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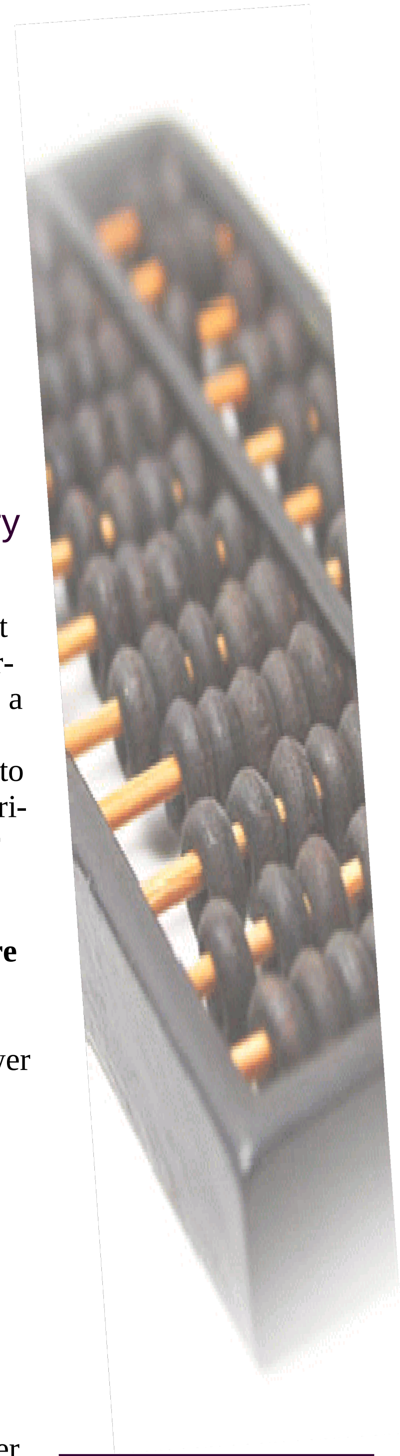
RATIONAL INVESTING versus the MUTUAL FUND "MARKET" APPROACH

by James Lowry



When security market investment returns are exceptionally good and interest rates are perceived to be on a downward trend, investors are encouraged to put their capital into mutual funds *as proxies for the securities markets*. In the marketing competition upon which the success of mutual fund companies depend, a clear understanding of the popular assumptions about mutual funds and a "market" investment approach is often lost. As a consequence the question as to whether mutual fund investments are really the best way to participate in securities markets is neglected. The following analysis deals with some of the major issues involved in answering this question.

The most common assumptions used in the marketing of mutual funds are as follows:

- Mutual funds are highly diversified: the greater the diversification, the lower the risk.
- Mutual fund investors should be in mutual funds for the long-term.
- Investment returns are more dependent on an active or tactical asset-mix strategy than on any other factor.

How mutual funds operate:

While it is true that mutual funds are operated on the basis of a multitude of goals and by managers with varying ideas about investment, there are a number of things that most have in common and which investors should understand and carefully investigate:

, *Management fees* are usually fairly high and are not directly tax deductible for the individual investor or institution. There are often charges to buy or sell mutual funds or restrictions that incur fees if early mutual fund *redemptions* are desired.

, In addition to management fees there are usually *operating costs*, which include payments to custodial, transfer agency, accounting, auditing and legal firms.

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, The portfolio of securities is bought and sold relatively frequently - often once a year or more. These transactions have *tax consequences* which are in some manner paid for by the investor, directly or indirectly.

The easiest way to deal with the complexity of the above marketing assumptions and operational factors is to break them up into *theoretical* and *practical* components.

THEORY

Diversification: the idea that maximum diversification equals the lowest risk is a statistical assumption based on the Law of Large Numbers - that is, that the extremes always revert to the mean given enough time. In terms of the securities markets this means that buying the whole market is the safest thing anyone can do. To believe this dogma an investor must believe that an analysis of single companies cannot discover that some companies are safer investments than others. The end result is that investment is regarded as investment in the "market" rather than investment in a "business".

Asset-Mix: if maximum diversification is the safest route, it follows that the only way to gain an edge on the competition and to justify any claim to expertise is to be able to "adjust" asset-mix on a consistently favourable basis. This procedure is termed tactical or active asset-mix allocation. Since investment is in the "market", a market professional is one who can predict the expansion or contraction of the so-called macro-economy and make accurate predictions about the consequent price changes in security classes. There are two major problems in this thinking: the first is a *contradiction,* the second is an *impossibility*. The contradiction lies in the fact that asset-mix implies minimal diversification; usually only three categories or security proxies - cash, stocks and bonds. Sometimes this is expanded to include real estate and foreign securities. The impossibility is that the macro-economy has so many variables that, like the weather, it is impossible to make consistently accurate predictions. Dependence on a tactical or active asset-mix strategy can, therefore, be very risky and is more akin to *market timing* than *fundamental business analysis.*

Long-term Investing: the rationale for being a long-term investor is the assumption that it is impossible for anyone to predict short-term market price fluctuations. This rationale is all but repudiated if there is concentration on short-term changes in either asset-mix or in the security holdings within asset-mix classes. Yet frequent turnover of securities and related asset-mix changes is the norm rather than the exception for most mutual funds.

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PRACTICE

Aside from theoretical inconsistencies and contradictions, there are real *financial consequences* to *high portfolio turnover* and *high fee structures* that are much more significant than they appear when unexamined. Below are some calculations which show in a general way the difference in return between a portfolio turned over once a year and one bought and held for the duration of the investment.

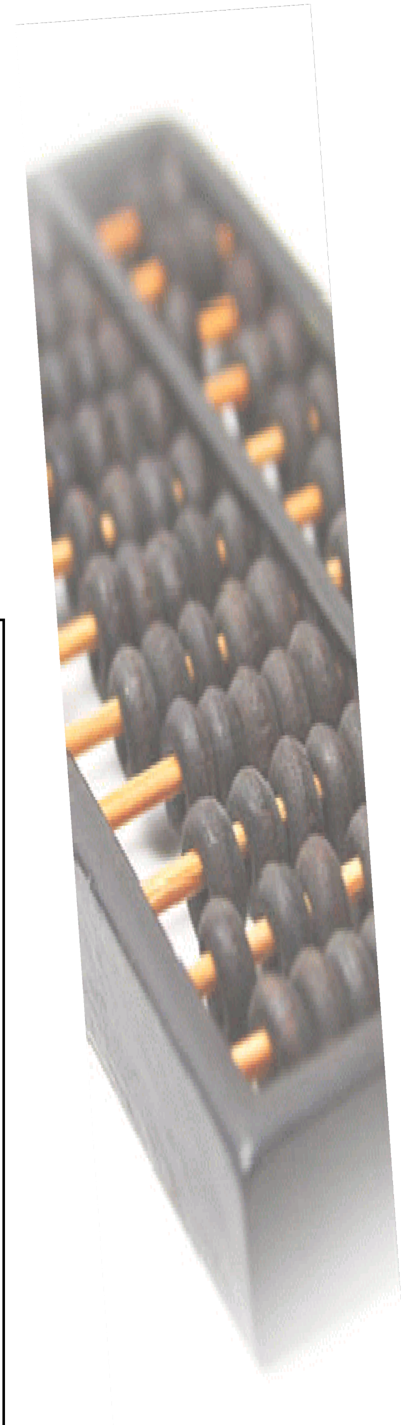
MUTUAL FUND RETURNS VERSUS BUY-AND-HOLD STRATEGY

ASSUMPTIONS

MUTUAL FUND	Portfolio	BUY-AND-HOLD
Portfolio Turnover	yearly	sell after ten years
Taxation (40% bracket)	paid annually	paid - 10th yr.
end		
Dividends and Interest	reinvested	reinvested
[Rate]	3.5%	3.5%
Transaction Fees	0.25%	1.0%
Mgt. & Admin. Fees	2.0%	1.0%
Amount Invested	$100,000	$100,000
Annual Cmp. Return (pre-tax)	10.0%	10.0%

RESULTS

Beginning Value	$100,000	$100,000
Ending Value (after tax)	$192,843	$219,575
Annual Cmp. Return	6.79%	8.18%



CONCLUSION

In order for the ending value of the mutual fund portfolio to match that of the buy-and-hold portfolio, that is, to have a value of $219,575, the mutual fund portfolio would have to achieve a pre-tax annual compound return of 12.57%. This means in plain language that the mutual fund would have to make 25.69% more money than the buy-and-hold portfolio each year to just stay even with the buy-and-hold portfolio.

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