Should Individual Investors Buy Mutual Funds?

Mutual funds pool money from many investors and purchase stocks, bonds, and other securities. Mutual funds allow investors with moderate wealth levels to hold a diversified and professionally managed portfolio at relatively low costs. This article discusses the recent growth in mutual fund assets and the aggregate performance of mutual funds.

The mutual fund sector has grown dramatically over the last decade. The worldwide mutual fund assets increased from around USD 5 trillion in 1995 to over USD 17 trillion in 2005 according to the Investment Company Institute (ICI). There are currently more than 50,000 different mutual funds available in different countries.

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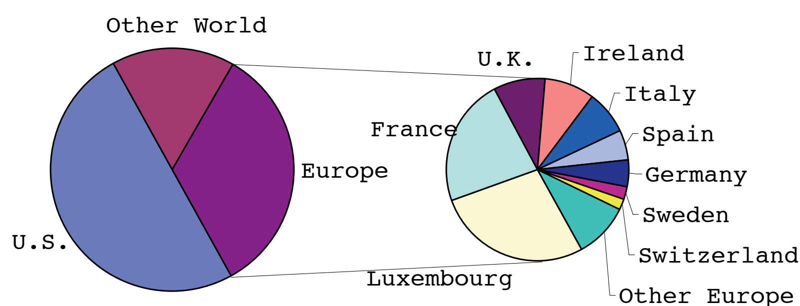
This substantial number of funds is caused by a large demand for variety, high competition, and geographic market segmentation. Mutual funds investors demand variety due to differences in risk-aversion, time horizons, liquidity needs, and tax considerations. The significant competition in the mutual fund sector also contributes to the large number of funds since each fund family offers its investor a set of basic mutual funds to enable a "one-stop-shopping." This necessarily results in a duplication of similar funds. For example, in the U.S. there are currently more than 50 index funds that all hold the identical 500 stocks in the Standard & Poor's 500 index. Finally, due to regulatory restrictions mutual funds can often not be offered in multiple countries. Therefore, mutual fund companies are forced to set up separate funds in different countries. Such a segmented market structure increases the costs of mutual fund investors because it does not allow funds to take full advantage of economies of scale.

Exhibit 1: Distribution of worldwide mutual fund assets in 2005



Source: Investment Company Institute

The assets under management at mutual funds differ dramatically across countries. Exhibit 1 depicts the relative size of home-domiciled funds in 2005. The U.S. accounts for about half of the worldwide size of mutual funds. On the other hand, European funds contribute about one-third to the total worldwide value of mutual funds. Because of favorable tax and regulatory environments, Luxembourg and Ireland control a large share of the European mutual fund market. On the other hand, funds domiciled in Switzerland account for only about 2 percent of the assets of European mutual funds. It is unfortunate that Switzerland as an important financial center does not belong among the top players in the mutual fund arena.

Performance of mutual funds

Despite the professional management of mutual funds, the performance of the average mutual fund appears to be relatively disappointing. Exhibit 2 summarizes the average aggregate returns of all domestic equity funds offered in the U.S. since 1980. The reported returns are weighted by the size of the mutual funds to ensure that the numbers represent the aggregate performance of funds. I focus my analysis on U.S. mutual funds due to data availability. However, I suspect that the performance of Swiss mutual funds is not dramatically different from their U.S. counterparts.

Mutual fund investors in the U.S. realized an average return of about 12 % between 1980 and 2005. More recently, the average equity fund returns have been

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lower due to less favorable market conditions. Since 2000, mutual fund investors did not gain from their equity investments.

Investors and the media often compare the performance of mutual funds to the performance of the aggregate U.S. stock market. Mutual funds, on average, do not appear to outperform the aggregate stock market. Between 1980 and 2005, mutual funds underperformed the U.S. stock market (which is approximated using the value-weighted returns of all publicly traded stocks in the U.S.) by 0.7%. A similar under-performance occurs over the two shorter time periods. Thus, investors in U.S. equity funds tend to perform worse than the aggregate stock market.

By comparing mutual fund returns with aggregate market returns, we compare apples with oranges for several reasons. First, whereas the aggregate market index returns exclude costs, the mutual fund returns reported in Exhibit 2 include these costs. Fund families charge fund investors annual expenses. For example, the annual fund expenses averaged about 0.87% per year between 1980 and 2005. In addition, the trading of the securities causes transactions costs which reduce the overall performance of the funds. Second, equity funds tend to hold about 5% of their assets in cash or short-term fixed income securities to satisfy the liquidity demands of their investors. These investments tend to reduce the average performance of mutual funds relative to stock market indices that only include the performance of equity securities.

To be able to compare more fairly the performance of mutual funds with the market index, Marcin Kacperczyk from the University of British Columbia, Lu Zheng from the University of California at Irvine and I analyze the performance based on the equity holdings of mutual funds.[1] Mutual funds in the U.S. are currently required to disclose their equity holdings to investors at a quarterly frequency. We use these disclosed stock positions to compute returns of a hypothetical portfolio which includes the previously disclosed equity positions. The return of this hypothetical portfolio is better comparable with the average market return since it does not include trading costs and also ignores cash positions. We observe that the equity holdings of mutual funds over the whole sample period between 1980 and 2005 exceeded the performance of the market index by about 1% per year, as shown in Exhibit 2. These results show that fund managers have investment ability but that management and trading costs and cash holdings reduce the performance below the index.

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The previous results only report aggregate returns. There is a significant performance difference among funds. For example, in 2005, 5% of equity funds had returns exceeding 75% and 5% of funds have returns below -50%. Despite this large variation, it is extremely difficult to predict funds that perform well in the future. In particular, funds with stellar past performance often do not continue to perform well in the future. Individual investors tend to fare well by holding funds with low fees and stable investment strategies and should not mindlessly chase funds with stellar past performance.

[1] The study on "Unobserved Actions of Mutual Funds" is available at http://webuser.bus.umich.edu/sialm/

The performance of mutual funds is comparable with the performance of the aggregate stock market. Mutual fund investors cannot expect to obtain extra-ordinary returns by investing in diversified mutual funds. However, investors with moderate wealth levels tend to be better off with mutual funds than by managing their equity portfolios on their own. ■

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Exhibit 2: Average performance of U.S. domestic equity mutual funds

Time range	Aggregate mutual fund return	Aggregate market return	Aggregate equity mutual fund holdings return	Aggregate expense ratio
1980–2005	12.0%	12.7%	13.7%	0.87%
1990–2005	9.4%	10.2%	11.1%	0.94%
2000–2005	-0.1%	0.3%	0.8%	0.95%

Sources: Own computations based on CRSP and Thompson Financial

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About the author

Clemens Sialm grew up in Romansh-speaking Disentis (Switzerland) and went to college at the University of St. Gallen. He did his Ph.D. in Economics at Stanford University and became an Assistant Professor of Finance at the Ross School of Business at University of Michigan in 2001. Sialm's research interests are in the areas of investments and taxation. He analyzes the investment strategies and the behavior of mutual funds and hedge funds. Furthermore, he investigates the impact of the tax system on asset prices and optimal portfolio decisions. His research has been presented at the main finance and economics conferences and has been published in the top finance journals. The research has also been featured in the Wall Street Journal, the New York Times, Business Week, and the Financial Times, among others.

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