FINANCIAL PREPAREDNESS

"One of life's most painful moments comes when we must admit that we didn't do our homework, that we are not prepared." ~ Merlin Olsen

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The Problem With Mutual Funds

I recently became the investment manager for a large portfolio that was full of mutual funds. I'm in the process of unwinding the positions, and thought I'd write about why I'm not a fan of the product.

To be fair, the mutual fund was a great invention—for 1907, when the first fund launched. They provided outsourced, professional management and instant diversification (to at least some extent). For an individual investor who lacked the knowledge, time and energy to manage their own portfolio, they were a godsend.

I invested in mutual funds myself for many years until I became more knowledgeable about investing. This old field artillery officer wanted to allocate my scarce capital in a more granular way, so I cashed in my artillery battery for a sniper rifle and started investing in individual stocks.

The advent of decimalized stock prices, "payment for order flow" (that's where hedge funds, high-frequency traders, etc. pay brokerage firms to send their [mom & pop] customers' orders to them so they can trade against Dumb Money) and better technology and efficiency have reduced trade commissions from the exorbitant levels charged by the likes of Merrill Lynch in the 1970s to free (or almost free) today. And by the way, once you own a stock, the expense ratio is 0% (though the financial firms that sponsor American Depositary Receipts [foreign stocks priced in U.S. dollars that trade on American exchanges] do withhold a fee when dividends are paid).

One of the biggest disadvantages of mutual funds is how they trade. Unlike with ETFs and individual stocks, there is no intraday liquidity, so you can't use limit orders and be a patient buyer or seller. When you buy or sell mutual fund shares, you receive whatever the closing price is at the end of each trading day, and you never know for sure what that price will be.

Even worse, Vanguard has a rule (other investment companies may have the same rule) that once you place an order to buy or sell mutual fund shares, it cannot be changed or canceled. So let's say at 9:00 a.m., you place an order to sell $100,000 worth of a fund that currently has a very high price, but during that trading day, the market crashes 10% due to some shock and you no longer wish to sell. Too bad. Even though your trade won't happen until 4:00, you're SOL.

OK, so you wait patiently for 4:00 to arrive so you can find out what price you paid or received so you can make plans for the next trading day. Sorry, but you may need to wait another 14 hours. I don't receive email confirmations from Vanguard until around 6:20 the next morning.

Events such as the Great Financial Crisis and the arrival of COVID showed how important it is to have intraday liquidity with the securities in your portfolio. When the market is making very large moves, you can't afford to wait for 4:00 and hope you get a decent price.

For a patient trader who uses limit orders, the higher intraday volatility of individual stocks (compared to the lower volatility of a mutual fund's daily NAV) provides wonderful opportunities to buy or sell at great prices.

Another major problem of mutual funds (that are held in a taxable account) is the fact that they must distribute realized capital gains to the shareholders, who then have to pay income tax on those gains *even though the fund shareholder didn't sell any shares of the fund!* This can result in tens of thousands of dollars of additional (and unexpected) taxable income each year, which is problematic for a taxpayer who is trying to manage his taxable income. Some mutual funds have fairly high turnover, which can result in higher capital gains distributions, including more short-term capital gains (which are taxed as ordinary income at higher marginal tax rates).

A related problem is that when you buy shares in a mutual fund (again, this is only a concern if the shares are held in a taxable account), most funds already have significant unrealized capital gains that they haven't realized and distributed to fund shareholders yet. Many individual investors chase returns, so they buy mutual funds that have had large gains in recent years. Inevitably, after they buy, the pendulum swings and the fund underperforms. Imagine their surprise when less than a year later, the shares they bought are down 20% or more, and they receive a large (taxable) capital gains distribution *that benefited other investors* who owned shares in the fund earlier but now may be long gone.

Which brings me to yet another related concern that few mutual fund investors have even considered. When you go on a cruise, there are always a lot of people on the ship that you would rather not be around. But you're all stuck on the same boat, no matter what happens. During good times, the weather's great, everyone has a lot of money to spend and thousands of people crowd onto the ship. If the ship unexpectedly hits an iceberg and starts to sink, imagine how everyone would panic while trying to get on the lifeboats.

Unless a mutual fund is closed (which is rare), they have to take all comers (regardless of their investment behavior) at all times. Generally, investors are only interested in mutual funds after a long span of sunny weather (good times). Generally, a mutual fund will invest the bulk of that hot, new money from returns-chasing investors at the then-prevailing rich valuations, because those new investors want exposure to the Magnificent 7, and they want it *now*. They don't want to find out that 20% of their fund is in cash, they want to be *all in*.

Similarly, during stormy weather when it appears that the ship is at risk of sinking, everyone wants off the boat *now*, so the fund has to raise cash for redemptions by fund shareholders by selling securities at low (or even distressed) prices. Because of this “cruise ship” nature of mutual funds, they are pretty much forced to buy high and sell low.

These days, perhaps most of the money in stock mutual funds is also invested in index funds, which, as I've written, have their own additional disadvantages. Invest a mutual fund in an index fund and you have a doomsday machine masquerading as a common, sensible investment.

I haven't invested in mutual funds since 2008, so I don't know how this is done today, but historically, unlike ETFs, mutual funds have not been required to post their current holdings online, so you never really know what you currently own. In the past, mutual funds would typically disclose their holdings in a periodic report. One lesson I learned from the Great Financial Crisis—during which investors were frantically trying to determine how much exposure they had to failing financial institutions—is that *you must always know what you own*. The mutual funds that my clients and I owned at the time couldn't tell me, which made the situation even more stressful and frightening.

Investment companies and other firms that run actively managed mutual funds also have a potential conflict of interest that few investors have ever considered. Let's say you're the CEO of a large, publicly traded company (I'll use Boeing in this example) that offers a 401(k) plan to its employees. As the CEO, you have the final say in which investment company (such as Fidelity) or brokerage firm (such as Merrill Lynch) gets hired to administer the plan and provide its investment options. Such business can be lucrative, especially if the plan's investment options are limited to Fidelity's family of mutual funds. You have a captive audience that can't avoid using your products unless they either forego Boeing's matching 401(k) contribution or leave the company.

So financial services firms are keen to secure that business, and a CEO is in a position to extract a price. I think there is often an understanding that in return for the business, Fidelity's mutual funds will always hold a significant amount of Boeing's securities, or Merrill Lynch's research department will always recommend Boeing's stock to its customers. This harms the shareholders of Fidelity's mutual funds (who include the Boeing employees who participate in its 401(k) plan) since the funds buy and hold Boeing securities for non-investment related reasons, but it allows Boeing's management to exercise their stock options at artificially high prices.

Now you see why I'm not a fan of mutual funds.

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