itself, the gap grows to 6.1 percentage points—only 7.1 percent for the average fund investor, compared to the 13.2 percent return that was available simply by owning the stock market itself but (1) paying no management, marketing or administrative costs; (2) owning the entire market and eschewing any decisions on fund selection; (3) never guessing about the timing of share purchases; and (4) making no redemptions—just buying and holding, and staying the long course.

When we compound the performance of the average stock fund investor, then, the yawning gap between the annual return earned by the average fund and the return of stock market itself grows into a chasm of mind-numbing proportions. Specifically, while \$10,000 invested in the stock market earned a profit of \$109,800, the average investor earned a profit of just \$29,700. Together, the cost penalty, the timing penalty, and the selection penalty consumed an amazing 73 percent of the profit available simply by buying and holding the stock market itself, leaving the average fund stockholder with a mere 27 percent of the total. Investors have paid a staggering price for the excessive costs and excessive marketing focus of the mutual fund industry.

Endnotes

[1] For the first quotation, see Investment Company Act of 1940, <http://www.sec.gov/about/laws/ica40.pdf>. The second quotation is from the commission's unanimous opinion in its Vanguard decision, see *The Vanguard Group, Inc.*, 47 S.E.C. 450 (1981).

[2] Matthew P. Fink, "ICI President's Report," speech before the Investment Company Institute's General Membership Meeting, Washington, D.C.: May 22, 2003.

[3] From New York State Attorney General Eliot Spitzer's complaint against Canary Capital Partners, LLC, http://www.oag.state.ny.us/press/2003/sep/canary_complaint.pdf.

[4] Reuters News Service, "Fidelity Receives Subpoena," *Houston Chronicle*, October 7, 2003.

[5] Judith Burns, "Skepticism Rings Industry Cleanup," *Wall Street Journal*, December 28, 2004.

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- [6] Dennis K. Berman and Christopher Oster, "Wells Fargo Nears Deal to Acquire Strong Financial," Wall Street Journal, May 26, 2004, C4.
- [7] "Stale Prices and Strategies for Trading Mutual Funds," Jacob Boudoukh, Matthew Richardson, Marti Subrahmanyam, Financial Analysts Journal 58, 4 (July/August 2002): 70.
- [8] Financial Analysts Journal, November/December 2002, 17.
- [9] Ibid.

Additional Information

- i) To understand the arithmetic, an extreme example may help. Assume that a fund's long-term owners hold 1,000,000 shares in a \$10 million fund, each with a value of \$10.00. If a favored investor were to purchase 100,000 new shares at a bargain price of, say, \$9.00, the asset value of each share held by those owners would be immediately diluted to \$9.90, or by 1 percent.
- ii) The authors underestimated the total. A later report by the SEC put the number of hedge funds engaged in mutual fund market timing at nearly four hundred.
- iii) Following the timing scandals that were revealed late in 2003, fund managers tightened the controls designed to preclude excessive trading in fund shares, and the shareholder redemption rate has tumbled to about 25 percent; nonetheless, the resulting average holding period is just four years, only slightly above the previous 2 1/2-year average.
- iv) A study released by Morningstar in April 2005 estimated that direct equity fund expenses totaled some \$40 billion in 2004. I'm using the lower, more conservative, figure, which is based upon Lipper data.
- v) Yet such an increase was not universal. Since its formation in 1974, the expense ratio of the Vanguard Group's funds, which are operated on an "at-cost" basis, declined more than 60 percent, from 0.66 percent to 0.23 percent.
- vi) "Opportunity cost" is how we describe the long-term returns lost to shareholders by the fact that equity funds now hold a fairly constant position in cash reserves equal to about 5 percent of assets. So if the long-term return on stocks exceeds the return on U.S. Treasury bills by, say, 6 percent per year (assume that stocks return eight percent and Treasury bills 2 percent), the opportunity cost would be that 6 percent equity premium multiplied by 5 percent of assets, or 0.3 of assets percent per year.
- vii) I first came across this phrase thirty years ago in a prophetic article by Charles D. Ellis in the July/August 1975 issue of the Financial Analysts Journal.
- viii) Because we used the fund classes without 12b-1 fees, and omitted the impact of initial sales charges, the expense ratios of these 942 funds were understated relative to industry norms. Further, since we made no adjustment for survivor bias, the average return was also overstated.
- ix) A crude example: Assume a fund's assets rise from \$100 million to \$110 million during a given year, without cash flow, and its asset value rises from \$10 per share to \$11, a 10 percent time-weighted return. Next, assume that \$100 million was invested on the last day of the year at the \$11 price. The fund's average assets were \$150 million, but its gain remained at \$10 million, a 6.6 percent dollar-weighted return, or 3.4 percentage points less than the time-weighted return.

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