The Death of Mutual Funds

A short history of mutual funds and why they are dying.

For a while I have become more and more frustrated with the mutual fund industry. Many investors in mutual funds have been complaining loudly about the performance of their funds and the huge capital gains taxes that are tacked on by the IRS.

Many investors in mutual funds would like more transparency in their funds so they could find out what specific stocks that they are invested in. Most mutual fund investors are feeling like they have lost control over the decision-making process regarding their funds. I truly believe that there are better wealth building methods that an investor can adapt to protect their assets and financial well-being.

The reason I am writing this review is for a wake-up call. In my opinion mutual funds and become a dinosaur of the financial industry. Investors have been slowly draining their wealth away for many years in mutual funds; fees and excessive cost are taking a toll in their pursuit to beat the market. During the boom years of the 1990s we saw plenty of double digit returns, and there seem to be a happy marriage with the investor and mutual funds. We see now that the beginning of the 21st century, there are red flags flying high and bright giving a warning to investors. Mutual funds have a record of underperformance, hidden fees, higher income tax consequences, and a lack of investor control. Many investors are now beginning to realize that they're wasting their time and wealth in mutual funds.

Don't get me wrong, mutual funds did not start out as a bad investment. In fact, , mutual funds have let many Americans amass fortunes during their working life in their retirement since the 1940s, when the security and exchange commission or as we know them the SEC founded the Investment Company act that created the concept of putting multiple stocks and/or bonds in separate funds. Since its invention, mutual funds have been good for Americans for many decades.

Mutual funds were supposed to create an opportunity for the average middle-class American to invest like those with more substantial resources. These funds became the investor's new best friend, offering professional management, many choices, and for a long time, stress-free investing. It was truly a powerful force in the marketplace. These pools of equities offered investors diversification and more safety than most single securities at a price that was affordable.

Soon mutual funds increased even more in popularity due to the government offered retirement plan. We know these plans as our 401(k)'s, SEP's, and IRA's. The fact is, today, over 40% of mutual fund assets come from these retirement plans. IRAs were as low as $2,000. This sum is a major reason that vast sums of money were pumped into mutual funds. American investors finally had an affordable investment for the middle class family.

Times have changed. The mask is off in the real face of mutual funds is being exposed. If you read this full report you will see what I am talking about.

In the early years mutual funds were all about making money for clients, but now it seems that they're focused only on gathering as many assets as they possibly can. Now they are sidestepping the spirit that was born in the 1940s. They're also optimizing as much market share as they can get even if they have to break a few laws to do it.

Let's look at some statistical facts. In 1980 there were 500 mutual funds available to choose from with a total of $100 billion invested. In 2005 can you guess what the numbers of mutual funds are? Go ahead take a guess before you read below.

Here is the answer. In 2005 there were 8,300 mutual funds with a total of $8.1 trillion invested according to the Investment Company Institute. This is not a misprint; this monster keeps growing and growing.

Before around 2003, the worst thing we could say about a mutual fund was that most of them lost money. From 2003 on, we can now say something even worse about mutual funds. A large number of mutual funds are now losing money fraudulently! In 2003 New York State Atty. Gen. Eliot Spitzer crusaded ineffectively to put the brakes on the likes of major financial companies or improper trading of mutual fund shares. Blue-chip companies such as Bank of America, Strong capital management, Bank One, were implicated along with small trader hedge fund Canary capital partners in schemes to milk investors of billion's each year, according to Spitzer.

Spitzer exposed the more than 60 years of backsliding. An industry entrusted with nearly $8.1 Trillion of the American public's money. Mutual funds used to be the investment vehicles and investors relied on to finance the American dream of a home in the suburbs, the kid's education, and a comfortable retirement.

Today we see that the nation's 93 million mutual fund investors are basically overwhelmed by the competing claims of some 8,000+ mutual funds. Most of the time, these investors are clueless about how to enhance their wealth with mutual funds. The average stock fund lost 12% during the year 2000, 2001, and 2002. Since that time the results of not been much better.

The real fact is that investors pay upwards of 72 billion in funding costs and fees per year. What do they get in return? They almost always receive mediocre performance, and when you factor taxes in, many actually suffer a financial loss. A stable bond fund, real estate, individual stock, or even a treasury bill may perform as well as the average mutual fund with risky high trading equities.

Let's get to the real problem of mutual funds. It is the expenses. Average investors are so confused by these expenses that they have no idea what they're paying. The sales commissions for the most active managed funds are tacked on by the stockbrokers and are usually around 6%. The fund deducts .05% from your account for its service. Cash drag, is a reserve set aside for opportunity cost or to pay off redemptions will add another 0.6%.

The buying and selling of stocks that fund managers perform all year long causes these transaction costs. In fact, the average return of the stock is 90% or higher yearly for nearly every stock and mutual fund portfolio. By conservative estimates, this wraps up an expense of 0.7%, not including capital gains tax, which will also eat away at your profits. On top of this add another 1.5% for management fees and expenses including the dreaded 12 B1 that those outside the industry criticized. You better believe those inside the industry exploited for all that it's worth!

Let's take an example. Let's say your fund is generating a good return in today's market of 12% of total assets as a long-term investor. The commissions, cost, Cash drag, and fees reduce this to 8.7%. In short, your fund manager is close to 3.3%. Therefore, the fund is underperforming the market by 3.3%. After taxes, which I estimate conservatively to be around 0.7%, you will have no more than 8% of the original 12%. This is only two thirds of your fund's return that you get to take home and put in your pocket, but in reality it is probably less than this.

The bottom line is that mutual funds cost way too much. The typical investor is averaging 3.5% in cost. The reason that you see conflicting fee charges for mutual funds is that there are multiple fee revenue streams and many fees that are charged, but are hidden to you.

Did you know that around 15 years ago there was not one TV channel that covered detail market news? Today there are according to Robert B. Jorgensen

- Hundreds of radio stations that report financial news
- Specialized financial newspapers and magazines
- Three major cable channels that are devoted to financial news
- Most major and minor newspapers have business page
- Thousands of newsletters that cover financial topics
- Hundreds of thousands of websites that pertains to financial investments
- Financial salespeople to make calls
- Advertisers, slick brochures, and mailing pieces abound with financial offers

Literally hundreds of websites are positioned to reveal the latest hot investment opportunity. All these triggering devices want you to believe their rubbing the lamp with one rub and it will propel you to untold riches.

“Investors today are being fed lies and distortions, and are being exploited and neglected”, says Arthur Leavitt, former chairman of the SEC. “In the wake of the last decades rush to invest by millions of households, and Wall Street's obsession with short-term performance, a culture of gamesmanship has grown amongst corporate management, financial analyst, brokers, and mutual fund managers, making it hard to tell financial fantasy from reality, and salesmanship from honest advice”.

It's time for you to know the truth about mutual funds or you will suffer the consequences.

- The tax consequence - if fund managers sell stock at a profit, you take a capital gains hit even if your fund lost money.
- The quick change consequence - you invest in the fund to fulfill a certain investment strategy. Be careful, the manager can change the strategy.
- The power vacuum consequences - the fund managers make the entire buy and sell decisions, not you.
- The no diversification consequence - unless you're diversified across fund sectors, you may wind up owning the same stock in different funds.
- The names the game consequence - a stock funds name doesn't always reflect its investing intentions.
- The moving manager consequence - managers come and go. If you lose your manager, your account will probably suffer.
- The huge fund the consequence - the more assets a fund takes in, the higher the chances of lower performance.
- The fee consequence - you'll pay myriad fees and commissions.

The bottom line is mutual fund companies fall short in regarding to performance and returns with investors stock funds, yet they are a master at charging exorbitant fees and add on charges. In short, mutual funds are a marketing success, not an investing success.

What does this mean to you as an investor of your hard-earned money into mutual funds? You've entrusted your money and your wealth to mutual funds but guess what, you're getting the short end of the stick. This is surprising because we've always been told that the stock market is the single best place to build wealth for your families and your retirement. This is true if you're getting the most value for your dollar by putting those dollars in the right investment vehicles. If you're not, your portfolio is on a treadmill going nowhere along with the assets of millions of other dejected mutual funds and mutual fund investors.

My purpose here is to get you off of the mutual fund treadmill and I hope by this point I at least got you thinking.

So the question is what went wrong with something so right? In 2005 mutual funds assets totaling over $8.1 trillion. This increase calls for companies priorities to shift. It's evident that the mutual fund industry does not hold the individual investor in the highest regard.

John Bogle, an outspoken critic of mutual funds and the founder of Vanguard financial, says his biggest complaint of the mutual fund industry is that it's now run like a business. Bogle traces the industry's demise to a 1956 federal court ruling allowing mutual fund firms to become public enterprises. This changed the playing field, according to Bogle. “That opened the door to look at this business as an entrepreneurial business in which the focus was on making money for the stockholders,” he said. “Once you change the investment profession into a marketing service business, you put management in the backseat and marketing in front.”

These changes in priorities will hasten the downfall of mutual funds in much the same way that the catastrophic changes in their environment wiped out the dinosaurs. This doesn't mean that mutual funds and the companies that produce and market them are going to become extinct. In fact the opposite is true. At the time of this writing, mutual fund companies are evolving. They're developing new alternatives and investment strategies in order to hold on to their client base and secure new clients. Eventually, though, mutual funds will take a backseat to new forms of investing for the emerging affluent investor. Mutual funds as we know them are going by the way of the dinosaur.

Mutual funds are dying in their original state because of the unfairness of fees, unnecessary taxes, lack of investor control, and a host of other reasons. Investors have never grasped these points until now. Today, a lot of investors understand the drawbacks of mutual funds because the events of the last five years have brought the message home. They discovered that they're paying out millions of dollars in excessive cost in running needless risk-all in the hope of outperforming the market.

We need government to rise to the occasion. As the government examines more critically the operating policies of mutual funds, things will change-in much the same way we transformed transportation from the horse and buggy to the automobile. If you are like me and don't want to wait on the government to fix your problems then the only choice is to take your financial future into your own hands.

Increased federal and state scrutiny will trigger more reforms that will probably get ball rolling in Congress, like the mutual fund integrity and fee transparency act that the mutual fund industry successfully lobbied against.

Meanwhile, underperformance is the norm for mutual funds. In recent years, the mutual fund companies could perhaps be forgiven for the huge marketing expenses and increased salaries of their star managers if the product delivered as advertised. But this is no longer the case. Underperformance is the norm rather than the exception. It's a fact. In spite of our respectable pass during the 1980s and 1990s, the average mutual fund returned 2% less than the returns of the market each year.

"In the mutual fund industry, we used to be in the business of long-term investing; now we're in the business of short-term speculation." John C. Bogle, founder of Vanguard financial.

Not only do the fund managers tend to underperform the S&P 500 yearly, but the underperformance also has growing more pronounced over the years. The individual managers responsible for funds are now marketed as stars. The truth is they're not stars, but comets.

Investors and potential investors are subject to the billions of dollars of advertising promotion of the virtues of funds and mutual fund managers who are supposedly skilled in handling their money. The chances of the fund manager beating the market are small-so small that the average mutual fund only outperforms the market two times out of every five, according to mutual fund researchers.

If you're still not convinced, consider this

- Through the end of 2001, there were 1226 actively managed stock funds with a five-year record. Their average annualized performance trailed the S&P index by 1.9% per year (8.8% for the funds and 10.7% for the index).
- Through the end of 2001, there were 623 active managed stock funds with ten year record. Their average annualized performance trailed the S&P 500 up 1.7% per year (11.2% for the funds and 12.9% for the index).
- The figures above include the sales loads charged by many funds. Loads are akin to brokerage commissions, which come straight out of your returns. They are charged when you buy or sell shares of your fund. Even with these load funds excluded, the five-year average trailed the S&P 500 by 1.4% per year, and the 10 year average return trailed by 1.4% as well.
- Though these figures include discarded mutual funds, which would reflect poor performance in bringing these averages is down significantly. The exclusion of these mutual funds is called “survivorship bias”. With returns correlated for survivorship bias, average actively managed funds trailed the market by about 3% per year.

Cost will drag down your performance. Fund managers are supposed to be good, and some of them are: only we don't know which ones are good until the returns come in. Most managers, unfortunately, will only equal the market as a whole before cost.

What drags performance down are the management fees, trading costs, sales loads, and other incidentals. And thus, direct and indirect costs defeat the performance of mutual funds before you get your feet wet.

Mutual funds must disclose that past performance is not indicative of future results. Unfortunately, most investors and financial media use past performance as their primary selection criteria. The truth is most mutual funds rarely outperform the markets for a significant period of time. Let me put this fact in bold so you could see it with your own eyes and comprehend the power of this statistic. **Only one fund in the history of mutual funds has outperformed the S&P 500 for more than 10 years straight!**

Next let's take a look at taxes associated with mutual funds. There are no tax advantages to mutual funds, only disadvantages. If you pay taxes in all mutual funds, you have created a natural adversarial relationship. You'll probably have to pay taxes when your stocks are sold in the portfolio. Not only that, you may also have to pay taxes when your stock fund loses money.

Mutual fund companies during the tax year are required to distribute capital gains and the dividend to their shareholders. Unless you own the nontaxable mutual fund (i.e., municipal bond fund, retirement account, etc.), you probably are going to have capital gains.

Mutual fund companies are not looking out for you when it comes to taxes. Shareholders pay capital gains taxes; mutual fund companies don't. Your capital gains are taxed at the standard tax rate: 28% to 36%, depending on your reported income, for stocks held less than one year. If you hold funds for more than a year, it's 15% across-the-board.

Statistics show that American households paid 345 billion in capital gains taxes on mutual funds in the year 2000. These gains have accumulated throughout the 1990s. When the air came out of technology stocks, portfolio managers begin dumping them.

But even if the stocks have lost their original value, they still accumulated capital gains. Remember, even if your stock fund loses money, you're still liable for capital gains because during the funds history it made money, making its capital gains embedded. I haven't even mentioned dividends. Even if you reinvest your dividends back into the fund, the IRS says you're still subject to tax on your dividends. Wow!

There are ways to cut your tax bill with mutual funds if the companies were responsible. Critics charge that fund companies could lower their capital gains distributions if they wished. One way is through improved bookkeeping. The fund companies were programmed to sell their highest cost years first once they reduce the large block of stock, it could result in the tax savings for the investors. This is called HIFO (highest in, first out) accounting, according to Vanguard, the low-cost index fund company, because it could save investors as much as 1% of assets each year due to lower cost.

Trading this often would hinder the capital gains explosion, but because the average mutual fund turns over its stocks once in the course of a year (on which the commission in on the average five cents a share every time a shares traded), this seems unlikely.

“This is much higher than most investors pay for online brokerage “says *Business Week.* The mutual fund structure prevents “tax harvesting,” the timing of securities by his soldiers to utilize capital losses or defer capital gains.

Regardless of when you buy into a mutual fund, you become the proud owner of the liabilities that were incurred before you even put your money down. So you buy into a fund for $10,000 on December 12 at $10 a share. Shortly before the year ends, your mutual fund company calculates a yearly capital gain of two dollars a share. Guess what? Because you have 1,000 shares, you shortly will receive the distribution of $2,000 all taxable to you. Even though you've only been in the fund for a couple weeks, you will have to pay the same amount of taxes as the fellow that had been in it all year. Your original $10,000 investment may still be intact, but now you have $2,000 tax bill.

That's why you should never buy into a fund in December when mutual fund companies record the year’s performance (my full opinion is that you should never buy a mutual fund period). Examine funds by their after-tax returns, rather than pretax. You won't find these figures in the fund advertisement or the colorful brochures. You can find these figures in the fund's prospectus-in very small print. Thanks to the SEC’s February 2003 ruling requiring mutual fund companies to include pretax and post-tax information in their prospectus, companies cannot conceal this information.

The only problem is that most investors don't read the prospectus. For example a lot of investors bought into a popular fund that year saw the capital gains were spread amongst a lot of people. A bear market emerged because many investors rushed to liquidate that particular fund and its manager had no choice but to sell stocks as possible to raise enough capital for those redemptions. A huge capital distribution was left for the remaining stockholders.

There are examples of investors who put a few thousand dollars into a fund and later were hit by Uncle Sam for a five figure tax bite. Was there a chance that the mutual fund managers could have foreseen the taxpayer's dilemma and altered their selling strategy? Not a chance. Mutual fund managers are not paid to maximize tax efficiency, only to generate returns.

We can look at mutual funds as a billing iceberg. Most of an iceberg is unseen, underwater. Mutual fund companies have become increasingly adept to apply extra hidden revenue streams to their funds, in addition to standard fees, which are climbing. In fact, as returns have diminished during the post-2000 era, mutual fund companies have actually been raising fees.

The average mutual fund investor isn't even aware of these fees he is paying-disclosed or undisclosed. In fact, shareholders are paying for mutual fund advertising and promotions through 12 B-1 fees. Unfortunately, as mentioned earlier, most investors don't read their mutual fund prospectus, where a lot of essential fee information can be found. All 93 million mutual fund investors reward mutual fund companies annually with about $70 billion in operating cost-and most investors don't realize they're paying it.

What is investing in funds really costing you? You can expect to pay approximately 3% to 4% of your fund assets yearly in total cost (upfront or backend cost) for a load fund. For no load fund, you'll still be paying around 3% to 3 .5% for your portfolio mutual funds. If you do some serious checking into these costs over the life of your portfolio you'll see some serious money going into the coffers of the mutual fund companies over and over again.

Unlike paying your gas bill or your light bill regularly, you'll hardly ever receive a bill from your mutual fund company. Your costs are simply deducted from your portfolio returns right off the top when the broker executes a trade. You may scream if your daughter makes an unauthorized credit card purchase, but where are you when you pay a 5% load on a $25,000 mutual fund investment?

With the boom of mutual fund returns in the 1990s, don't you think the fund companies with these huge infusions of cash coming in and internal expenses stabilizing reduce fees for their shareholders? Don't count on it. In fact, because the fixed cost of fund companies (staffing, accounting, research, and so forth) became smaller, fees actually could've been reduced. Remember, fund companies increase revenues many times to over 7 trillion in the year 2000 from 371 billion in 1984. Instead, the internal fees these companies charge investors have risen by approximately 30%. Go figure!

John Bogle says "the drive to make money for others - the fund's shareholders - may not be as powerful as the drive to make money for oneself through ownership participation in the management company. There are two sides pulling against each other in mutual fund companies: the shareholders (the investors in the mutual funds) and the stockholders (the investors in the mutual fund company)."

The Mutual fund industry profits by keeping the lights off. As long as the fund companies keep you ignorant, the negative elements of mutual funds won't ever be brought to light. Most investors traditionally have to make do with minimum information. That's the bare minimum ruled by the SEC. Twice a year, you get to see what's going on in your account.

Investors said they want their financial information 24 /7. Even though the internet has sped up the tracking of investments considerably, major fund companies have been painfully slow to keep investors current. This means that when you check your holdings on the web, your figures are out of date, and possibly flat out wrong, or altogether missing because fund managers are changing your portfolio so rapidly.

Arthur Levitt, former chairman of the SEC says “investors simply do not get what they pay for when they buy into a mutual fund; most investors don't even know what they're paying for. The industry has often misled investors into buying funds on the basis of past performance. Fees, along with the effect of annual expenses, sales loads, and trading costs, are hidden.

Fund directors as a whole exercise scant oversight over management. The cumulative effect of this has manifested itself in the form of late trading, market timing, and other instances of preferential treatment that cut at the very heart of investor trust. It would be hard not to conclude that the way funds are sold and managed reveals a culture that thrives on hype, promote short-term trading, and withholds import information.”

We must never underestimate the rich man's appeal of mutual funds. Many older and wealthier Americans in this country own mutual funds and are comfortable with the investment process that has been around for some 60 years.

That feeling is disappearing. Today's investors are more comfortable with change. Today, those with emerging affluence are asking themselves if they should stay with the ultimate retail investment-one that is associated with mass market investing and that is now viewed by many as a commodity.

Mutual fund managers don't differentiate between one investor to another. Their job is to boost the inflow from the account and to get the numbers regardless of who's investing in the fund. The bottom line is mutual funds do not treat their investors like the good old days.

Unless you are totally shut out from the world, you have, like most of us, regular contact with people. Family and friends are given. You like human contact and feel goodwill towards people most of the time.

The downside of human contact is when you find yourself in the overstuffed elevator and get stuck between floors. It's uncomfortable, stressful, intimidating, and even scary.

The same can be said of mutual funds. You'll have crowded elevator contact but you still have contact with people. Dealing with other investors in your mutual fund can invoke feeling similar to the overcrowded elevator-stress and intimidation. The inflows and outflows caused by human nature may be some of the more subtle difficulties of mutual funds. Fellow investors panic when the markets fall and become greedy as the markets rise.

Instead of following the traditional words of investor wisdom-buy low and sell high -just the opposite occurs. Every investor feels the impact of a bloated fund with too much cash. It becomes too unwieldy for good management control. This causes funds to grow too quickly, turning good performing funds into bad performers from one year to the next.

“One advantage of mutual funds that's really a disadvantage is it’s easy to get out of them”, remarked Peter F.Tedstrom, of Brown and Tedstrom, Inc. “this makes it simple for an investor to call in an order as soon as the market dips,” said Tedstrom, “consequently, in the end, the investor suffers poor performance returns by frequently trading in and out of his or her portfolio.”

In conclusion, I want to ask the question. Is this the end of mutual fund domination? I don't think so. You must understand that mutual funds are an American icon. Since the first mutual fund was formed, it has been the building block of our country's investment strategy and home to some 93 million Americans today. Habits die hard, even in the face of the facts given above my guess is that only half of the readers take any significant action.

An investment pattern with this concept originally developed slowly, Americans put about 20% of their discretionary wealth in the mutual funds during the 1970s and 80s. By the time the 1990s rolled around, investors were investing at a rate of 25%. In 1996, that rate rose to 60%. At the end of the century, the rate of investment in the mutual funds by Americans climbed to a staggering 82%!

Let's face it; millions of Americans will continue to put their hard-earned wealth into the mutual fund vehicle. They don't get the message. Did your parents ever ask you “if everyone else jumps off a bridge are you going to do it also?” Just because most people are too lazy to do their homework does not mean you have to be.

We now have better options out there for you to accumulate future wealth. You can retire comfortable, you can secure your family's future, and you can break the chains of bondage that holds a lot of investors down. The more money you accumulate by the time you retire, the more comfort and freedom you will have. You could stay on vacation a week longer, you can take trips to see the grandkids two or three times a year instead of just once.

Most likely the giant of the mutual fund industry will continue to grow and churn away people's accounts. But I hope this special report has awakened a hunger to gain knowledge, do research, and have the courage not to follow the herd mentality of the average investor. If enough people read this report, understood it and acted on it we would see the death of Mutual Funds.

You are not the average investor. You are above average! The fact that you have this whole report proves that to me.

You have the power and control and create your own destiny for your future and the future of your children's children. There are better alternatives for your investments other than mutual funds. I hope by writing this report I have encouraged you to take control of your own investments or at the very least to never buy another Mutual Fund.

Helping you retire on time,

Big A

www.ETFtrendtrading.com