Things to Consider About Mutual Funds

American capitalism boomed in the early part of the 20th century. The nation was smack dab in the middle of the Industrial Revolution, ordinary citizens enjoyed newfound wealth and the stock market soared. Everyone wanted a piece of the action.

There was just one problem though: Investing wasn't that accessible. Online brokerage companies like E-Trade didn't exist in the 1920s. Good money managers were hard to find and typically had high account minimums. Trading took place on the floors of stock exchanges, and big-ticket orders went to the top of the stack. So, the ordinary investor had very few options.

This changed in 1924, when Massachusetts Investment Trust had an idea for normal investors to "mutually" pool their money together in a common "fund." Collective buying power meant they could hire a top-notch money management team and get stock traders to take them seriously.

Voila! Just like that, the first mutual fund was born.

Today, mutual funds are one of the most widely held investment vehicles in the world. In the U.S. alone, over $18 trillion is held in mutual fund accounts.[1] As with any investment, there are pros and cons to mutual funds.

The Good

1. You Get Help

If you are not sure what investments you want to buy or sell, or when to buy or sell them, there is help. A mutual fund comes with a seasoned team of analysts, traders and money managers to guide those decisions on your behalf. Sure, they charge a fee for this service, but it is usually charged as a percentage of assets, so smaller investors can get on board without some of the excessive fixed costs.

2. Investment Boundaries

Mutual funds all come with a clear directive the management team must follow while running the fund. For example, one fund might have a directive to find the best U.S. large company stocks. Another might only invest in short-term government bonds. This gives the investor a level of comfort surrounding the decisions made on behalf of his or her money. For example, conservative investors might feel more comfortable with a government bond fund manager who can't buy risky stocks.

3. Quick Access to Cash

It's important to be able to turn your investments back into cash when you need the money. Some investments can be easily sold, and others are tougher to liquidate. Mutual funds are highly liquid and can provide daily access from the mutual fund parent company.

However, for all the great aspects of mutual funds, there is a downside filled with hidden costs and potential conflicts of interest.

The Bad

1. Closet Indexers

There are two primary types of mutual funds: indexed and active. Indexed funds are built to mimic a major market index like the S&P 500 or the DOW. They don't bet on individual investments — they just follow the index.

The internal fees are generally low, as the management team doesn't have to do much when they take this passive approach. The majority of mutual funds, however, are "active," meaning the team is actively looking for investments that have the opportunity to beat their corresponding index. Logically, these funds should have a higher fee to cover the cost of these additional efforts.

Here's the problem. Many of the active mutual funds on the market today are really just "closet indexers," meaning you are overpaying for what is essentially an index fund. How can you tell if this is happening to you? Ask to see the "tracking error and "active share of your mutual fund. The higher these numbers are, the more active the management.[2] Our investment monitoring process is always mindful of these numbers to help ensure active funds stay active.

2. Hidden Fees

You might assume that all the costs of owning a mutual fund are fully disclosed. After all, that's what the fund management fee is, right? Well, it isn't quite that simple. Mutual funds are legally allowed to charge expenses to the fund over and above the standard expense ratio. The fees must be disclosed in the prospectus, but to the average investor, it could be difficult to pinpoint all the associated fees.

One such expense is the cost of trading securities inside the fund. Research by the University of California, Davis showed the average fund on the market has 1.44 percent of additional trading costs on top of the standard management fee.[3] This is significant. As an investor, you might think you are only paying .5 percent to a fund when in fact you are paying nearly four times this amount.

Part of our due diligence process is to combine what we believe to be the best funds moving forward at the absolute best cost available.

3. Share Classes

This is one commonly misunderstood aspect of mutual funds. Each individual fund can be packaged up into different "share classes." It is the same fund, just packaged multiple different ways. Imagine a 12-ounce can of Coca-Cola. It could be packaged in a standard can, a Christmas collection can, an Elvis memorabilia can, etc., but, regardless of its packaging, it's still a Coke.

Mutual funds work in a similar way and can have a significant expense to the investor. Take, for example, the American Funds Growth Fund of America. It is offered in 17 different share classes, at a wide variety of costs.[4] Remember, this is the same fund, with the same investments, with the same management team. So, why would you pay more? A common answer is because you didn't know any different, and someone told you it was the best thing since salted pretzels.

An important item to consider is that each class will have different services, distribution arrangements, fees and expenses, which will result in different performance results. Our investment management team is always focused on accessing the best share class available for our investors. There is no reason to overpay for nearly the exact same service.

Final Thoughts

Knowing how to identify these potential issues may help you benefit from the good funds while avoiding the bad ones. It will help you know where to look in order to make sure that your interests are best represented at all times.

---

[1] Statista. May 2018. "Total Net Assets of Mutual Funds in the United States." https://www.statista.com/statistics/255518/mutual-fund-assets-held-by-investment-companies-in-the-united-states/. Accessed June 21, 2018.
[2] Jerry Sais Jr. and Melissa Sais. Investopedia. March 19, 2018. "Active Share Measures Active Management." https://www.investopedia.com/articles/mutualfund/07/active-share.asp. Accessed June 21, 2018.
[3] Kenneth Kim. Forbes. Sept. 24, 2016. "How Much Do Mutual Funds Really Cost?" https://www.forbes.com/sites/kennethkim/2016/09/24/how-much-do-mutual-funds-really-cost/#6d93d48ba527. Accessed June 21, 2018.
[4] American Funds. 2018. "The Growth Fund of America." https://www.americanfunds.com/individual/investments/fund/agthx. Accessed June 21, 2018.