It's time to ditch your Mutual Funds!

A look at the truth about Mutual Funds in the United States

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Equities * Retirement Income * Estate Plans

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Mutual funds have established themselves as the "go to" investment vehicle for hundreds of millions of US Investors and are found in self-directed portfolios, advisor managed accounts, and as primary vehicles of retirement plans such as 401Ks.

The popularity of mutual funds is driven by the prospect of an average investor being able to tap into the expertise of big-time fund managers, easy portfolio diversification, low minimum investment thresholds, accessibility, and liquidity.

Wall Street, Mega Banks, Big Box firms, and financial advisors of all stripes, love these vehicles because they require no real effort in research and/or management, and yet they are able to add a management fee on top of the fees already present in every mutual fund they sell. Mutual funds reside as one of the top sacred Cash Cows to Wall Street and the Financial Advisor industry. According to the latest statistics, half of today's investors hold mutual funds in their private portfolios, and fully 64% of 401K accounts are invested in funds.

Make no mistake…stock-based mutual funds, and their bond holding cousins, target date funds, are huge business for the financial industry, and are the greatest thing ever for whoever holds your money. Somebody else does all the work, and assumes the inherent risk of reputation, all while your independent advisor and/or Big Box asset management firm collects the money. Mutual funds epitomize the concept of money for nothing for many in the financial industry.

Despite their popularity, and the zeal which Do-it-Yourselfers exhibit for the category, questions remain about managed fund effectiveness, and evidence points to the conclusion that mutual funds may be well past their prime as the most effective option for Investors at multiple levels of the net worth scale. An examination of historical results supports the idea that mutual funds are also ran, has-beens, as wealth building vehicles.

In 2018, the S&P 500 posted a gross loss of 6.20%, including dividends. According to Dalbar's *Quantitative Analysis of Investor Behavior* for the period ending December 31st, 2018, the average mutual fund investor lost 9.2%. This is while an actively managed 100% equity strategy minimized gross losses to 1.18%, and a no-fee index based vehicle's loss for the year stopped at 0% for the same time period. ***(For a complimentary copy of the 2018 Dalbar survey Summary of Investor Returns, email jhale@lifetimeincomestore.com)***

Mutual fund managers not beating the S&P 500 is not a new occurrence. The following is a verbatim excerpt of Murray Coleman's report on managed funds of all stripes, *SPIVA: 2018 Active vs. Passive Scorecard:*

Assets held by active managers fell behind their index fund rivals in the biggest and most hotly contested part of the U.S. funds marketplace, large-cap equities.

By the end of 2018, some 92.09% of active large-cap core stock fund managers over the past 15 years had underperformed the S&P 500. In addition, this was the ninth straight year that a majority of actively run funds in such a congested U.S. funds marketplace had lost to their respective blue-chip index, according to the latest SPIVA research. Large-cap growth managers did even worse over that period -- 94.59% trailed their respective S&P index through Dec. 31, 2018.

Such a drubbing came as the S&P 500 was losing more than 4% on the year, once again dousing a popular fable of active (fund) managers that they provide extra protection for investors during periods of heightened market stress.

The SPIVA (S&P Indices Versus Active) Scorecard tracks how professional fund managers are doing against their respective indexes. It's referred to as a "persistence" report since such research is designed to show how consistent returns are over time for stock and bond managers. Ironically, these research reports usually turn out uncovering just how **inconsistent** ***active management really is -- over both shorter- and longer-term periods of study.***
This is certainly the case with the 2018 Scorecard. Besides finding failing returns in large-cap equities, SPIVA reports that by 2018's completion 97.44% of all small-cap core funds trailed the S&P SmallCap

600 Index over the trailing 15 years. In terms of style, 98.17% of active small growth managers lagged their respective benchmark, while 93.51% of small value funds lost to their most similar S&P index. In a down year for equities, SPIVA found that most active fixed-income managers still struggled against their benchmarks. In terms of long-term government fixed-income funds, 98% of active managers failed in 2018 to outgain their respective Barclays index over the past 15 years. For active intermediate-term government bond fund managers, 92% were laggards.

Knowing all of this, including the fact that mutual funds have been soundly trounced for the last 15 years by a number of investment strategies, makes this financial pro wonder a bit about why Investors cling on to what is essentially a memory of the Mutual Fund Glory Days…which is the 1980s when Peter Lynch ruled Wall Street with his gilded returns of his Magellan Fund at Fidelity. Unfortunately, that was a long time ago in a market far, far away. Last I heard, the retired Mr. Lynch had put his Scottsdale home up for a mere $14,000,000, or $1,000,000 per square foot. Mutual funds were very, very good to him! I heard through the rumor mill some guy paid the asking price in cash…I'll bet he didn't own mutual funds!

A question might pop into your mind right about now…and if it didn't, I'll point it out.

Do you know who doesn't own mutual funds? *Answer: Really wealthy and successful investors.*

Another question: Did Warren Buffet build his immense empire owning mutual funds? *Answer: Absolutely NOT!*

Why hold on to a relic dog from the past? I mean…I have Clients in a no-fee index annuity contract that has returned 6.3% for 25 years which smoked Dalbar's measure of returns for the Average Equity Fund Investor and handesomly beat the Average Asset Allocation Fund Investor. Why keep something that, by every legitimate measure, has been passed by strategies with better returns and lower fees, for at least the last 15 years, if not longer?

The answer to the question of holding on may lie in the fact that, while overall performance of mutual funds is down, a generation of Do-it-Yourselfers continues to employ them in their own self-directed accounts, and they are a natural easy vehicle to employ in 401Ks. The sheer numbers of those types of accounts that exist continue to feed the Wall Street money machine, and those folks are only too happy to keep stuffing the Beast with 3rd party assets that require no management, research, or other input from them, and for which they can earn commission on top of annual management fees. When something doesn't quite make sense, it is always helpful to follow the money, and when you delve into the money in mutual funds, it takes one to some rather dark places! We'll soon explore those dark environs, but let's talk about Wall St advertising first.

Despite year after year poor performance, articles and ads in the financial media attempt to renew our faith that this will…definitely…be THE year of the rock star mutual fund Stock Pickers. You can't read a financial publication, or go online, or watch TV, without seeing an article or ad that is promoting mutual funds and the inherent benefits of doing business with this Big Box firm, or that Mega Bank…(which are all interchangeable anyway)…or the latest stock picking guru. The whole of Wall Street is presented as your friend and will provide you with the retirement magic you deserve. The ads and stories are ubiquitous..they are literally everywhere…and the constant pounding of the message has had the desired effect. They have turned a generation of investors into mind-numbed robots who cannot wait to hear from the guys at the club about the next hot fund they should be adding to their portfolio. I have found mutual fund investors often exhibit a degree of paranoia that someone has something they don't…like an addict always in search of the highest grade stuff!

I actually had a prospect who manages his own account actually take the position that, while an institutional strategy may deliver significantly better results over time, he'd probably be ok just continuing to do it himself with mutual funds. That's rather like a McDonald's customer refusing to accept that, despite all the marvelously happy ads over all those years, the food just ain't that great for you. You might be ok, but long term you won't be as healthy as you could've been had you just dropped the cheeseburger. It was at that moment it struck me…mutual funds are the junk food of Wall Street!

How does an otherwise perfectly intelligent investor fall accept mutual funds as the best way to achieve "ok" status in retirement? That's an easy question to answer if you understand the power of repetitive marketing and advertising. Wall Street is well versed in the "mere-exposure effect", a concept we'll revisit later.

Let's go ahead and delve into the Darkness…a world of the unknown or just the plain ignored!

If you're a mutual fund investor...you might want to make sure you're sitting down, and have a defibrillator handy!

Of the thousands of people I have spoken to about retirement income plans over the years, I found that not…a…single…one…of them…knew the true cost of ownership tied to each of their mutual funds. That's a rather bewildering situation because one would think it would go a long way towards helping an investor understand why so many of his mutual funds don't make market returns. One general truism about investing…the higher the fees, generally the lower the returns. While fees aren't the only factor keeping the Mutual Fund Man down, they certainly don't help.

For YEARS, it has been common knowledge in the industry that many big-name mutual funds are chock-full of what are commonly known as "hidden fees". Apparently, end-users of those investments information regard any negative information on their babies as more "fake news". If the information comes from a financial professional, bad news about mutual funds is discounted as heresy, or competitive sour grapes.

And yes, if it occurred to you…those advisors, brokers, bank people, and 401K enrollment folks, declared fiduciary or not, are each very well aware that mutual funds do indeed have hidden fees. They just don't tell you. So, welcome to fiduciary redefined! Shouldn't a non-fiduciary disclose the hidden fees just out of common courtesy, or maybe…self-respect? You would think so, but that would betray Wall Street's dirty little secret…and could potentially cost them all commission income!

But let's get back to those hidden fees we talked about earlier. Are you ready?

These are the inside ways of mutual funds that ensure Wall Street will spend enormous amounts of money to keep the average investor hooked. As I said, always follow the money!

The first cost of mutual funds is the only one you're relatively sure you're paying because it is listed in the prospectus, and because it's listed in the prospectus, most financial pros feel obligated to tell you of its existence. Notice I said most, not all! An advisor may be charging you a fee ON TOP of the published expense ration, so they may not mention the prospectus price. You better check!

Cost No. 1 – Disclosed Costs

Disclosed costs of mutual funds are *supposed* to be revealed to you and are typically found in the fund prospectus. These are made up of many costs that typically include management fees, shareholder fees, redemption fees 12b-1 fees, and others.

A recent study published in the Financial Analyst Journal that was authored by Finance Professors at the University of California – Davis, the University of Virginia, and Virginia Tech *(Shedding Light on "Invisible Costs: Trading Costs and Mutual Fund Performance; Roger Edelen, Richard Evans, Gregory Kadlec, et. al)* found the average published cost of Mutual Funds to be 1.19%. My own research for the prospects we have served shows that number to be 0.91%, but we'll go with the academics' number for this discussion. They are way smarter than me!

Cost No. 2 – Hidden Fees

This is where things get interesting and the blood pressure of mutual fund investors starts creeping. Take notes on this one because you could get lost in all the backdoor stuff in this category.

Mutual fund managers conduct a multitude of trades with many of those to benefit investors in the fund…other than you! Once you're in a fund, other investors continue to pile in…especially if the word is out down at the club that your fund is hot!...and many divest because, of course, all the new money makes it hard for a longer teured investor to get a return! Trades must be made to accommodate the money flow, and as a member of the fund co-op, you get to share in the costs of those trades. That's right, even if the trade lowered your fund value, was not made to benefit your portfolio, and was never requested by you, your share of trade costs must be paid. You're in this marvelous fund, so you must pay the cost to be the boss!

There are three main sources of these expenses. First, when trades are made, brokerages earn commissions. Second, mutual funds will often buy securities from dealers at "ask prices" and sell securities to dealers at "bid prices". As is the rule, ask prices are higher than bid prices. This ask-bid spread represents the dealer's commission is shared by all members of the fund, and that includes you if you're into mutual funds.

The third cost generator of hidden costs is driven by the vast purchasing power of mutual funds. When funds trade their moves are often so large that they can cause security prices to move. They can literally move markets with all that money you are giving them! Their purchases can push prices up, and consequently, their selling can push prices down. This little peach of a process is known as "price impact",
and the net effect of its power is…the fund and you lose money.

How much does all this hidden fee rigamorole cost you? According to the study, the average annual Hidden Cost of mutual funds is 1.44%

Now…keep up with your calculator in hand! We've only just begun!

Cost no. 3 – Tax Inefficiency

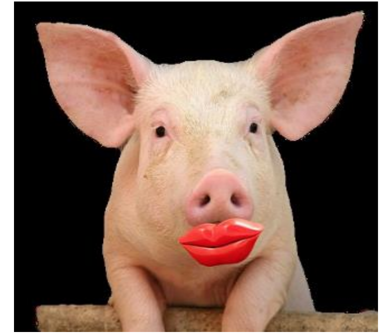
In the investment world, mutual funds are "King of Tax Inefficiency", and they have no challengers for the throne! Here's just one example of how that crown is earned.

Say you bought a mutual fund and it has a stock valued at $50/share. Say that value drops to $40/share. Assuming no other stock prices change, you have a negative value on your initial investment. Now…suppose the fund decides to sell the stock because…you know…the fund bought it at $30/ share the week before you bought into the fund, and they only operate for the common good, not your specific good! So…since the stock was sold, they now have a capital gain of $10. As a member of the fund, you own a share of that capital gain tax. That means you pay taxes on gains you didn't enjoy. What a country!!!

According to the study, the average annual cost of tax inefficiency in mutual funds runs about 1.10%. Stick that in your calculator, and let's move on to more fun and games. The next one is my all time favorite!

Cost No. 4 – Backdoor Behavior

These are fun! There are a hundred thousand mutual funs out there competing for your hard earned investments dollars, so it shouldn't surprise that they may engage in some underhanded behavior to earn that business, right? All's fair in love and investing, you betcha!



One of the beautiful things fund managers do to earn your business is something I refer to as "Lipstick on a pig". That's an old farmer and rancher's term you hear quite a bit down at the hog auction, and which belies my Oklahoma roots. Putting "lipstick on a pig" mutual fund means that, prior to reporting their quarterly earnings, some fund managers sell their poorly performing securities to hide the fact they held those losers in the barn. They then turn around and buy securities whose value recently increased to make it look like they owned those blue ribbon hogs all along! You don't know the difference, and your advisor or broker certainly won't share that info, so you get stuck just like a fat hog after the sale. "Lipstick on a pig", indeed.

Another beautiful thing is risk shifting. Here managers try a short squeeze by placing large bets on new stocks just before their quarterly reports are due to hit, but as they are generally done in desperation, the study found these gambles don't generally pay off, and they cost you money in trades, commissions, tax inefficiency, and all the rest. Dr. Graham taught us investing is a long term proposition, and short term risk can cause immediate pain. Apparently many mutual fund managers never read The Institutional Investor!

Another Backdoor practice is that of shirking. That's where fund managers with large institutional investors tend to care more about their clients, and do better work, than managers with primarily individual investor clients. The study found managers with mostly individuals are more likely to be lazy, and shirk their responsibilities to drive earnings. If you are an individual investor, you better figure out how to get institutional sized, or you won't be getting the best management. I know that is a dichotomy of sorts because it's going to be difficult to achieve institutional levels when you're invested in…mutual funds.

Another common occurrence in portfolios that include an array of "balanced" mutual funds is something called overlap. This happens when the 197 individual fund managers that oversee the multitude of individual components of your mutual fund platform buy the same securities, but for different reasons. It is often the case that one fund manager buys a stock to add to your fund based on his or her hunch it will increase in value. Another fund manager may buy that very same stock betting it will go down. The end result is you end up owning the same stock in multiple funds, and you're never aware you are competing against yourself!

The last of the common Backdoors the study found is another real beauty, and it's known as "cold buying". That's where mutual funds buy "cold" IPOs their investment banking partners couldn't sell to some schmuck over in Europe or Asia, and they had to put it somewhere! So…yep…it ends up in your mutual fund with a AAA stamp from the ratings agencies.

Are you feeling like you just watched *The Big Short 2*, and I am your Dr. Michael Bury? I just may be!

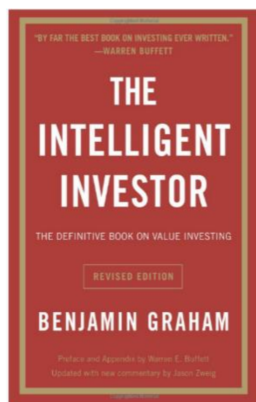
What's the end result of all those hidden fees that your church elder fiduciary advisor, golf buddy broker, or close friend at the bank, failed to tell you about when they sold you that well planned and researched mutual fund portfolio? Let's look at a real-world example.

If you had invested $100,000 in a mutual fund that you read in the financial pages..or you could decipher the statement…had earned 9%, you would think you likely had made a nice return. And you should feel that way. But, somehow it never seems to add up, and you never seem to have the same kind of returns and growth as the guys at church, or down at the club, and you always have that little voice in your head asking why. Hopefully, now you at least know more about the truth, and the questions you need to ask. But let's look at what the study found your money to be at the end of the day.

With all these costs…which the person responsible for your investing in the fund in the first place knew all about, but never thought to disclose to you…your $9,000 return could be eroded by Disclosed Costs (1.19%), Hidden Costs (1.44%), Tax Inefficiency Costs (1.10%), and Sneaky Behavior (2.49%). That's a total of 6.22% in fees, which would have brought you a gain of 2.78% for the year. Remember, the Dalbar has the Average Stock Fund investor at an average 3.88% annually for the last 20 years, and the Average Asset Allocation Investor at 1.87% over the same time period. They have the last 5 year averages at 3.96% and 1.50% respectively. Hopefully, your funds did better than that in the midst of the largest period of stock market growth in history!

Now, let me say I have seen funds as high as 7%, but in my experience, most of the people for whom I have researched mutual funds have been closer to 3%. So, if it makes you feel better, your actual costs could be lower than those found in the study. However, if you're paying close to 3% for an investment that has not approached its benchmark or index in 15 years, you have only minimized the damage. I know of a strategy that has met or beat its benchmark, and returned double digits net of fees, for the last ten years, and it only charges 1%...unless you have big money. It would take a whole case of lipstick on that mutual fund to even be in the same pen with that kind of investment result!

Do you now understand how mutual fund dealers can afford all those ads and articles that keep investors coming around for a dead investment strategy? Who funds all the ads across financial media channels? The ones who have the biggest ad budgets. Who has the biggest ad budgets? Those with the most money! Who has the most money? Those that sell mutual funds to the public! Always follow the money…*it's all in the fees, especially the ones you can't easily see!*



And that brings us back to back to that term I shared earlier, and the prospect who said he would likely achieve at least OK continuing with his mutual fund approach long term. The fact is people will eventually begin to find reasons to like anything, as long as they're exposed to it long enough, is that phenomena is called the "mere-exposure effect." It was first tested and identified in the 1960s by psychologist Robert Zajonc.

According to Dr. Zajonic's findings, regardless of how you feel about an ad, or even if you tune them out, they likely achieve the goal anyway. The principal shows that even if you never see the ever present ad, you will eventually succumb as more and more people, and non-advertising media, around you incorporate the things the ads in question promote, and become normalized. It turns out familiarity doesn't breed contempt, but just the opposite. Stick with an object or person long enough and you'll eventually find something you like about it. It doesn't matter if it's good for you, or not…you'll eventually come to have good feelings. So, you can blame the addiction to mutual funds on your friends at the club, the Wall Street Jounal, and CNBC, and the fact that Wall Street is well versed in the "mere-exposure effect".

Bottom line, the conclusion remains that mutual funds may just have outlived their effectiveness, and it's high time you investigate an alternative. While stock picking is a science not widely practiced because the costs and discipline required are prohibited in our fast food world, it still exists with a certain breed of practitioners. Those that are good at it have usually done for a long period of time, and they have an uncommon focus, discipline, and loyalty to the method Dr. Benjamin Graham perfected at Columbia way back in the 1930s and 40s. Read his book, *The Intelligent Investor*, which is the holy grail of the investment world

There are firms in the business who manage money in the manner Dr. Graham taught Warren Buffet, and which is employed by the worls's most successful investors, institutions, and endowments. These advisors typically avoid recommending mutual funds for all the reasons listed in this document. I always find it interesting looking at the the of the most successful institutional investors in today's market, and understanding that while that group owns 85% of the US Large Cap, none of them own a mutual fund. Average investors are always surprised when they discover that the wealthiest amongst us either manage their own using a sophisticated multi asset class approach, or they have sufficient assets to attract the services of qualified money managers to do it for them. Dr. Graham's old school approach is expensive in its demand for constant research, incredible discipline, global experience and understanding, and the economies of scale involved do

not favor every investor. In place of that approach, Wall Street developed the one-size-fits-all model provided by modern mutual funds.

Sophisticated portfolios are built to fit the individual, not the masses. Because of the expense of researching, developing, trading, and managing top shelf results, a sophisticated style of investing is hard to scale to serve the needs of average investors. The result of that is average investors are never exposed to the same level of financial advice those at the highest levels receive. At the end of the day, a Money Manager who does not take backdoor money, commissions, or charges the hidden fees in so many of today's most popular mutual funds, have to serve 2-3 more clients to drive the same fees as one who does, simply because the fees they charge include the actual management functions paid for by hidden fees we have discussed in this piece. An industry absolute truth…the easiest way to make money as an advisory professional or firm in the financial services industry is to sell mutual funds. All one has to do is rationalize the gain against the fact mutual funds have been proven to often be the most expensive option for the client and, more likely than not, do not provide the best overall results. That's simply a fact. Average investors don't know about a sophisticated approach because the vast majority of the industry chooses to take the fast food, one size fits all, approach to advising investors, and the easy money that comes with that method. Average investors are never told there is another way that is more fee and tax efficient with a history of beating banchmarks, and delivering better results.

There are those committed to providing sophisticated levels of advice without mutual funds, asset allocation funds, and other 3rd party vehicles, along individualized management and service, to Investors regardless of portfolio size, albeit those are few and far between. There are only a handful of US money managers in the industry who can say they have meet or beat their benchmarks over the last 10 years. *Your challenge then becomes to find one of those firms, and convince them to take you on as a client!* The vast majority of these firms are open only to accredited investors and by invitation only.

Lifetime Income Store Advisors is one of those firms, with a key difference. Our Money Managers have met or beat their benchmarks over the last 10 years, but is committed to working with a broad range of portfolio values. I urge you to do your due diligence with us before you go another day in a mutual fund laden portfolio. Examine the historical results delivered all the way back to the 1990s. Measure transparency on fees, liquidity, and diversification, and compare what you find in your current portfolio. Read up on Dr. Graham and the method he taught built on stocks that never included mutual funds, and which is the foundation of all we do. If your only experience is with mutual funds, you are going to be surprised at what you learn. And if you have $500,000 of investable assets, you won't have to convince LISA to take you on as a Client, and enjoy the most sophisticated style of investing employed by the world's most successful investors.

Lifetime Income Store Advisors (LISA) believes an actively managed and uniquely diversified portfolio of multiple asset classes produces long-term risk-adjusted results that outperform other investment styles such as mutual funds, ETF managers, and managers of managers. If you don't do anything else, call Jeff Hale at 404-495-4430, and let him educate you on the truth of sophisticated investing that never includes mutual funds, ETF funds, funds of funds, or managers of managers. He works for one flat, transparent fee, and never gets commissions, or back door money. He is a Fiduciary who cannot put you into an investment that does not suit your risk and objectives. Jeff is one of the truly few committed to bringing top shelf advice to Main Street.

Thanks for reading, and many happy returns!

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