Tools of the Trade: Problem Solvers

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For us capitalists, mutual funds may be one of the greatest inventions ever. These unique entities make it possible for a significant portion of the US population to participate profitably in our economic system. In this column, I examine some of the most important stages in the evolution of mutual funds, and the implications those stages have had for advisors and their clients.

At each stage of this evolution, a major development that solved one problem also created a new problem. The good news is that the mutual fund as an investment vehicle has continued to evolve along with our knowledge of what works and what doesn't. As a result, your ability to give clients the tools they need for a successful investment experience has grown immensely.

The history of the mutual fund dates back to 19th century Great Britain. However, the first major development in mutual funds as we know them today occurred in 1924 with the introduction of Massachusetts Investors Trust, the first open-end mutual fund. Until then, most Americans put their money in banks. Those who did invest had to build portfolios of individual stocks and bonds—a luxury available only to the wealthy.

Mutual funds changed all that by pooling together the capital of thousands of investors, essentially giving more Americans an easy way to participate in the wealth creation that capitalism offers. They also enabled smaller investors to build properly diversified portfolios. They provided more investors with access to professional money managers who, in theory, had superior insights and a better ability to pick stocks and time markets than other investors. This concept of active management was highly appealing at the time. Of course, it also was the only game in town.

Investors were lukewarm toward mutual funds at first, due largely to the 1929 Crash and the Great Depression that followed. Interest started ramping up following passage of the Investment Company Act of 1940, which imposed a wide range of rules and regulations on the funds and gave them broader appeal. Consider that in 1940 fewer than 70 funds existed, with total assets of $500 million. Today, more than 8,100 funds trade, and total assets have soared to $7.5 trillion.

In the industry's early days, historical market data was sparse at best. Investors had one way to size up fund performance: They compared one fund's returns to another, and made it their goal to invest with those managers who were better than their peers. Competition was between the managers.

Things started to change during the 1950s as computers with the ability to crunch huge amounts of data came along. That allowed the academic community to do extensive stock market research. Most notably, Roger Ibbotson and Rex Sinquefield in the 1970s documented the returns from different segments of the capital markets going back to 1926.

The result is that investors finally had a standard by which they could evaluate fund managers and ask a previously unanswerable question: Are managers adding any value through their stockpicking and timing decisions over the return that could be earned by owning the market? You can probably guess the answer. It didn't take long to see that the active managers as a group had failed miserably to add alpha.

The Index Fund Revolution

This discovery caused some of the more enlightened members of the financial services industry to realize that instead of trying to beat the market, a better approach would be to capture the returns the market offered via indexing. But it wasn't easy to convince the industry that the way it had been doing business for decades was faulty. Despite compelling academic evidence supporting it, indexing as an investment philosophy faced an uphill battle. As John Bogle points out in his book, *Common Sense on Mutual Funds*, one early adopter of indexing actually earned the "Dubious Achievement Award" from *Pensions & Investments* in 1972.

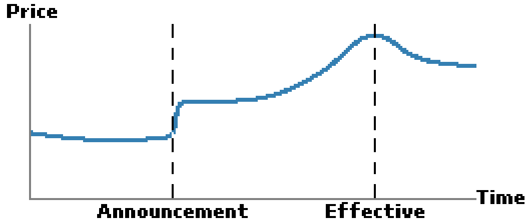
Eventually, in the early 1970s, two firms—Wells Fargo Bank and American National Bank—each introduced institutional-class S&P 500 index funds, and indexing was officially launched. Then Vanguard in 1975 brought index investing to the masses with the first retail S&P 500 fund, Vanguard Index Trust. Of course, we've all seen the numbers since that time showing how a passive, buy-and-hold strategy that owns the market addresses the rampant underperformance that results from buying and selling the wrong stocks and being in or out of the market at the wrong times. Look at just about any extended time period and you'll see that the indexers outperformed a majority of the active managers.

But remember, for every problem that a development in the industry solved, a new one sprouted. With index funds, that problem is the cost associated with tracking an index. Market indexes are reconstituted from time to time, of course, as some stocks drop out and others are added. The index manager, whose job it is to track his bogey, is forced to sell the old and buy the new—generating trading costs and taxable gains that get passed along to shareholders.

The effect of these costs on index investors depends largely on how often the committee in charge of a particular index decides to shuffle it around, as well as the types of stocks that make up the index. But regardless of the specific index or its rebalancing policies, the cost of tracking is there—and it erodes investors' returns.

Cost of Reconstitution

When indexes like the S&P 500 are reconstituted, investors in index mutual funds pay the price.



	S&P 500 Index[1]	MCSI EAFE Index[2]
One-Day Return After Announcement	3.2%	3.4%
Runup to Effective Date	3.8%	4.5%
Decay After Effective Date	-2.1%	-2.6%

Consider the chart to the right, which shows the reconstitution effect on the S&P 500. The day after Standard & Poor's announces which new stocks will be added to the index, those shares gain an average 3.2%. They rise an average of another 3.8% leading up to the day when the stocks are officially added—the same day most index fund managers buy the shares. Following the effective date, however, those stocks decline by roughly 2% on average. In their attempt to avoid tracking error, index fund managers consistently buy high. The chart shows the pattern is even worse for international funds tracking the EAFE index.

Passive Investing's Next Stage

While tracking an index is the goal of an index fund, the passive investor has a different goal: To get the rate of return offered by a particular asset class. That's the idea behind the third major development, asset class funds.

Asset class funds do not slavishly track an arbitrary index of securities that's put together by a committee. Instead, their goal is simply to generate the return available from an asset class, such as large-cap value, small-cap growth, and so forth. They do this by investing in a broad range of applicable stocks but not constraining their portfolios to fit perfectly into the mold created by a benchmark. For example, if Russell removes 10 stocks from one of its small-cap indexes and replaces them with 10 others, index managers have to follow that lead. Asset class fund managers, by contrast, can simply add those 10 new securities to their existing portfolios. Since there's no artificial limit on the number of stocks that the fund can own, there's no need to clear out the old to make way for the new.

The upshot: Asset class funds' structures are truly aligned with the goals of their shareholders. They offer asset class rates of return and broad diversification, but without the unnecessary extra costs that come from tracking. That's one big reason why asset class funds historically have outperformed their pure index peers and the indexes themselves.

I won't be so bold to say that asset class investing is flawless—although I must say that no one ever debates me on its merits. Even asset class funds present issues that must be examined. For example, some of their holdings from time to time will migrate from small cap to large cap or value to growth. That migration can add costs and capital gains when, for example, a value-oriented fund has to sell a security that no longer fits the definition of a value stock.

Although there are ways to reduce this effect, the ideal solution may be a type of investment vehicle in which a client would have a single portfolio that owns fractions of thousands of individual securities from the full range of desired asset classes, such as value, growth, small cap, large cap, emerging markets, and so forth. Because this approach would avoid the need to build a "component" portfolio of several mutual funds, it could potentially reduce costs even further. And while such an option is essentially available to very wealthy investors via separate accounts, I would like to see this become a practical alternative for smaller investors.

One thing we can be sure of is that the industry will continue to evolve and improve. Our understanding of the financial markets is always growing and the "final chapter" of this business will never be written. Therefore, I like to think that we'll continue to find new ways to help advisors better serve their clients. Certainly doing right by your clients is the key to becoming a superior advisor and building a great practice. As I'm fond of saying, do your job and the numbers will take care of themselves.

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[1] Lynch, Anthony, and Richard Mendenhall, "New Evidence on Stock Price Effects associated with Changes in the S&P 500 Index," *Journal of Business* 70 (1997):351-83.

[2] Chakrabarti, Rajesh, Wei Huang, Narayanan Jayaraman, and Jinsoo Lee, "Do International Investors' Demand Curves for Stocks Slope Down Too?," working paper.