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Are You Racing with a 300-Pound Coxswain?

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Confronting the hostile mathematics of equity mutual funds



A coxswain in a racing shell is sort of like a jockey in a horse race — their contributions are in the areas of strategy, management, coaching, encouragement and steering, all intended to be delivered in a small, light package. Coxswains weigh about 120 pounds — if less, they are required to carry sand bags to bring them up to the mark; if more, they are just adding unnecessary drag. In a world where boat races are usually won by a few seconds, a heavy coxswain pretty much assures defeat.

It's the same thing in mutual fund investing. High costs create drag and kill performance. Portfolio management fees, operating expenses, 12b-1 fees (collectively "the expense ratio"), front end loads, contingent deferred sales charges, trading commissions, market impact costs, and taxes — all combine to reduce an investor's chance of earning the market rate of return.

Why do investors continue to pour billions of dollars into high cost funds? Because they don't realize that they have a choice.

About half of all mutual funds are distributed through what is euphemistically called the "Advice Channel": full-service brokerage firms, banks, insurance companies and financial planning firms. Within that world, there are two camps: "advisors" who receive at least some compensation based on what their clients invest in — and advisors who don't.

I would propose that the quality of advice offered by people with a financial stake in what goes into your investment portfolio is suspect. If you are a client of a brokerage firm, for example, you should not be surprised if you find that the **only** funds that are offered to you or put into your account are funds on which your brokerage firm earns some sort of a commission. It's highly unlikely that your broker will ever show you Vanguard funds or DFA funds. Brokerage firms have high overhead — those costs must be passed on to **someone**. You're it.

In order to make the advice channel work, the mutual fund industry has created a dizzying array of investment choices through something called the "multi-class share structure" — A shares, B shares, C shares, etc. (Please see Appendix A.)

Unless you know, in advance, exactly how long you are going to hold these kinds of mutual funds, it's virtually impossible to make a rational decision on which share class to buy. Yet your broker leads you through this maze of choices as if he's giving you wise counsel. In

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*reality, it's just a bunch of razzle-dazzle designed to distract you from asking the questions you **should** be asking: Is that all there is? Isn't there a more efficient way to invest?*

Let me be blunt. If you look in your portfolio and you see A Shares, B Shares, C Shares, etc. the first reason you have been sold that product is not because it is a great investment, but because your broker is getting paid to sell it. It may be a very reputable fund, possibly even with a well-known manager. And sometimes these managers outperform the market for extended periods of time. But in the long haul, you are destined for disappointment **because the math is against you. You have a 300-pound coxswain.**

Here is a real-life example:

A friend of mine came to me with a portfolio constructed for her by Merrill Lynch Asset Management. Merrill had carefully chosen 13 retail mutual funds (no doubt right off their "approved" list) and then invested my friend's money in the A Shares of each fund. She was down 4.5% before the music even started. The funds had a weighted-average expense ratio of 0.94% and a weighted average turnover of 64%, (meaning that the managers of the funds in her portfolio, on average, sold 64% of the stocks they held each year and bought different stocks, incurring substantial trading costs and taxes in the process).

Turnover is expensive. Morningstar published a study last year that concluded "the average equity fund pays approximately 0.30% of assets a year in brokerage commissions... and while the average brokerage cost is significant, much more startling are the huge fees paid by some individual funds that in some cases approach or exceed the entire expense ratios of many core funds". In addition, "the market impact and opportunity costs are the tougher and more important pieces to measure because they can easily dwarf brokerage commissions".

Market Impact Cost? The research of Fama and French has concluded that a measured exposure to risk in small and value stocks can increase your expected returns, since risk and return are related. But for years, the argument against investing in small, value, and international (especially emerging market) companies was that the cost of trading their stocks would overwhelm the additional return they offered. This is the issue of market impact. A stock may be quoted 10 bid, 10 ½ offered but the bid can literally evaporate when a large block is offered for sale. 100 shares might trade at the quoted bid, but the balance of the block will trade at a lower (and often much lower) price. This is especially true in the case of less-liquid stocks. Market impact is a huge cost for most money managers, generally considered to be much greater than commission costs.

When I added up all of the costs imbedded in my friend's portfolio it looked like this:

Average Fund Expense Ratio	0.94%
Front-end load (amortized over 10 years):	0.45%
Trading commissions (Morningstar average):	0.30%
Merrill's "advisory" fee:	1.60%

Grand Total:

3.29%

BEFORE MARKET IMPACT COSTS AND TAXES!

So, to be crystal clear, what these numbers are saying is that this portfolio would have to beat the market by 3 1/2% to 4%, *on average*, for this person to actually get the market rate of return.

As my old friend Harry often says, "That dog don't hunt."

Study after study has concluded that no one can either consistently time the market or consistently outperform the market through superior stock selection. Yet that is exactly the business strategy of the vast majority of mutual funds. In the pursuit of outperformance (for the bragging rights that will bring in more assets under management), active managers blithely churn their portfolios, creating **unseen and unreported** transaction costs and taxes. 65% of all of the money invested in mutual funds is taxable, and yet managers routinely create capital gain income and taxes for their investors, because it is not captured in the measurement of the manager's performance.

It's a credit to the marketing skills of Wall Street that investors continue to pour money down this drain. And what is truly amazing is how many really wealthy, very successful, and very

smart people allow themselves to be led down this path.

Is there an alternative? Absolutely. Once you turn your back on timing and selection, successful investing becomes a challenge of finding the most efficient and effective vehicles for compounding your capital. The costs described above can be cut **by 60% to 75%** by using the right funds. And the expected returns of these funds, designed to efficiently capture the opportunities in higher-yielding *asset classes* of the market, can substantially enhance portfolio performance.

But that's a story for another time.

Appendix A

A shares carry a front end load – an upfront sales charge that can be as much as 5%. So if you have \$100,000 to invest, only \$95,000 of your money is actually put to work. Brokers suggest that this is a good deal, because A shares have the lowest management fees and administrative costs (“expense ratios”) and don’t carry the “contingent deferred sales charges” typically associated with B shares.

B shares, on the other hand, are described as a good deal by brokers because they don’t have upfront sales charges. However, they tag you with contingent deferred sales charges (CDSC) and 12b-1 fees. CDSC are charges levied against an investor who chooses to sell his fund “early” — within a pre-defined period, usually 6 to 8 years. 12b-1 fees are a charge to existing investors in a mutual fund to pay for the fund manager’s marketing costs to attract new investors to the fund. Since it is widely accepted that smaller funds are more nimble and thus have a better chance of outperformance, paying 12b-1 fees on a fund is sort of like paying money to handicap your own investment performance. Also, the expense ratio of B Shares is higher than A Shares.

C Shares have no upfront charges and the deferred sales charges expire after one year. Catch-22? The expense ratio is higher than on the A shares or B shares.

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