

Advisor Intelligence

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Why We Invest In Funds Rather than Stocks

It is a well-publicized dogma that owning individual stocks—either by picking them yourself or having them picked for you by a professional separate account manager—is superior to investing in mutual funds. Some of the arguments include the assertions that direct stock investors have full control over taxes, management fees are low or non-existent, and they have greater control in crafting a portfolio that meets their specific risk and reward goals. Mutual funds, on the other hand, can't even match the performance of the broader stock market despite the supposed expertise of their managers. They incur expenses and can be less tax efficient. So why would anyone in a position to own stocks directly want to own funds instead? When you look beyond the simplistic case just presented, which is often all that is presented on the topic, there are in fact compelling reasons even for larger investors to own funds. We are going to go through them in detail in this article, and address some of the truths and myths we see widely reported on the subject.

The first question an investor needs to ask in addressing the question of funds versus stocks is whether they believe it is possible for active management (either themselves or a manager) to outperform the indexes. In considering the performance of active managers of mutual funds versus indices, the fact that mutual funds on average fail to beat the market over time is one that has been widely reported over the years. This type of reporting is somewhat cyclical and often shortsighted (failing to take risk into account or to make use appropriate benchmarks), and tends to be most prevalent after periods of large-cap dominance. But nevertheless we agree that it is true. It makes perfect sense, since the average of all managers essentially is the market, and since managers' returns are reduced by trading costs and expenses.

So the question becomes: Why should you choose funds as your active management vehicle if the odds are you are going to underperform the market? Given a choice between paying 1.2% to get the "average" manager, and having an index fund that charges only 0.20%, we choose the latter without hesitation. However, just because the "average" manager can't beat the market over time doesn't mean there aren't some managers who can. In fact, in any group of portfolios, even if they were randomly chosen, statistics dictate that there will be some above the mean and some below. The trick is figuring out which managers are truly good and which just got lucky and look like they're good.

On the other hand, investors who do not believe active management can reliably outperform indexes are not impacted by the stocks-versus-funds issue we are addressing here. The same arguments they would make about fund managers would apply to separate account managers as well, and so they should invest in index products with the lowest possible expenses. We have written about our thoughts on active versus passive

and have in many articles laid out the research process that underlies our belief in our ability to successfully select active managers. Since that ground has been well covered, in this article we are going to focus on specific advantages relating to investing in skilled managers versus investing in stocks directly.

Why We Use Funds

Fund managers are skillful

Just because a lot of managers are average doesn't mean all of them are. The real pros have spent years acquiring skills, expertise, and a historical framework that is difficult for the average investor to replicate. These attributes are very helpful—indeed, virtually indispensable—to generating above-index returns. While there is no shortage of supply in the financial press telling you “the top stocks to own this year,” or “the only variable you need to look at to identify the winners from the losers,” the reality is that stocks are hard to analyze. The fact that the average fund manager can't do any better than the market is proof of this—the competition out there is intense. Contrary to what many argue, it's not as simple as just “buy what you know.” Certainly an investor may come across selective circumstances where they have an information edge and might invest successfully in a stock. But one or even several stocks don't address diversification and risk. And there is no guarantee that what an investor might know about a company has any bearing on a company's investment appeal. A simplistic assessment of Cisco that it is a dominant, rapidly growing company in an industry that is reshaping business and society might be correct, but it doesn't make it a good investment at a hundred times earnings. Analyzing all (or most) of the fundamentals is necessary to owning good stocks. You need to know what can go right, as well as what can go wrong, and that requires a lot of homework. Also, things change over time; “buy and hold forever” might work for someone like Warren Buffett, but for average investors this is probably beyond their scope.

Valuation work is also complicated. Do you know how to accurately implement a multi-stage dividend discount model? Do you have access to a comparable-sales database and know how to evaluate what constitutes a comparable sale? Do you know how to mark tangible assets to their true market value? Probably not. And there's no reason you should! Most people also don't know how to do a coronary bypass, write a legal brief, or operate a backhoe. That's why you hire a professional to do those things for you. Lots of people got burned in the tech mania because they didn't know how to do this work. If they had, they would have had stronger questions about whether the valuations were realistic and sustainable. We know how to do much of it, which was part of the reason we were crowing so loudly that tech looked extremely overvalued well before the bubble approached its bursting point.

Owning stocks is time consuming

We know from talking to and challenging fund managers—and seeing how much effort they put in—that owning stocks takes an enormous amount of time. Unless an investor is prepared to spend both a lot of time on the front end (doing the initial research and analysis) and periodic maintenance research, they might not want to be buying stocks.

You have to keep an eye on things so that you are aware of changes that may be material to the investment thesis. Fund managers spend all their time stock picking and managing the portfolio. Very few of them work 40-hour weeks; it's probably more like 60 hours or more. And even with all that effort, the average manager still isn't able to beat the market. Do you want to spend your entire life working on your investments? Probably not. More likely, you are investing to reach some goal. It's a means to an end. There are a lot of other fun things to do with your life, and they're probably a lot safer for your finances.

Professionals have superior resources and better access

The Internet has vastly increased the amount of information available to anyone with a PC and a modem. But having information without context, judgment and experience doesn't make someone good at it. Similarly, going back a decade, word processors allowed anyone to design documents, but as the ensuing proliferation of ugly documents proved, it didn't make them any good at it! In the case of investment information, it goes beyond just greater access. There are certain advantages that the pros have that even the Internet cannot equal. Professionals have better access to company management, better resources (that can be very expensive), more analytical firepower. This gives them an edge over Joe Q. Public. They know more about what positives and negatives are facing a company. They are better equipped to evaluate how those forces will impact the company and its stock. They have better databases, which in turn have more timely and accurate data than what is available to the average individual. They can talk to company management to find out if they are capable and have integrity. The average investor doesn't get to talk to management, because management won't return the phone calls of Joe Q. Public, who only owns 400 shares of stock.

More easily achieve diversification

Many studies have been done about how many stocks an investor needs to achieve a diversified portfolio. Some estimates have been as low as eight, some considerably higher. However, we don't think you need a statistical study to know that the number is a lot bigger than eight. If you want to own large-caps and small-caps (which we think you should), as well as international stocks, you need to own enough stocks in each of those areas to be diversified. And we haven't even started talking about bonds yet. So even if you only needed eight stocks in each of those three asset classes, you'd already be up to 24 stocks, and realistically you probably need more, especially if you want to make tactical moves into areas such as REITs. However, you could achieve an even better level of diversification with just a handful of mutual funds. We think it makes sense to own slightly more than a handful—perhaps as many as a dozen or so—since this allows an investor to have style diversification (growth vs. value), market-cap diversification (large vs. small), and asset-class diversification (domestic and international equities, bonds, and any others that may represent tactical exposure). If you were to own just one or two funds in each area, you could get the job done with perhaps a dozen or so funds. (Our model portfolios are a good representation of this concept.) You could certainly cover your bases fairly easily and with a lot less work than what it would take to achieve the same level of diversification with individual stocks.

Leveraging the resource and diversification advantages by delegating security selection to professional managers allows you to devote greater resources toward determining a strategic and tactical allocation—which studies show is highly influential on portfolio performance. Asset allocation is not easy either, but it is far easier for a do-it-yourself investor to gather and apply good outside asset-allocation advice than it is to try to apply stock-picking advice, which has an exponentially greater degree of variables involved.

Making portfolio moves is easier

Tactical allocations are quite a bit easier with funds. One of the things that we've learned over our many years in the investments business is that when a fat pitch comes along, you want to take maximum advantage of the opportunity. So when we see a great opportunity in an area such as high-yield bonds, we want to take advantage of it quickly and accurately. Quickly means: you don't want to spend a lot of time figuring out which bonds are most likely to correlate with the overall asset class when things turn up; the market could move away from you before you've got the allocation fully established (we've seen this happen to fund managers with individual stock on more than one occasion). Accurately means: you want to make sure that the exposure you've got is going to correlate with the asset class. We have made that mistake at the fund level on occasion, where we were correct on the fat pitch call but didn't benefit as fully as we might have with a more "pure play" fund. A mutual fund is much more likely to trend with the asset class than an individual bond, which is subject to all kinds of unique forces. Of course, you still have to make sure the fund you're using is going to track well, but that is considerably less challenging than attempting to do the same thing with individual stocks.

Rebalancing is also easier. Due to the natural fluctuations of the market, portfolios deviate from their target allocations. Sometimes it's by a small amount that doesn't really justify making trades. However, time and/or big market moves can get things off target. For example, say there's a big bull market (remember those?). As stock prices rise, your equity positions will make up an increasingly larger portion of your portfolio, while slower growing bond positions will make up a relatively smaller portion. If you own funds, you need only make several straightforward trades to get you back to targets. With stocks, however, you face a series of more difficult decisions. Which stocks are the most overvalued? Which are the most likely to have good fundamentals going forward? What sectors am I over/underweighted to? Do I sell all of one or two stocks, or partial amounts of more stocks? The same issues would apply to bonds. Making these decisions with funds isn't necessarily easy, but comparatively speaking it's much simpler.

Individuals are highly susceptible to making decision errors

The field of behavioral finance demonstrates that all investors, not just individuals, are hard-wired in certain ways that greatly increase the probability of making poor investment decisions. Skilled, experienced professionals with a disciplined approach, however, are probably less likely to make the same kind of decision errors as individual investors. A big part of the value that comes from a clearly defined and consistently implemented investment process is that it reduces the chances of making these kinds of mistakes. And a fund manager has shareholder accountability to keep them from making

huge errors—the prospect of losing your job creates a different perspective from that of losing your money. Individuals don't have that same restriction; since nobody is watching, there's nothing to make them think about the consequences of their actions. We remained entertained (and concerned) by stories from individual investors we know who buy and sell individual stocks on sometimes remarkably flimsy reasoning, and it is clear to us that decision errors are alive and well. On the bright side, there are two sides to every trade. So just as informed voters should root for voter apathy, so as to prevent their thoughtful vote from being diluted by the votes of the poorly informed, disciplined and rational investors should welcome the decision errors that create opportunities (even while they may feel sorry for the friends and relatives making them).

Separate accounts are not always what they seem

While this issue does not pertain to individuals who pick their own stocks, we think it is an important issue that deserves attention. Separate accounts—individual stocks that are picked for an individual investor by a professional—are often managed by junior people working off a model portfolio, rather than the named manager, and are often run using block trading without regard to tax consequences. As such, they may not be much better than an average mutual fund and could generate a surprisingly unimpressive tax bill.

Problems with Mutual Funds

As we said earlier, funds are not without their problems. We value rational and impartial thinking, since it is key to being successful, and we have considered also the problems faced in mutual fund investing. We explain below some of the key issues with funds and the reasons why we do not think they outweigh the positives.

Expenses

There are few certainties in investing. For investors who hire professional management, expenses are one of them. When you are buying individual stocks of your own choosing, you don't have to pay anyone to manage your money for you. And it is a simple truth that expenses chip away at returns over time. For example, take a mutual fund with a 1.5% expense ratio and a gross 10% annualized return over 15 years. If you started with a \$100,000 investment, the dollar cost of the expenses would be roughly \$78,000, reducing what would have been \$418,000 to about \$340,000 (not taking taxes into consideration). That's a big difference. If you use 20 years as the horizon, the difference is even bigger: \$511,000 vs. \$673,000. This is part of the reason we don't look at funds with high expense ratios. However, assuming that the managers are able to add value, you have to be willing to pay them something. You just don't want to pay them an amount that exceeds the value they add. And given the certainty of expenses and the uncertainty of adding value, you'd like to have a comfortable margin between the two. During the massive tech run-up in 1999 and early 2000, we heard many investors saying, "Who cares if the fund charges 2%, it was up 100% last year!" We would also gladly pay 2% for skill that brought a 100% gain. In reality, though, rather than skill it was more often the case that outsized gains were earned through naïve rationalizations that allowed managers to ignore fundamentals and take excessive risks. The gains can quickly disappear, but the expenses remain, (in fact they may increase as assets shrink)

and over time those expenses add up. Again, this is why we simply won't consider recommending funds that are likely to have high expenses over time.

Less control over taxes

Another common complaint about funds is that they are tax inefficient. Funds make distributions every year; there's nothing we can do about that. They may be long-term, may be short-term. It all depends on what the fund manager sold during the year, and it doesn't matter when you bought the fund. You are liable for all the gains the manager realized during the tax year. This is far from ideal. But you'd also have to pay taxes if you sold individual stocks. You have to pay taxes sooner or later. What you lose is the time value of the money paid in taxes today, which otherwise could have been reinvested. By paying some taxes now, you are reducing the tax liability you'll have to pay when you ultimately sell. The impact of paying the taxes each year rather than paying it all when you sell the fund outright is actually considerably smaller than most people think.

Also, there are strategies you can use to reduce taxes with funds, and many of them are actually easier to implement with funds than with stocks. For example, by selectively harvesting losses throughout the year, you can accumulate losses to offset some of the gains paid out by the funds. For example, let's say you own the ABC Large-Cap Growth Fund at a loss. You could simply sell that fund and buy a similar large-cap growth fund in which you also have strong confidence in the manager to replace it. That way you maintain your asset class exposure, but also get to receive the tax benefit of the loss. This is harder to do with individual stocks, since a specific stock generally has more unique characteristics that make them hard to replace exactly. And if you're worried about buying a fund right before it makes a big distribution, wait until after the distribution or buy it in an IRA where there are no tax consequences. Meanwhile, funds that make sizeable short-term capital-gain distributions on a regular basis should probably either be avoided or held in tax-exempt accounts, since these are taxed at an investor's marginal tax rate, which is almost always quite a bit higher than the 20% long-term capital gains tax rate, and as such it has a much more detrimental impact on your after-tax returns. The bottom line is that while you have virtually no control over the size of a fund's distributions, these distributions generally are not as economically significant as many people think, and there are still plenty of strategies you can use with funds to help manage your tax liability.

Negative developments that make you want to sell the fund

Asset bloat, management turnover, or other negative developments at the fund company may make you want to sell. We'd love to "buy and hold forever" with funds—just as some people would like to do with stocks—but the reality is that sometimes things change. But guess what? In this regard, funds are no different than stocks. A drug company can go under because it loses a patent. A better semiconductor technology comes along and, all of a sudden, your chip company is a second-tier player. Your discount retailer with lots of debt on the balance sheet gets hit during a normal recession and before you know it they're filing for Chapter 11 bankruptcy. With funds, maybe someone buys out the advisor and raises the expense ratio. Maybe the fund manager decides to retire, creating a leadership vacuum. Maybe you've got a manager that was

great with small-cap stocks, but lets his asset base get too big, and now he's floundering in the more efficient large-cap universe. The investment universe is dynamic. Things are always changing, and being willing to accept and adjust to the changes is a part of the game, regardless of the investment vehicle you are using.

Not all fund managers act as fiduciaries

We look for fund managers who think of themselves as caring custodians of shareholders' money. We especially like it when they put a large percentage of their own net worth into their funds; that way we know they'll be eating their own cooking and that their interests are aligned with shareholders'. However, some fund companies see managing funds as nothing more than a very profitable business. They act like owners, even though in truth they are simply contractors who have been hired by the fund's owners (its shareholders) to act on their behalf and in their interests. Whatever it takes to maximize profits (usually by growing their assets under management), they'll do it. That might mean running too much money in a particular style, even if it hurts performance. It might mean that they hire additional staff to help with the increased workload (researching and buying more stocks), thereby potentially diluting their pool of talent. But that is not unique to mutual funds: there are plenty of CEOs of companies who put their own interests ahead of those of stockholders. And in both cases it is not difficult to find funds or companies that do act in the best interest of shareholders—it is just another research consideration.

Cash drag

Equity funds tend to hold some cash. The level varies from fund to fund, but in an up market, this cash acts as a drag on performance (while it helps performance in down markets). We account for this by reducing bond positions. For example, Joe Q. Investor wants to have 75% in equities and 25% in investment-grade bonds. Due to the cash held by the funds, however, his actual exposure to equities might be something like 71%. The solution in this case might be to target 79% equities and 21% investment-grade bonds, with the logic being that real exposure to equities is only 75% after you take cash into account. This isn't a perfect match to a 75/25 portfolio (since cash is not exactly the same as investment-grade bonds), but for all intents and purposes, the characteristics of the two portfolios would be essentially identical.

Conclusion

Through all the contact we've had with managers and fund company executives over the years, we will be the first to acknowledge that mutual funds are far from perfect. Unfortunately, we have found no other investment vehicles that are, either. While an important part of our research process involves very specific and detailed evaluations of managers and research teams and their investment process, in many cases we never even get that far. This is because our process starts with an evaluation of the more tangible issues like those we have just discussed. We don't like buying problems, so we spend a lot of our research effort on avoiding or minimizing them, and we keep a close watch on the funds we own. Compared with the choice of direct investment, which brings with it a range of far more difficult problems, it is our view that funds afford a better chance for success. This success does not hinge on the success or failure of the fund industry at

large, it only requires the ability to find a small number of good funds within this large and highly imperfect industry. This is what we do, and we can say with confidence that we are able to find enough high-quality fund investments to be successful, and our record validates this. It is our hope that the extensive work we do in this regard affords our subscribers the opportunity to share in this long-term success.

—Josh Weiss, CFA