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Are Mutual Funds Headed for Extinction?

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The advent of the mutual fund was one of the greatest innovations in the field of finance. Mutual funds created a practical means for common folks to invest in the markets which used to be only accessible by the wealthy. The mechanics of how mutual funds operate have not changed much in the many decades since they have been around. Simply put, a group of investors pool their money together and form a unit trust where all investors get a pro rata ownership of what they contributed to the pool in the form of units (or shares). The pool is then used to buy a number of underlying investments such as stocks or bonds. At the end of each day, all investments in the trust are priced and a Net Asset Value (or NAV) is determined by dividing the total value of the trust investments by the units outstanding. Investors who want to purchase shares of the trust may do so based on the NAV established at the end of each day.

Mutual funds have been available to Canadians for over 80 years, and now number more than 15,000 worth well over $1 trillion. Companies or individuals who sell mutual funds like to promote the benefits of mutual funds:

- ✔ Professionally Managed
- ✔ All-In-One solutions
- ✔ Diversification (or risk reduction)
- ✔ Convenient payment plans
- ✔ Easy administration for tax reporting
- ✔ Variety of investment strategies
- ✔ Assurance of regulatory oversight
- ✔ History of strong investment performance

For the most part, all of the above claims are true. But here are a few facts that the same companies and individuals who sell mutual funds neglect to mention:

#1 – A "professionally managed" fund does not guarantee that you will make money or achieve performance that is better than "the market". In fact, most studies show that the vast majority of professionally managed (or actively managed) funds underperform the market after fees over longer periods of time.

#2 – The fees charged by the companies who sell mutual funds are OUTRAGEOUS! Mutual funds extract fees directly from the fund assets so investors do not explicitly see fees (regulatory changes may improve this). Regardless, in the low-growth, low interest rate world that we currently live in, you can expect that mutual fund fees will account for approximately 33% of expected returns in an average year and that is not fair!

#3 – Mutual funds are almost always sold based on the presentation of impressive historical performance. Yet, companies are required to disclose something comparable to "Past performance is not a guarantee of future performance," which is 100% true. Sadly, human behaviour shows a strong inclination to buy funds that have performed well in recent time periods and the companies and individuals who sell mutual funds know this and therefore promote the funds that fall into that category. When is the last time that you saw a mutual fund being promoted that had "awful" historical performance?

Mutual funds were created to serve a market that was not being served. In the absence of any alternatives, mutual funds could continue to serve that market for outrageous fees. But consumers have another choice: Exchange Traded Funds

(ETFs). ETFs serve the same market as mutual funds and have fee levels that are SIGNIFICANTLY less expensive. Our ETFs vs. Mutual Funds Report addresses the differences and similarities between ETFs and mutual funds, but it suffices to say that ETFs are an equally impressive financial innovation as mutual funds…50 years or so later.

The popularity of ETFs has exploded over the past few decades resulting in many new issuers of ETFs and an increasing number of investment styles/strategies. With so many to choose from, investors must be careful to understand what they are getting, and shop around to make sure that they are finding the most cost-effective choice for a given investment strategy. ETFs have steadily eroded the market share of mutual funds and now account for close to 10% of total "fund" assets in Canada.

If pure logic and rational decision making was used by investors to decide whether to buy mutual funds or ETFs, then mutual funds would already be extinct. Then again, if everyone acted rationally, casinos would not exist either….

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