10 Things Mutual Fund Companies Won't Say

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How runaway pay, powerful lobbies and rising fees are diminishing the value of the humble mutual fund.

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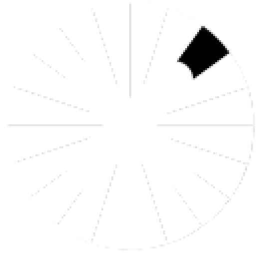
1. "Cheap funds often outperform pricey ones."

If there's one thing people assume when shopping, it's that the more something costs, the better it is. It may not always be wise to shell out top dollar for that storm-cloud-silver Bentley convertible. But if you do, you can probably rest assured that you scored a nicer ride than your neighbor who bought a 10-year-old Corolla on Craigslist. But when it comes to mutual funds, cheaper -- not pricier -- usually means better. Sound counterintuitive? Think about it this way. Most investors regard the highest-quality funds as the ones that will eventually hand them back the biggest pot of money. Every extra dollar portfolio managers spend on items like researching stocks or hefty salaries for star analysts reduces that total.

Fund companies argue they can more than make up for any money they spend up front if they pick the right stocks. Indeed, some star funds, like the $5.7 billion Sequoia have managed to do just that. Although the fund is slightly more expensive than its peers -- customers pay $100 per $10,000 invested, compared with about $93 on average -- it's been worth it. An investor that chipped in that same $10,000 five years ago would have $12,457 today, compared with $10,436 for a fund that tracked the market.

Still, the trick for investors is picking a fund that will outperform over the next five years, not the past five. And many academic studies have shown that low cost rather than past performance is the best way to predict future returns. That makes the mutual fund business unique, according to experts like William Birdthistle, a law professor at the Illinois Institute of Technology. "It's the only industry where price correlates inversely to the quality of the product."



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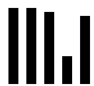

2. "We can't beat the market."

For baseball players, batting .300 has always been a magical goal. For pop stars, it's going platinum -- selling a million copies of an album. Mutual fund managers reach for a golden ring known as "beating the market." That means when Standard & Poor's 500-stock index is up 10%, they are up 11%. In some ways, that doesn't seem like such a lofty ambition. If not for the drag put on returns by investment costs, blind luck alone would guarantee that roughly half of funds would beat the market in any given year. But of course, those fees do make a difference, as do other expenses that investors don't pay directly, like brokerage commissions. In fact, over the past five years, only about one in three mutual funds beat its target, financial-data firm Morningstar reports.

Is picking funds a loser's game? It depends on whom you ask. Mutual fund companies and some independent analysts, including Morningstar, have long argued that smart investors can beat the odds. "It requires discipline," says Russel Kinnel, Morningstar's director of mutual fund research.

But many academics who've studied mutual fund returns, like the University of Maryland's Russ Wermers, say shopping around for market-beating mutual funds is typically a waste of time. When researchers like Wermers apply complex statistical models designed to remove the element of luck from the equation, the number of market-beating funds plunges almost to zero. "It's tough to find any asset managers that add value," he says.

3. "When skill fails, we just double (or quintuple) our odds."

Imagine a school with more teachers than students, or a restaurant with more chefs-de-cuisine than place settings. That's something akin to the situation in the mutual fund world. There are just under 5,000 stocks listed on major U.S. Exchanges. By contrast, there are more than 8,500 mutual funds and exchange-traded funds, by Morningstar's count.

Seem out of whack? One explanation, put forward by prominent academics John C. Coates and Glenn Hubbard in a well-known research paper paid for by the mutual fund industry, is that the vast number of funds is "consistent with strong competition" and that quirky as it may seem, it will inevitably lead to lower prices.
Others offer a more skeptical take. While small investors may not recognize how big a role luck plays in determining winners and losers, it's certainly no secret to industry insiders. Since individual funds are relatively cheap to launch and keep running, a bigger roster of funds boosts the odds that at any given moment, one or two will be handily beating the market. "If you have enough, some always look good," says independent consultant Geoff Bobroff.

4. "People aren't buying our product..."

While mutual funds that aim to beat the market remain by far the most popular variety, in the wake of the financial crisis they've been losing ground to cheaper alternatives that aim merely to match market benchmarks. Since 2008, investors yanked about $1 trillion from traditional active stock funds, while pouring $600 billion into benchmark-hugging index funds, including the wildly popular exchange-traded funds, according to researcher EPFR Global.

While the resulting savings has many consumer advocates applauding, others debate whether it's a permanent shift, or merely reflects a natural tendency for investors to temporarily distrust hotshot stock pickers during a bear market. One theory put forth by Bobroff, among others: With the market taking wild up and down swings based on macroeconomic news like the latest development in the European debt crisis or the Federal Reserve's decision to pump more money into the economy, it's gotten even tougher than usual for managers to earn their keep by sussing out slight differences between competing companies. But that could change if the market starts rising steadily again, the way it did in the 1980s and 1990s. "Active management isn't dead," Bobroff says. "It will come back."

5. "...except when we pay them kickbacks."

Benchmark-tracking index funds would perhaps be gaining even more ground on pricier stock-picking if not for an important but controversial advantage enjoyed by many active fund companies: cash they pay to intermediaries like big Wall Street brokerage houses that employ armies of financial advisers to peddle their funds. Although the payments have been made for years, critics describe the system in the bluntest terms. "It's basically kickbacks," says John Freeman, an emeritus professor of business and professional ethics at the University of South Carolina Law School.

The industry has long disputed the notion that the payments, which can be earmarked to cover record-keeping costs or for educational events like conferences, are in any way inappropriate or that they skew brokers' judgment.

In place of the K-word, fund executives use the term "revenue sharing." Both brokerage firms and mutual fund companies typically mention these agreements in disclosures they make available for investors that want to study them. One thing that the fine print typically won't say, however, is how much money is at stake. An exception is brokerage

Edward Jones, which gives a detailed accounting of its revenue-sharing agreements with mutual funds as result of a recent regulatory settlement. In total, Edward Jones received more than $150 million from mutual fund and insurance firms in 2011. To put that in context, that amounts to about one third of the company's $480 million profit.

6. "Hedge funds are our idols."

One type of mutual fund that's grown by leaps and bounds since the financial crisis are those that mimic hedge funds. While fund researcher Morningstar counted just 112 such funds in 2007, today there are more than 300. That's partly due to the fact that many of these investment strategies, often designed to provide steady returns in all market conditions, gained 0.6% on average in 2008, just as stocks plunged, losing more than a third of their value.

Such steady results whetted investors' appetites, according to Bob Worthington, president of alternative investment company Hatteras Funds that launched its latest mutual fund in October. Demand is growing, he says.

But some critics worry that even the strategies that have proved successful for hedge funds won't translate to the mutual fund world where portfolio managers face far more restrictions on how they can run funds. Others argue funds' typically rich fees -- which appeal to fund companies at a time when low-cost index funds are putting pressure on profit margins -- can be a big red flag for investors. "Some are good," says Kinnel. "Some are high-cost garbage."

7. "Our boards are rubber stamps."

Mutual fund companies are supposed to act in the best interest of their shareholders -- just not the shareholders of their funds. Because mutual fund executives must ultimately answer to the investors that own stock in the mutual fund company, the funds themselves are supposed to have a failsafe, a special board designed to protect shareholders.

But as a SmartMoney investigation into mutual fund boards earlier this year discovered, sitting on a fund board may be the best part-time job in the world. Directors, often paid hundreds of thousands of dollars per annum, typically meet for just two weeks out of every year.
Advocates say boards play an important role in vetting things like trading practices and making sure fees that investment managers charge are in line with competitors'. (See the fund industry trade group's explanation at ICI.org.)
But not everyone is buying it. Because directors are appointed by the firms they are supposed to be policing, most are unwilling to make waves, according to critics like Freeman at the University of South Carolina. "They do zilch," he says.

8. "Blame us for runaway CEO pay."

When companies pay top executives millions of dollars a year, often amid a foundering stock price, investors could be forgiven for wondering, "Who on earth is responsible for this?" The answer may well be your mutual fund. Executive pay is set by company

boards of directors. But shareholders elect directors and, since the Dodd-Frank financial reform bill, enjoy a direct although non-binding vote on executive pay too. Mutual funds, which collectively own about one-fourth of all the stocks in the U.S., are the largest individual shareholders of almost every big company from Microsoft to Goldman Sachs.

But even as the financial crisis and the debates over economic inequality it spawned have kept big pay packages in the headlines, critics say mutual funds have mostly reacted with shrugs. One study by the AFL-CIO found the 40 largest fund firms voted to approve executive pay about 85% of the time.

For their part, mutual fund companies argue those votes can be misleading, since many prefer to negotiate with management behind the scenes or simply sell the stock if they don't like the way a company is run. Of course, perspective could play a role too. Mutual fund employees' average annual wage, according to IbisWorld: $225,000.

9. "We played a starring role in the financial crisis."

What most Americans understand about the financial crisis in September 2008, is that it started with investment bank Lehman Brothers, whose collapse set off a kind of domino effect that reverberated throughout the economy. What they may not know is that one of the first and biggest dominos to fall was a money-market mutual fund -- the Reserve Fund -- whose Lehman-related losses led it to "break the buck," essentially letting the value of its shares fall below their $1 peg.

As investors began to flee other money market funds, corporations like General Electric struggled to borrow money in bond markets and soon the government stepped in to temporarily guarantee about $2 trillion in money-market fund holdings. The mutual fund industry downplays the importance of the move, pointing out that a majority of the money that investors yanked out of slightly riskier funds targeting corporate securities was moved to safer ones that focus on government bonds. But then-Treasury Secretary Henry Paulson called the move "the single most powerful and important action taken to hold the system together before Congress acted" to pass the bailout bill that October.

10. "Our lobby crushed bipartisan efforts at reform."

There isn't much liberals and conservatives agree on when it comes to financial reform in the wake of the financial crisis. But making sure the government won't have to backstop money market funds again would seem to be one of those rare issues to win support from both sides of the ideological spectrum -- with free-market sticklers like the scholars at the American Enterprise Institute taking the same side as the Obama administration.

Can't lose, right? Wrong. When Securities and Exchange Commission Chairman Mary Schapiro proposed forcing money market funds to let their per-share values float above or below $1 to more accurately reflect the value of their investment portfolios, the idea went nowhere. That's in large part due to the efforts of the Investment Company Institute, the mutual fund industry's powerful Washington lobby, which argued the change would chase investors out of money funds and into riskier instruments. ICI even

commissioned a third-party study of about 200 corporate finance chiefs claiming -- surprise! -- they would do just that.

The gambit appears to have worked. When SEC Commissioner Luis Aguilar, considered a key swing vote, explained his opposition to the move, he seemed convinced, saying, "I remain concerned that the Chairman's proposal will be a catalyst for investors moving significant dollars from the regulated, transparent money market fund market into the dark, opaque, unregulated market."

What's next? Proposals to reform money market funds have been taken up by the Financial Stability Oversight Council, a new board of top regulators including Federal Reserve Chairman Ben Bernanke and Treasury Secretary Timothy Geithner, which could prompt the SEC to take another look.