The Evolution of Mutual Funds

Many of our client conversations focus on macro-level investment & planning issues: whether to invest conservatively or aggressively, asset allocation, cash flow illustrations, tax planning, etc. However, this quarter we want to take a step back for a brief history lesson; what is the history and evolution of the mutual fund, how does that play into the active vs. passive debate, and what does that mean for portfolio management today?

At their core, mutual funds were created to allow small investors to diversify their investment portfolios even if they didn't have large enough accounts to buy shares of hundreds of stocks. Invented in the 1920's, they became popular in the 80's and 90's as pension plans were replaced by 401k's, creating millions of inexperienced investors that needed access to diversification and professional management.

To satisfy this increasing demand, the role of "stock-picker" shifted from a traditional broker to a fund manager. The best fund managers branched out and started mutual fund "families" (think American Funds, John Hancock, T Rowe Price) offering funds in multiple asset classes. At this point middlemen entered the equation, turning these mutual funds into retail products that could be sold and therefore earn commissions. This led to the proliferation of various investment products – "A, B & C Share Classes", Variable Annuities, & Universal Variable Life Insurance were some of the most common.

Interestingly, as the industry grew it became increasingly siloed – a given Broker-Dealer (B/D) would only allow its advisors to offer certain products & funds, but not others. Worse, of the limited options available some would pay substantially higher commissions (or kickbacks) than others. This not only produced a conflict of interest, but it created a situation where every fund family needed to offer many funds (whether they were good or not), and advisors were largely forced to sell certain fund families (whether they were good or not). The fees continued going up, and the quality of the average fund began going down.

Enter Vanguard – founded on the concept that most funds are incapable of beating the market, advisor commissions cost more than the advice is worth, and the combination of all the various fees almost guaranteed underperformance. The solution – "Index Funds" – provided investors with diversified exposure to a given asset class with negligible fees by simply buying all investments in that asset class. As years went by Vanguard was largely proven right, resulting in trillions of dollars shifting from the old fund families into index funds. This movement took on a life of its own, and new "fund families" sprang up specializing in various types of low-cost passive management.

North Woods Asset Management
1231 Delaware Ave Suite 201
Buffalo NY 14209

716-220-8497

info@north-woods.com

While good for retail investors, this trend was devastating for the old fund families, the products that had been created out of them, and the B/Ds who sold them. Many funds were closed, and those that did not were forced to reduce their fees to survive. Products such as variable life, variable annuities, and A B & C share classes became unattractive to investors and came under increased scrutiny by regulators to justify their high fees & commissions. The more sophisticated Financial Advisors no longer wanted to be told by a B/D what they could & could not sell to their clients and began moving away from the old B/Ds and began registering as independent Investment Advisors (RIAs). The regulators encouraged that trend by reducing bureaucracy & red tape for RIAs who were willing to take a legal fiduciary obligation to their clients (something B/Ds and their advisors do not take) and charge transparent fees for their services instead of receiving various commissions & secretive kickbacks.

That largely takes us up to today – the B/Ds still exist but they are a shadow of what they used to be as most of the top advisors have transitioned to the RIA model (including us). The various passive or index fund families now control the majority of mutual fund assets. The active managers that remain are generally the best performers or are in niche areas where indexing is difficult, and all have significantly lower fees than they used to – which takes us to the final evolution in this story, the one that is happening right now.

The irony of index funds is that the more successful they are, the more opportunity they create for active managers. By forcing the poor-performing active managers out of business, it has concentrated talent and made it easier to identify the better performers. By forcing lower fee structures, they've diminished that advantage over active managers. And because the indexes are predictable and lack any sort of price-discovery (which means paying attention to whether a stock price is attractive or not based on its earnings), the bigger the passive funds get the less efficient stock prices become – thereby increasing the opportunity for good active managers to outperform the market.

This is not to say that the pendulum has swung entirely, rather it is a reminder that markets & industries evolve, and we cannot assume that whatever worked best in the past will necessary be best in the future. As you have heard us preach many times (if you were listening), we believe every asset class is unique and we should choose our investment strategy accordingly. A belief in low-cost passive management in one asset class should not imply the same belief across all asset classes.