Investing In Mutual Funds. Rationale, Costs and Benefits. . Mutual Fund Distribution and Other Issues. Asian Fund Distribution

Some Issues In Mutual Fund Investing.

1. One of the problems in mutual fund investing is how they are sold to investors.

a. High front end commissions. Mutual funds typically charge a commission to invest in them. This commission is paid to the distributor of the mutual fund, such as a bank or an independent financial adviser. Just like any other product marketing has a cost. Mutual funds can charge up to 5%, sometimes more, in commissions. Distributors receive these fees ostensibly for providing advice. Perhaps, but if so, why are the fees charged by the funds and rebated to the distributors and not paid directly by clients to their bank. *By accepting payment from the fund manager instead of the investor, distributors work for the fund manager, not the investor.* How about sophisticated investors who do not require advice but are faced with subscription commissions wherever they turn? In a low yield environment even a 1% commission can eat up 3 months' worth of gross returns.

b. High management fees. Mutual funds charge different clients different fees. Institutional clients pay half of what retail clients pay, sometimes even less. The primary reason for the difference is that retail funds' fees have to be shared with distributors such as banks and IFAs in what are called trailer fees. A fund charging 1.5% per annum will pay its distributor 0.75% per annum on the assets raised. Fortunately there are some banks who eschew this practice and either invest their clients' money in institutional share classes, which incur much lower fees, or rebate any trailer fees they get on to their clients. In certain markets like the UK, it has become illegal to pay trailer fees to distributors. In Asia trailer fees are the norm.

c. Opaque fee structures and conflicts of interest of distributors. The payment of trailer fees to distributors creates a conflict of interest. Distributors have a strong incentive to sell funds with high trailer fees or commissions. Whereas fund distributors claim to represent the interests of their investors they are in fact being paid by the fund managers. Low volatility funds often also have low expected returns and fund managers scale their management fees accordingly. Since trailer fees are usually a cut of management fees distributors prefer to sell investors high risk, high returning funds which charge high fees to low volatility funds. Investors are allowed to believe that their banks are working for them when in fact they are working for the fund managers as their distributors.

2. Underperformance of benchmarks is addressed below under “When ETFs are more effective.”

3. Mutual funds are aggregation vehicles when it comes to market systemic risk. As more capital comes to be controlled by fewer independent decision makers, systemic risks are raised. CLOs and CDOs dominated the demand for loans and bonds in the years prior to the 2008 crisis.

a. The size of a fund should be seen in the context of its market. A fund which represents too large a proportion of total trading or total holdings in a particular market is risky from a liquidity aspect.

b. The aggregate size of mutual funds as a percentage of total market size is another risk factor since mutual fund managers and their investors are likely to behave similarly.

There are a number of reasons for investors to invest in investment funds.

1. They are a practical and convenient tool and component to deploy a diversified global portfolio. Regional, country, sector and asset class funds allow the investor to construct a portfolio to their own requirements.

2. Investment funds offer a diversified portfolio within a defined investment objective. Funds diversify the idiosyncratic risk while retaining the thematic risk so a single security or issuer cannot derail a sound thematic investment strategy.

3. Outsource investment strategy to experts in their particular fields. Funds allow investors to delegate investment strategy to professionals of a particular focus and specialization.

4. Related to point 2 abov
e is divisibility. Some securities can only be traded in large values. If an investor's portfolio is too small it may be impossible to invest in such securities or to invest in such securities with sufficient diversification.

5. Access. Certain instruments and markets are not easily accessed by retail investors. Catastrophe bonds, asset backed securities, structured credit, freight futures, commodity derivatives, etc are examples of instruments which are traded by institutional investors and not retail investors but which can be accessed through funds.

When Exchange Traded Funds Are More Effective.

1. One of the criticisms of mutual funds is costs. Mutual fund managers charge annual management fees, and some even charge performance fees. In order for a manager to return the same as their benchmark on a net basis, they must outperform their benchmarks by the quantum of their fees on a gross basis. Empirical evidence suggests that on average, mutual fund managers are unable to compensate for the fee drag. An exchange traded fund or ETF may be the solution to the fee problem. Due to scale and the mechanical nature of the portfolio construction ETFs charge very low fees. In some cases, the index replication strategies are sufficiently clever that they even recoup the little transaction, administration and custody expenses incurred by the fund.

2. Highly efficient markets are difficult to outperform. The US equity market is a good example where very few active managers outperform the index. In such markets, an ETF is more efficient.

3. Highly liquid and efficient markets are easier to replicate in an ETF. In illiquid markets.

4. ETFs can be traded at any time during the trading day. Mutual funds are typically traded at the NAV at the close of the day. Some mutual funds have poorer redemption liquidity which may be weekly or monthly.

5. The cost in trading ETFs is normal trading commissions which have seen significant

compression over the years. Mutual funds can and often do involve paying a hefty up front commission to the distributor of the funds. Commissions can be as high as 5% or higher in certain markets.

When Mutual Funds Are More Effective.

1. There are some markets which are simply not tracked by indices or ETFs. An example is the non-agency MBS market. While there are a number of large and well known MBS (mortgage backed security) ETFs these invest entirely in agency mortgages. The non-agency MBS market is simply not represented by any ETF.

2. There are some funds which have a theme or strategy that is not represented by any index or ETF. Hedge Fund Research, an index compilation company has compiled investable indices called HFRX so that even hedge fund strategies are replicable and can be accessed through an ETF but there remain some areas which ETFs have not reached. ETF providers are, however, trying to complete their shelf and are constantly evolving new strategies.

3. On average, by definition, mutual funds make a gross return equal to their benchmarks, which after fees and expenses, is below the benchmark. There are, however, mutual funds whose managers consistently outperform their benchmarks. The incidence of these managers is in part determined by the efficiency of the market. More efficient markets like US equities, are more difficult to outperform. Less liquid and less efficient markets enable active management and outperformance. They also enable underperformance.

Bottom Line:

1. As with all things investors should know the product at least as well, if not better than, their advisors.

2. Regulators should address the conflicts of interest in how mutual funds are offered to end investors. Regulation in the UK for example has been enacted to address the trailer fee issue.

3. Investors should be aware not just of the fees, costs and expenses in fund investing but of who are the beneficiaries of these fees, costs and expenses so that a judgment can be made as to the quality of advice they obtain from the various parties.

4. There are circumstances under which actively managed mutual funds can be used and circumstances under which ETFs should be used. One is not always and everywhere superior to the other.