

Are Mutual Funds The Best Investment For You?.

By Robert Goldin, Investment Dispute Consultant with MacGold Direct Inc.

Over the years I have been consulted by many investors who have complained about the losses in their (actively managed) mutual fund investments.¹ Strangely enough no one has ever complained about the mutual funds hidden or undisclosed costs², which together with the disclosed MER³ (The funds management expense ratio), were to a large extent responsible for the poor performance of their mutual funds. These investors were not aware of these hidden costs--- the only costs that they thought they were paying was the disclosed MER. Had these investors known about these hidden costs, they say that they would have thought twice about investing in mutual funds.

To fully understand the impact of costs, even a 1% increase, Glorianne Stromberg, a financial services expert was quoted as saying " Every 1% you pay in fees or charges will reduce your capital by about 20% over 25 years. That could mean the difference between being comfortably well off and struggling to make ends meet".⁴

¹ Traditional mutual funds, also known as A Class mutual funds, as opposed to passively managed funds such as Index funds.

² The words "undisclosed or hidden costs" are used interchangeably.

³ The MER is made up of trading and administrative costs of about 0.5%, the mutual funds' fee of between 1% to 2%, usually a 0.59% trailer fee for fixed funds, and a 1% trailer fee for equity mutual funds, plus G.S.T.

⁴ Glorianne Stromberg: National Post (Financial Post- Investing Guide) October 30, 2003

The Cost Structure For Mutual Funds

1. Disclosed Costs.

A mutual fund's¹ disclosed costs consist of commissions (or early redemption penalties), plus the MER, which are disclosed in the fund companies' prospectus. These are the only costs disclosed to investors!

2. Undisclosed Costs

There are also other costs of buying mutual funds that are not disclosed in the fund's prospectus. These are:

A) Trading costs

(i) Brokerage Commissions.

These vary from 1% upwards. So if a mutual fund manager buys say 5000 shares @ \$20.00 each and pays brokerage commission of \$1,500.00, the transaction is recorded in the mutual fund's books as costing not \$100,000.00 (5000 shares x \$20.00) but as \$101,500.00 (\$100,000.00 plus the commissions of \$1,500.00. If the shares are sold, at say \$100,000.00 they will show up in the books as \$98,500.00 (\$100,000.00 less \$1,500.00 selling commissions), so in effect, the brokerage commissions are paid by the fund company, and then passed on to its investors through lower returns. Brokerage commission is directly related to portfolio turnover, which measures the volume of trades executed during a year as a percentage of total assets. The lower the portfolio turnover the lower the trading costs incurred, and conversely the higher the portfolio turnover the higher the trading costs.

¹ The words "mutual fund" refer to actively managed equity and bond mutual funds, and include F and I Class mutual funds.

(ii) Bid/ask Spreads.

These are the differences in price charged by market makers to buyers and sellers executing trades. A good estimate of a bid/ask spread is 1 % to 2 %, sometimes more. These charges are likewise passed on to the investor.

(iii) Market Effects.

When a fund owns a substantial block of stock, it cannot sell that position without the sale affecting its price. The sale of a large block of stock tends to drive the price down causing the fund company to get less for the stock. Conversely, large purchases of stock tend to push the price paid up, so investors wind up paying more for the stock. The investor loses both ways.

Different types of investments attract different trading costs as this table shows:

Types of Funds	Typical Trading Costs
Large-cap value fund	0.65%
Large-cap growth fund	1.59%
Passive (index) funds	1.38%
Small -cap value fund	1.60%
Small -cap growth fund	3.12%

* Source Harry Marmer, *Perspectives on Institutional Investment Management*

B) Idle Cash

Another cost of fund management is opportunity costs, the lost return on cash or cash equivalents held by the fund to pay shareholder redemptions. The percentage of a fund assets held in cash is known as its "liquidity ratio". The average liquidity ratio for actively managed equity funds in the USA was 6% for the beginning of 2002. Over the past 30 years the average has been closer to 10%¹. The less money invested, the lower the return, because cash earns very low returns. The liquidity ratio in Canada is also a single digit numbers.

C) Tax Consequences of Holding Mutual Funds.

Mutual Fund shareholders incur tax consequences in three ways. Firstly when they sell their units in a mutual fund at a profit they pay capital gains taxes on any appreciation in the value of the fund. Secondly when a mutual fund sells its stocks for a profit, it passes those gains on to the mutual fund shareholders who are taxed on the capital gain, even if they don't get the benefit of it. It can happen that a mutual fund investor could wind up paying capital gains tax on a mutual fund that actually shows a loss! Thirdly investors may be liable for capital gains tax on gains that were already imbedded in the funds holdings when they purchased it.

Bond Mutual Funds

Although carrying a lower MER (usually half a percent less) it has some of hidden costs of equity mutual funds. The bonds in a bond mutual fund can be sold for a profit or a loss

¹ "The Great Mutual Fund Trap" by Gregory Baer and Gary Gensler. Broadway Books New York 2002, page 106

because, although a bond's face value is payable at maturity, before maturity, their values rise and fall in response to market forces and interest rate fluctuations.

F Class Mutual Funds

These funds have the same features as actively managed mutual funds except that they are fee based and do not charge trailer fees as part of their MER. These funds generally therefore have lower MERs, (about 1% less for equity and 0.5% less for fixed income) funds. However, a financial advisor, in order to be compensated, will charge a direct fee to the investor (usually more than one percent for small accounts and less than one percent for larger ones). In reality since G.S.T. is charged on mutual funds' MERs, the investor saves about 1.07% on equity and 0.535% on fixed income funds when buying F class as opposed to traditional mutual funds.¹

I Class Mutual Funds

The "I" stands for institutional. This mutual fund also has the same features as an actively managed mutual fund except that it charges a lower management fee for investments of \$500,000.00 or more, together with, usually a lower trailer fee.

Hidden Costs

Hidden costs could increase an investor's equity mutual fund's costs by about 4% (more if bought with a up front commission of between 3% to 5%, or a rear end load (in effect a

¹ The Professional Financial Advisor" by John de Goey 2003 Isomniac Press pages 117 and 129

deferred sales charge of up to 6% to 7%)¹. So with a MER of say 2.75%, and investor could in reality be paying total costs of approximately 6.75% per annum (2.75% plus 4%). For the mutual fund to break even it would have to earn a minimum of 6.75% per year. To show a reasonable return say of 5% per annum, the mutual fund would have to show returns of approximately 11.75% per annum upwards to offset the MER and other costs of 6.75% per annum.----- Very difficult in any kind of a market.

The Impact of Undisclosed Costs

Under the title "*Is Your Fund Firm Earning Its Keep?*" Rob Carrick in "*The Globe and Mail*" of October 4, 2003, writes about the fees charged by the mutual fund industry and how they impact upon returns. Carrick looks at "the bang that unit holders of the country's largest funds have received for the bucks they paid in fees. One way to do this (he writes) would be to look at how much of the funds returns over the past five years were soaked up by the fees charged to investors to cover operating expenses and pay dealers and advisors". Carrick gives a formula to be used in assessing this value called the Fund Fee Value Indicator.

It works like this: You look at the funds five-year compound average annual return and then add its MER. The result is the fees charged by the fund as a percentage of assets, i.e. its gross return, or what it made before fees were applied. The next step is to divide this

¹ A penalty of between 6% to 7% is charged if more than 10% of a mutual fund is sold in the first year, reducing by one percent a year, if the mutual fund is sold in the following years Where a deferred sales charge is charged, an investor is permitted without penalty to sell up to 10% of his/her shares without penalty.

gross return into the MER and then multiply it by 100. The figure obtained represents the percentage of gross return needed to pay the funds expenses.

Carrick deals with some of Canada's largest mutual funds as measured by assets. From his list I have selected three of the best performing equity and dividend funds mentioned in the article Trimark Canadian (Canadian Equity), PH and N Funds (Canadian Dividend) and Trimark Fund (Global equity) for comparison.

Fund.	5year return. (compound average annual return)	5year average MER.	Gross Return.	Percentage of Gross Return needed to pay expenses
Canadian Equity Trimark Canadian	9.75	1.63	11.38	14
Canadian Dividend PH and N Funds	15.72	1.18	16.90	7
Global equity Trimark Fund	9.75	1.62	11.37	14

Globefund.com and fund company prospectuses.

Adding mutual fund's hidden costs of say 4% to the MER according to my calculations the table would look something like this:

Fund.	5year return. (compound average annual return)	5year average MER.	Gross Return.	Percentage of Gross Return needed to pay expenses
Canadian equity Trimark Canadian	9.75	5.63	15.37	36
Canadian Dividend PH and N Funds	15.72	5.18	20.90	24
Global equity Trimark Fund	9.75	5.62	15.37	36

These figures show that for example, with Trimark's Canadian Equity and Global Equity Funds with MERs of 1.63% and 1.62% respectively, 14% of its gross return is needed to pay expenses. When the undisclosed costs of approximately 4% are added to the MER, the percentage of gross return needed to pay the expenses grows to 36%. With the PH&N Dividend fund, with a disclosed MER of 1.18%, the percentage of gross return needed to pay expenses is 7%. However adding in the hidden costs of approximately 4 %, the total costs increase to 5.18% and the percentage of gross return needed to pay the expenses jumps from 7% to 24% ---- Quite a difference!

Even Without a Mutual Fund's Undisclosed Costs, How Does the MER of the Average Equity Fund Affect Investment Returns?

Cost Erosion

A) In a recent report, Brian Tang, an analyst at Fundamental Research Corp in Vancouver compared the expense ratios and 10- year performances of 116 Canadian equity mutual funds and found that overall, the average Canadian equity fund had a MER of 2.21% and a 10-year return of 7.47%. The S&P/TSX Total Return Index posted a 8.36% return during the same period.

B) The Ontario Securities Commission has calculated that, for an investment held for 25 years and compounding at an annual average of 8%, a mutual fund with 2.75% MER, would take nearly a quarter of the return in fees and costs, leaving the investor one third short of what he otherwise would have earned through compounding.

C) William Mercer's, Malcolm Hamilton gives this hypothetical example:

If you have RRSP money in a mutual fund with a 2.1% MER and the investment returns 7% per year for 25 years, the mutual funds' fees and expenses would eat up 39% of the total accumulated amount of money over that time. On a \$10,000.00 investment it would mean \$33,066.40 going to the investor and \$21,207.90 going to the mutual fund.

D) In his book "Common Sense on Mutual Funds", John Bogle, founder of the Vanguard Group, one of the world's largest mutual fund companies, demonstrates the impact of a high MER on a mutual funds return over 50 years. A \$10,000.00 investment in a fund that returned an average of ten per cent a year would generate a total of \$1.174 million: a fund whose lower MER resulted in an average of 11.9 per cent annual return, would have generated \$2.764 million, 2 ½ times more or a difference of \$1,590 million

These examples only take into account a mutual funds disclosed costs i.e. its MER.

Imagine what an investors return would be if **all** the mutual fund costs (both disclosed and undisclosed costs of up to 4% p.a.) were taken into account.

The median MER of the largest 50 Canadian equity funds (more than \$100-million in assets under management) is 2.5% For the bottom 50 (less than \$10-million in assets) the median MER is 2.76%

Fundata Canada Inc.

MERs in the United States are about 1% lower

Very Few Mutual Funds Beat the Market Over a Multi Year Period

Statistics show that most mutual funds do not beat the market on a regular basis, even without undisclosed costs being taken into account

The Situation in Canada

Mark J. Heinzl in his book "Stop Buying Mutual Funds"¹ refers to the following table which shows the average annual compound rates of return for the benchmark TSE 300 (as it was then known) total return index and for the average Canadian equity mutual fund to June 30, 2000. Both the TSE 300 returns and mutual fund returns assume all dividends and distributions are re-invested. These mutual fund statistics are based on the mutual fund tables published by the Globe and Mail.

	1yr	2yr	5yr	10yr
TSE 300 Total return	47.4%	18.3%	19.7%	13.8%
Cdn. Equity Fund	27.6%	10.6%	14.7%	11.6%
Cdn. large Cap Equity	29.7%	12.3%	15.1%	11.3%

After reviewing other statistics taken from the Globe and Mails' mutual fund website, www.globefund.com as at July 30 and October 31, 2000 as to how many Canadian equity funds beat the TSE 300 Index and statistics as at July 30, 2000 as to how many Canadian Bond Funds beat the Scotia McLeod Total Universe Bond Index ----- both over periods of one to ten years, Heinzl states "As you can see, very few funds are able to out perform market indexes over long periods of time. This is true not only for Canadian equity funds but for US equity funds, global equity funds and Canadian Bond Funds."

¹ Mark J Heinzl "Stop Buying Mutual Funds: Easy ways to beat the pros investing on your own" Wiley Trade Publishing December 2000, pages 22 to 24.

Paul Kedrosky cites the statistic that more than 80% of mutual funds underperform the major Canadian and US markets²

The Situation in the USA

A recent study by the Boston based research firm, Dalbar Inc. pointed out that the average investor only earned 2.57% per year while the S&P500 Index rose an annual average of 12.2% since 1984, whilst the average US equity fund grew by 9.3% p.a.

Over the past five years actively managed stock funds have averaged annual returns of approximately 6.30% while S&P 500 Index has averaged annual returns of 10.25%. The Wilshire 5000 Index which tracks over 6500 US companies, showed an average annual return of approximately 8.25%. Over a ten-year period surviving¹ mutual funds returned an average annual return of 8% whereas the S&P 500 Index returned an average annual return of 12.3%, whilst the Wilshire 5000 Index recorded an average annual return of approximately 11.9%.

Morningstar Principia Pro, data through September 30, 2001

- Over the five-year period ending December 31, 2001 only 33% of surviving actively managed funds beat the market. Only 25% beat it by more than 1% per year.

More Specifically:

² "Regulators Obscure Mutual Fund Dangers" Paul Kedrosky . National Post (Financial post) November 4, 2003

¹ Surviving mutual funds are those that did not go out of business due to poor performances. This data excludes those funds that did.

- Over the past ten year period ending December 31, 2001 only 28% of surviving actively managed stock funds beat the S&P 500. Only 11% beat it by more than 2% per year.²

Morningstar Principia Pro , data as of December 31, 2001.

Further Bad News for Canadians Owning Mutual Funds

Keith Kalawansky, in an article in the National Post (Financial Post Section) of October 27, 2003, under the heading "Fund Fees Soar Over Three Years", citing research data compiled by Fundata Canada Inc, writes that management and operating expenses of many Canadian Mutual Funds have risen steadily over the past three years gobbling up an increasing proportion of fund assets and crimping investors returns.

He writes that Fundata found that since 2000, for example, the MER of Canadian short-term bond funds jumped 20.6%, while the expense ratio rose 15.5% for Canadian mortgage funds, and 11.3% for Japanese equity funds. The median MER of a North American equity fund increased 8.7% while the MER for Canadian equity funds rose 8.9%

Constantly Picking Winners.

A lot of investors feel confident that either they or their investment advisors are able to pick winning mutual funds (i.e. that small percentage of funds that outperform markets annually) on a regular basis. However taking into account that there are over 3000 mutual

² This data is for surviving actively managed domestic US Stock funds, excluding Index exchange trade and institutional funds and multiple classes of the same fund and funds holding more than 20% of their assets in bonds

funds from which to choose, and that only a few of them outperform the markets, the chances of an investor or their investment advisor picking the winning mutual funds year in and year out are very slim.

Just because a fund made money in the past, does not mean that it will continue to do so in the future. In his *Random Walk Down Wall Street*, Burton Malkiel took the top twenty US best performing equity mutual funds of 1978 to 1987 and tracked them for the following ten years. His results showed while those funds had previously beaten the S&P 500, by 5.8 percentage points per year, during the next ten years they trailed it by 0.8 percentage points. (The above calculations did not take into account the mutual fund's undisclosed costs) Picking "winners" based on past results can be dangerous and costly.

Another problem in picking winners, and by implication getting rid of losers to finance the purchasing of the "winners", is that the investor has to continuously pay commissions of 4% to 5% for front end loads and redemption charges of up to 6% to 7% for deferred sales charges, each time they chop and change their mutual funds. If you add these additional costs to the MERs and the undisclosed costs, buying mutual funds could be very expensive.

According to Morningstar Principia Pro as of December 31, 2001, when an investor pays a sale commission to buy or sell units in mutual funds, the average commission that the investor pays could be as high as 4.1%. If the investor holds the investment for three years, the average load fund investor is paying an additional 1.4% per year.

Who Should Buy Mutual funds?

Dan Richards chief executive of Cartier Partners a major mutual fund distributor was quoted as saying that " for someone with \$25,000.00 to \$50,000.00 to invest, funds represent excellent value. Where they don't represent as good a value is where you have people with \$250,000.00 or \$500,000.00 or more."¹ So if you have a large investment portfolio and are heavily invested in mutual funds and are dissatisfied with your returns, you should ask yourself this question "are mutual funds the best investment for me?"

Disclaimer:

This article expresses the opinion of Robert Goldin and is for educational and general information purposes only. It does not constitute investment or legal advice. Under no circumstances are the contents to be relied upon for legal or investment decision-making. The information contained herein is obtained from sources believed to be reliable. However, no warranty can be made as to its accuracy or completeness and no responsibility or liability is assumed for its correctness or otherwise. The indicated rates of return of the mutual funds are the historical annual compounded total returns including changes in unit/share value and reinvestment of all distributions/ dividends. They do not take into account sales, redemptions, distribution or optimal charges or income tax payable by any security holder that would reduce returns. Mutual funds are not guaranteed and their values change frequently and past performance is no indicator of how the mutual funds will perform in the future. Readers are requested and urged, at all

¹ Article titled "Costs matter" -IE Money magazine October/November 2003 at page 33

times, to consult with professional investment advisors and legal counsel concerning the specifics of their particular situation, before making any decisions of any kind.

Robert Goldin October 2003.