# Why $30 Trillion Is Invested In Mutual Funds

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# Table of Contents

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For most investors who hope to make money in the stock market, the lure of playing individual names is difficult to resist. This tendency comes despite the odds that up to 90% of those who try to trade stocks on an active basis end up under-performing the wider market, and quite often end up losing much of the money they'd invested.

The stock market can actually be quite efficient, but unfortunately not efficient enough to sustain the lottery whims of individuals who pin their hopes on finding the next big 10- or 20-bagger. This strategy typically leads to swift losses and a quick exit from the markets altogether. Even investors who are patient, highly observant, and act within their circle of competence -- in other words, take the "right" approach -- still lose money amid down markets. Frustrated and searching for answers, these people also often abandon their investing journey.

## Trading's Terrible Track Record

Taking a cursory look at the mutual fund landscape, it becomes obvious that many funds simply do not have investors' best interests at heart. In comparison to their index fund or ETF counterparts, the fees that many mutual funds charge are often very expensive. However, there are plenty of cases in which the expense fees are a drop in the bucket when one finds a mutual fund portfolio manager that is able to deliver results to outshine the benchmarks most investors use to judge their portfolio results, such as the S&P 500.

So while I tend to agree that mutual fund *fees* are not as attractive as lower cost index funds or ETFs, it is imperative that investors focus in on the overall returns that great mutual fund managers may be able to deliver.

ETFs have earned a well-deserved spot in many investors' overall strategies, but when individuals use them to aggressively trade, and wind up losing money, the difference in fees between ETFs and mutual funds becomes moot. Those in open-end mutual funds tend to trade far less frequently, and thus lose less as a result. As such, it is important to focus on dollar-weighted returns, not time-weighted returns. A strategy of actively trading ETFs tends to lose more than a buy-and-hold investor focused on mutual funds.

Remember, when you become a trader, you really are becoming a speculator. Jesse Livermore said it best himself: "The speculator is not an investor. His object is not to secure a steady return on his money at a good rate of interest, but to profit by either a rise or a fall in the price of whatever he may be speculating in.”

## Allocating Assets Effectively and Rationally through Diversification

Solid asset allocation is a process of choosing the categories you will invest in (stocks, bonds, money market funds, REITs, etc.), and is vastly more important than choosing when to get in and out of the market. What’s more, the ability to diversify through mutual funds is critical to one’s lifetime investing success. It’s prudent for investors to maintain positions in bond assets, for example, not just for pure diversification (reducing market risk), but also because bonds are stable, income-focused investments -- simply owning a chunk of bonds in your portfolio helps prevent irrational decisions (reducing behavioural risk).

The number of mutual funds suitable for an individual investor will vary depending on one’s financial circumstances. Simple but broad diversification would imply four funds:

1. A **domestic equity** mutual fund,
2. A **domestic bond** mutual fund,
3. An **international stock** mutual fund, and
4. An **international bond** mutual fund.

Dividing the domestic equity portion into two funds, one specializing in small or mid-cap stocks and the other in larger cap stocks brings the count up to five. Splitting the international equity portion into mutual funds specializing in developed economies and funds specializing in developing and emerging economies makes six. To diversify even more, one could seek a mix of lower-yield and higher-yield bonds, and so on.

Again, it is up to each investor to decide how they would like to allocate their funds. It is typical for younger investors (20’s-40’s) to be more aggressive when it comes to asset allocation, leaning toward more of an equity approach, while it is feasible for someone approaching their retirement years to look for either a more balanced approach (stocks/bonds) or simply just an income preservation slant (bonds, money markets).

The benefits of diversification are difficult to achieve with commitments of less than 10% of your portfolio to any one area, which sets the upper range at not much more than 10 mutual funds. Thus, diversification implies a range of around four to nine mutual funds – all unique in investment objective and security coverage.

Over-diversification is a danger that investors face, as well. This results from fund investments that essentially duplicate each other via overlapping assets. Over-diversification adds nothing to performance, but generally adds frustration as well as cost in keeping track of and monitoring too many funds.

## Index Mutual Funds vs. ETFs

A popular argument among market watchers involves trying to decide between index mutual funds and ETFs. Here are some examples that paint both as having considerable merit.

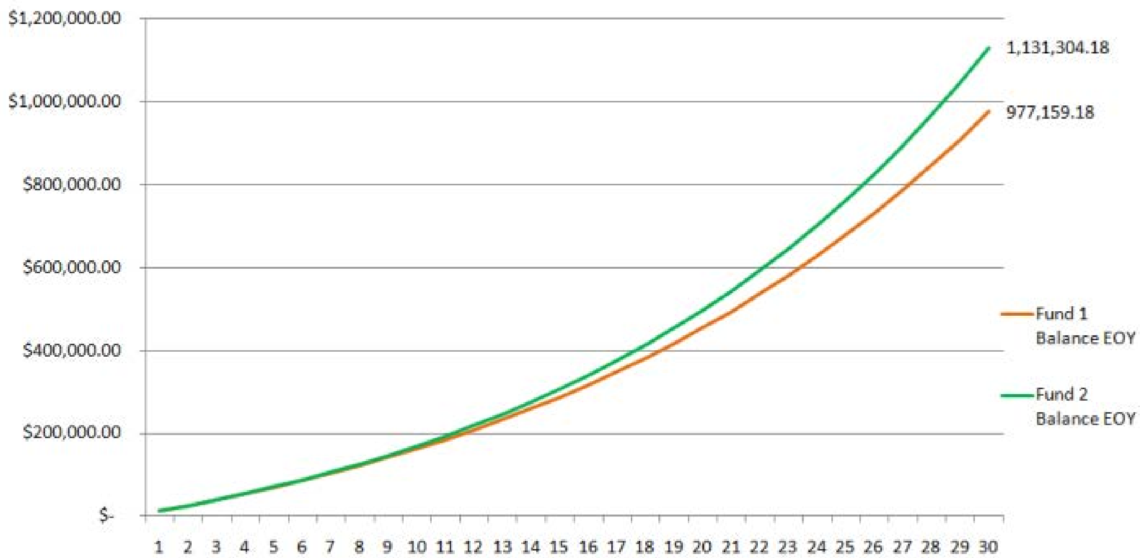
First, let's assume a $1,000 initial investment, a 5 basis point (0.05%) difference in the expense ratios (in favor of the ETF), and a flat $10.99 commission. Over all holding periods up to 20 years, you would be better off with the mutual fund (even at 20 years, the present value of the expense savings is only about $7). However, if the expense savings rises to 25 basis points, then you'd be better off with the ETF – *if* you expected to hold it for six years or more. If the expense savings rises to 50 basis points per year, the ETF is a better deal if you expect to hold it for 3 years or more.

Next, let's increase the investment to $10,000. At 5 basis points expense ratio difference, you would prefer the ETF if you expected to hold it for three years or more. When the expense ratio rises to 15bp/year or more, you would prefer the ETF under all circumstances.

For a $100,000 investment, you always prefer the ETF. However, there are two other important points to keep in mind. First, we emphasize that this analysis is for a one-time investment. If you are making regular investments over time (and incurring commissions on each purchase), you may well be better off with the index mutual fund. Second, if the tracking errors were greater for the ETF than the mutual fund, this would reduce the relative attractiveness of the ETF, as it would effectively reduce, or even reverse, the difference in expense ratios.

ETFs for the most part have low costs, but they tend to lose in a bigger way than fees. As noted earlier, people often aggressively trade ETFs, and since trading is so incredibly difficult, losing capital is quite common. Those in open-end mutual funds trade far less, and lose less as a result. Dollar-weighted returns trump time-weighted returns every single time.

All this said, there is a general downward trend in all fees related to the investment world, as more firms are forced to compete on cost (and as more investors become comfortable with a self-directed approach). Index funds were traditionally the leaders in the low-cost arena, with actively managed funds sticking more stubbornly to higher fees. Then no load mutual funds began a low-cost revolution, and more recently brokers have extended this war on fees to include commission-free exchange-traded products. Asset management fees are also trending lower for both hedge funds and registered investment advisors.




**Comparing ending balance of two index funds:**
**One with 1.00% MER and $0.00 commission (Fund 1),**
**One with 0.17% MER and $5.00 commission (Fund 2).**
**12x purchases per year of $1000 each. Gross rate of return 7.00%.**

So as we decide what area makes the most sense for us, choosing both mutual funds and ETFs together as part of one's overall strategy can indeed work. Unfortunately many in the industry have quite a lot of skin in the game, and so do we, considering we are **MutualFunds.com!** But the honest answer is that we can get great results from both types of funds, as long as we investors make the right choices for our individual needs and focus on the long term.

## The Modern Markets Encourage a Casino Mentality

Speaking of making money over the long-term, the "instant results" generation is at a huge disadvantage. Most of the focus today, thanks to the business media, is on checking your financial scoreboard frequently. As a result, many modern market watchers are more like gamblers than real investors. It's gotten to the point where most people will simply ask, "What did the market do today?" to gauge how investments are performing.

It's also easier than ever to access your brokerage account and check the status of your holdings. Investors these days have the benefit of smartphones, tablets, laptops, and more. Checking real-time stock quotes is simply a click or a tap today, no matter where in the world you are. We can't fight the trend of mobile access, but we should certainly pace ourselves. Realize the seeds we plant (particularly mutual fund investments) do not need constant monitoring. Instead, our investments are best left to grow without too much maintenance. Hence the beauty in letting mutual fund money managers do the job they're getting paid to do, while we concentrate in bringing more funds home with the focus on our own careers.

### Mutual Funds by the Numbers

To understand how important the mutual fund industry is for investors, one need look no further than the astonishing numbers that make up this investment strategy mainstay. According to recent Investment Company Institute data, the U.S. mutual fund industry remained the largest in the world at year-end 2012, with $13 trillion in assets, accounting for 49 percent of the $26.8 trillion in mutual fund assets worldwide. Total net assets increased $1.4 trillion from the level at year-end 2011, boosted by growth in equity, bond, and hybrid fund assets. Demand for mutual funds increased in 2012 with net new cash flows of all types of mutual funds totaling $196 billion.

Remember, markets do not decipher from one day to the next who will win and who will lose. That's why trading is such a tough game to play for all but the most sophisticated and disciplined traders (but even the best traders eventually have a big stumble most of us could not bounce back from). For investors, market pullbacks are similar to being hit by a pitch in baseball. It stings to see shares of your mutual fund investments you own fall. Just remember, with mutual funds, the goal isn't to see instant profits following a purchase. Instead, dividend investing is about buying income-producing assets as part of your long-term wealth-building plan.

So if you get gun-shy during market downturns, we suggest you try getting back into the box. Don't be afraid to swing the bat again just because you've been hit a few times. We are proud to steer the multitude of readers who visit MutualFunds.com each day away from the manic traders' approach.

## Selling Can be Bad – or Good

During times of financial turmoil, like those we've seen several times over the last decade, plenty of investors decided to raise cash. Unfortunately many also got too complacent sitting on the sidelines, missing the massive rallies. If you're a long-term investor, just keep your eye on the prize of building your retirement nest egg, knowing the market tends to go up a lot more often than it goes down, historically. Aim to put money to work each month, if possible.

Sometimes you'll have to make a tough call and get rid of one of your formerly favorite mutual fund holdings. The idea, of course, is that the mutual fund you replace that one with will help enhance your overall return in the long run. While we can count on mutual fund managers to pay attention to the markets, it is up to us as investors to keep tabs on what is working and what isn't. Again, this could be part of an overall asset allocation that one decides to put forth as the years go by.

Investing requires resources: time, energy, discipline, focus, and capital that most individuals cannot keep stocked for a long enough duration of time. The reality is that the number of individual traders continues to diminish, as the other players at the table continue to fortify themselves with every edge possible. That edge disappears when investors find great mutual fund managers that can harness institutional-level research on long-term horizons.

As long-term investors, mutual fund holders look to build wealth over time. However it is easy to get sucked in with the emotion of how much the markets will fall and then rally, some may be too tempted to get into the "timing game." Once you start trying to time the markets, the original game plan often quickly erodes. Understanding that markets can dip at times, a prudent investor should embrace most market pullbacks as opportunities to own solid companies at better prices over time. Sometimes, the prices will be a lot better than you may be used to. These are usually moments when investors are fleeing for the exits, when they instead should just keep their heads down and go about their business looking to put capital to work.

Just think, if you bought quality mutual funds during the massive selloff of 2008/2009, the phenomenal returns since then should have solidified your resolve to consistently put money into the best mutual funds you can find, regardless of how tough the investing climate gets at times. During extended periods of selling, the best approach to putting money to work is to tighten the belt and get more money available to pick up shares of quality mutual funds when they "go on sale."

## The Bottom Line

In short, mutual funds are the logical investment choice for the vast majority of investors for four key reasons:

- Their passive nature discourages active trading,
- Investors get access to high-quality money managers at a relatively low cost,

- Their structure allows for instant diversification to a variety of markets, and
- A relatively small amount of time and research is needed to pick good mutual funds, when compared with other investments like individual stocks.

## Appendix A: Size Of The Mutual Fund Market

**Table S1**

**TOTAL NET ASSETS IN U.S. DOLLARS**

Millions, end of period

| COUNTRY | 2009 | 2010 | 2011 | 2012 | 2013 | | | |
|---|---|---|---|---|---|---|---|---|
| | | | | | Q1 | Q2 | Q3 | Q4 |
| **World** | **22,945,327** | **24,709,854** | **23,795,808** | **26,835,850** | **27,854,629** | **27,448,756** | **28,877,513** | **30,049,934** |

Note: Components may not sum to total because of rounding.

Source: National mutual fund associations; European Fund and Asset Management Association (EFAMA) provides data for all European

[1] Funds of funds are not included, except for France, Germany, Italy, and Luxembourg. Home-domiciled funds, except for Hong Kong, New Zealand and Trinidad & Tobago, which include home- and foreign-