Reasons Why You Should Invest In Mutual Funds (or ETFs) Even When They Tend To Underperform.

Mutual funds have a bad name, and yet, they remain a useful investment tool. Here are some of the advantages of investing through mutual funds.

1. They provide instant diversification. By pooling the assets of numerous investors, mutual funds allow an individual to invest an amount of capital which would be impossible to diversify if they did it themselves, alone. A mutual fund pooling the collective assets of a group of investors is able to achieve sufficient size so that it can invest in a diversified portfolio.
2. They provide access to markets which may be difficult to get access to. Buying US equities or European equities is one thing but trying to buy high yield bonds, leveraged loans, CLOs, mortgage-backed-securities, or other less accessible assets can be difficult to do. Mutual funds provide access and exposure in a single instrument making them ideal for asset allocators.
3. Mutual funds are professionally managed. This doesn't guarantee a benchmark beating performance but at least it means that your investments aren't being frivolously invested without some form of management experience and expertise.

And here are some disadvantages:

1. They are often expensive, especially for smaller or less sophisticated investors who may not have access to institutional share classes (bearing lower fees)

2. They tend to underperform their benchmarks. This is closely related to the fee issue. Since all funds charge fees, and the average fund achieves the benchmark performance, the average fund must generate the benchmark performance, less fees, thus underperforming. ETFs are cheaper, but do check the exact fees and expenses. Not all ETFs are cheap
3. Liquidity may be mismatched. A fund may invest in illiquid investments yet advertise daily liquidity, or redemption terms which it cannot deliver. Such funds face difficulties when too many investors want their money back at the same time, which is usually when the market is falling quickly. Liquidity may be mismatched in other ways, such as when the underlying investments are very liquid. Even the most liquid funds typically redeem at the close of business on a daily basis whereas their underlying investments trade in real time intraday.

Mutual funds are neither good nor bad. Investors have to know how to use them effectively and to have realistic expectations.

1. Do use them to access markets that are difficult to access such as bonds, loans, ABS, structured credit, emerging markets, foreign markets.
2. Do use them for instant diversification.
3. Do make sure that you know what the investment objective of the fund is. Only then can you use them effectively in your portfolio to attain your objectives.
4. Don’t expect them to beat their benchmarks consistently. They may outperform for a time but more than 2 to 3 years is a gift. For the most part, expect them to underperform to the extent of the fees, but invest anyway because access, execution and organization has a cost.
5. Do your homework. It’s your money and you want to know

what you are getting into to avoid disappointment and making poor decisions when prices rise, or fall.

6. When investing in absolute return funds or hegde funds, the choice of portfolio manager is very important. It is the portfolio manager who is responsible for profits and losses, not so much the market.
7. When investing in long only, benchmark driven funds, the choice of strategy or market is very important. It is the market which is responsible for profits and losses, not so much the portfolio manager.