April 2006 – Mutual Funds: Pros & Cons

While under most circumstances we find the negatives outweigh the positives regarding mutual funds, we do recognize that they can in some cases be appropriate investments, and thus we deem them worthy of discussion. In this letter we will cover only the most common type, which is termed the open-end mutual fund and represents what most people associate with the words *mutual fund*. Although some deficiencies prevalent in open-end funds represent less of a problem in the newer exchange-traded funds, we will reserve that subject for a future letter.

Some important strengths of open-end funds are as follows:

- They can provide great diversification efficiently for small investments where individual stock portfolios would be uneconomical.
- For smaller portfolios they are professionally managed at costs with which managers investing in individual stocks could not compete.
- They offer liquidity in that most can be converted to cash within one business day.
- They are convenient from an ease of investment, record keeping and tax preparation standpoint.
- They facilitate reinvestment of dividends and thus dollar-cost averaging (a plan of regular investment that results in purchasing more shares when prices are low and fewer shares when they are high, producing a low average cost).

Some important weaknesses of open-end funds are listed below:

- They often charge high fees that contribute to lower net returns.
- They can be very tax inefficient. For example, due to the complex regulations that govern their taxability it is not unusual for an investor to have a loss in a given year yet face a tax liability.
- They average 90% turnover which causes excessive transaction costs and needless taxes (30% of their gains are short term).
- They may experience frequent management and/or style changes rendering a potential investor's investigation of prior performance to be of little value.

- Their disclosure of investment policies may be outdated or otherwise unreflective of reality. Consequently, the investor who relies on such information may make incorrect allocation decisions.
- Their managers are often young and inexperienced to the extent that they may never have lived through an entire market cycle.
- Their managers may be focused on the short-term while their investors should be long-term oriented.
- The funds can only be purchased or sold once a day at the closing value. Recent scandals in the industry were due in part to this restriction.
- They cannot be sold short and thus lack some hedging capability exhibited by equities.
- Funds, especially those with sub-par performance, may just shut down.

Finally, we believe that index funds merit a word of caution. An index fund is designed to mirror the performance of a market index such as the S&P 500. Most indexes and thus the associated funds are market-value weighted. For example, if the total market value of a stock is 5% of the market, then 5% of the index fund is invested in that stock. As a result, the most overvalued stocks are over-represented and the most undervalued are under-represented. For example, the investor at the height of the technology bubble who thought his or her S&P500 index fund to be conservative was actually 40% invested in technology stocks.

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