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It's Not Your Fault Your Fund Can't Keep Up

By SIMON CONSTABLE

Good news: The Standard & Poor's 500-stock index is up 12.6% (including dividends) for the year, one of the best first quarters in a long, long time. Many stock analysts are projecting a banner year for stocks, as investors pile into the market to counter today's low interest rates and fears that bond prices may be soon tumbling.

Dave Klug

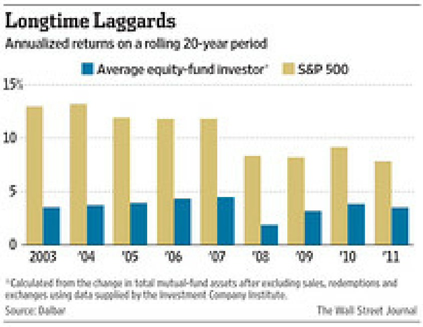
Bad news: Some of the biggest funds just aren't keeping up. The $59 billion large-cap American Funds Investment Co. of America Fund (AIVSX) was up 11% for the quarter. The story's similar for the $54 billion American Funds Washington Mutual (AWSHX), up just 7.7%, and the $37 billion Vanguard Windsor II fund (VWNFX), up 12.4%.

The really bad news: There's nothing unusual about any of that. A Morningstar survey for The Wall Street Journal Sunday found that only eight of the 25 largest actively managed funds—all types, from bond funds to foreign—beat the S&P 500 for the quarter.

That's right in line with previous analyses. On average, fully two-thirds of mutual funds lag behind their respective benchmarks, according to Morningstar. (Such studies stacked bond funds against bond indices; and stock funds were compared to stock indices.)

And over the long haul, according to fund guru John C. Bogle, virtually all fail.

Why does this happen? And what can you do about it?



Longtime Laggards

Annualized returns on a rolling 20-year period

*Calculated from the change in total mutual-fund assets after excluding sales, redemptions and exchanges using data supplied by the Investment Company Institute.

Source: Dalbar

The Wall Street Journal

Let's start with fees. The most obvious are those you pay to the mutual-fund firm. Fees known as your expense ratio will typically be less than 2% of fund assets and are often closer to 1%. Even if the fund manager gets the same return as the market you still have to pay that fee, so you'd still fail to beat the market.

On top of that, there are brokerage fees paid by the mutual fund to buy and sell securities. Just like you can't buy stocks without paying a commission, neither can your mutual fund. You pay those brokerage fees whether the value of the securities held by the fund rises or falls. You'll find the amount of brokerage fees paid in the so-called statement of additional information, which is separate from the fund's main prospectus.

These brokerage fees average another 1.44% in expenses, says Ric Edelman, CEO of Fairfax, Va.-based Edelman Financial Services, citing a 2005 study from the Financial Analysts Journal. Funds that do a lot of trading pay more of these fees than those that don't. Again, this makes it harder for the fund manager to beat the market.

Cash is another drag on your returns. The typical mutual fund holds about 3% of its assets in cash, says Russ Kinnel, director of mutual-fund research at Morningstar. That's money not being invested. So if the market is rising, the zero return on that cash drags on the overall performance of the fund. The cash is held so that it can be paid out to investors who want to sell their fund shares.

So how do you fight this problem?

Low Cost, Long Records

Dan Culloton, associate director of fund analysis at Morningstar, says investors should look for funds with low expenses and pick fund managers with long, consistent track records of success. They should avoid newly established funds, or those with relatively inexperienced managers. Then, look for funds without wild year-to-year swings in investment return.

It's worth noting that despite the latest quarter's lackluster showing, the three funds mentioned earlier all have low expenses, impressive long-term records and rate highly with Morningstar. So don't judge performance on a mere three months of data.

Mr. Culloton says his advice will get you a long way toward eliminating some of the duds. That way you'll stand a better chance of outperforming or at least matching the benchmarks.

But you face another formidable foe: yourself!

"Over the years, there has been a huge gap between what [mutual-fund] investors could have done versus what they put in their pocket," says Louis Harvey, CEO of Boston-based investment research firm Dalbar.

The reason is most investors fail to hold mutual-fund investments for long enough, and instead try to time their investments. But they tend to enter the market after it has risen, Mr. Harvey says. So they are likely buying at a higher price. They also are apt to leave the market after it has dropped, therefore selling at a lower price.

The result: investments that will massively underperform against their benchmarks.

The average equity-fund investor saw annual returns of only 3.49% in the 20 years through 2011, according to the latest analysis from Dalbar. Compare that with the average 7.81% annual return of the S&P 500.

For the average investor, that's more than half the possible returns left on the table.

It's not all bad news, though.

Mr. Harvey says the difference between the returns you might have gotten and what you actually got has been narrowing over the past few years.

Investors who got started in the 1990s have seen many rallies and routs in the stock market, according to a March report from Dalbar. "They found that remaining invested has, over the long term, produced positive results," the report states.

Indeed, investors looking to close the gap should be buying mutual funds, whether they be stock or bond funds, for the long term. Don't be tempted to bail when performance is poor because, over time, that has been shown to be a losing strategy.

And don't try to chase performance by getting into funds that have performed well recently. This is the equivalent of buying high and selling low—the exact opposite of what investors should be doing.

Drop Funds Altogether?

Mr. Edelman says to avoid mutual funds altogether. He says they worked well for the 20th century but are now "antiquated." "They are a slow, cumbersome and expensive way to do business," he says.

He prefers exchange-traded funds, which, he says, technologically overcome many of those problems and are less expensive. You don't have to go through the ETF company to make a trade; you can do so yourself at any time the market is open, electronically. Also, ETF firms disclose their holdings daily. What's more, ETFs don't have to keep as much cash on hand as do mutual funds because when you buy or sell an ETF the fund doesn't have to liquidate securities.

"The ETF is the 21st century version of the century-old mutual fund," Mr. Edelman says.

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