

INSTITUTIONAL ASSET CLASS MUTUAL FUNDS – THE NEW PARADIGM

Many years ago when we first began offering our investment strategies to clients, we had to use retail mutual funds. Unfortunately, we found significant structural problems with these funds. Now we have better tools – they are called *institutional asset class mutual funds*.

WHAT ARE INSTITUTIONAL ASSET CLASS MUTUAL FUNDS?

Institutional asset class mutual funds deliver the investment results of an entire asset class – a group of securities with similar risk and expected return characteristics. Institutional asset class funds are best used as building blocks in creating efficient portfolios and in achieving dissimilar price movement diversification. They are usually only available to institutional investors such as pension funds, banks, and insurance companies, or to clients of independent registered investment advisors.

The four most important attributes of institutional asset class mutual funds are:

1. low operating expenses,
2. low turnover,
3. low trading costs, and
4. consistent asset allocation.

1. Low Operating Expenses

You should only consider investing in mutual funds that are true no-load funds. They should have no front or back-end loads, redemption fees, or 12b-1 marketing expenses. All mutual funds, including no-loads, have operating expenses. These expenses include management fees, administrative charges, and custody fees, and are expressed as a percentage of assets. The average annual expense ratio for all retail equity mutual funds is around 1.5 percent. In comparison, the same ratio for institutional asset class funds is typically only about one-third of that. Other factors being equal, lower costs lead to higher rates of return. Therefore, the lower cost structure is a big advantage for institutional asset class funds.

An important study of retail equity mutual funds by Elton and Gruber showed that there is an inverse relationship between cost and performance.¹ In addition to showing that retail equity funds as a whole underperform the market, Elton and Gruber found that the more expensive a fund is, the worse it performs on average.

¹ Elton, Edwin J., Martin J. Gruber, Sanjiv Das, and Matthew Hlavka, “Efficiency with Costly Information: A Reinterpretation of Evidence from Managed Portfolios,” *The Society for Financial Studies* (1993).

James N. Whiddon, CFP®, MSFS

Lance Alston, CFP®

2. Low Turnover

Active mutual fund managers do a lot of trading, thinking this adds value. As a result, the average retail mutual fund has a turnover rate of over 75 percent on average. This means that 75 percent of the securities in the portfolio are traded on average over a 12-month period, representing \$75,000 of traded securities for every \$100,000 invested.

High turnover is costly to shareholders because each time a trade is made there are transaction costs involved, including commissions, spreads, and market impact costs. These hidden costs may amount to more than a fund's total operating expenses if the fund trades heavily or if it invests in small company stocks whose trading costs are very high.

Why do retail mutual funds have such high turnover rates? Because their managers are under tremendous pressure to perform. Good short-term performance leads to a bonus for the manager and a flood of new money for the fund. If the funds are performing poorly, managers often try to make up ground by changing the composition of their holdings.

In addition, fickle investors can cause excess turnover. Fickle investors are retail investors who chase after performance. They move in and out of mutual funds trying to find hot markets or managers. This forces fund managers to buy and sell more often than they would prefer. Unfortunately, fickle investors do not pay their fair share of the transaction costs they create. They are allowed to buy and sell at net asset value, effectively free-riding on the backs of buy-and-hold, long-term investors.² You should avoid funds with high turnover rates as well as those that attract fickle investors by advertising heavily.

Elton and Gruber also studied the effects of turnover on mutual fund performance. Not surprisingly, they found an inverse relationship between turnover and performance; the higher the turnover, the worse the performance. Fortunately, institutional asset class mutual funds have extremely low turnover rates, usually less than 25 percent per year. This keeps transaction costs low and improves returns.

TAXES

If a mutual fund sells a security for a gain, it must make a capital gain distribution to shareholders because mutual funds are required to distribute 98 percent of their taxable income each year, including realized capital gains, to stay tax-exempt at the corporate level. They distribute all their income annually because no mutual fund manager wants to have his or her performance reduced by paying corporate income taxes.

Two recent academic studies examined the extent to which capital gains distributions reduce after-tax returns on mutual funds. These studies demonstrate that tax efficiency is an important factor to consider in selecting equity mutual funds.

In one study, Stanford University economists John B. Shoven and Joel M. Dickson found that taxable distributions have negative effect on the rates of return of many well-known retail equity mutual funds.³ Shoven and Dickson measured the performance of 62 equity funds for the period from January 1963 to December 1992. They found that a high tax bracket investor who reinvested after-tax distributions ended up with an accumulated wealth per dollar invested of *only 45 percent* of the funds' published performance. An investor in a middle tax bracket realized just 55 percent of published performance.

² Some funds, especially those that invest in markets that lack liquidity, are beginning to use back-end charges to discourage investors from moving money in and out so quickly.

³ Shoven, John B. and Joel M. Dickson, "Ranking Mutual Funds on an After-Tax Basis," Stanford University Center for Economic Policy Research Discussion Paper (#344).

James N. Whiddon, CFP®, MSFS

Lance Alston, CFP®

JWA Financial Group, Inc. • 6200 LBJ Freeway, Suite 180 • Dallas, TX 75240 • (972) 661-3355 • www.jwafinancialgroup.com

This article is intended as general information and not as advice to specific individuals.

JWA Financial Group, Inc. is a Registered Investment Advisor

In another study, Robert H. Jeffrey and Robert D. Arnott concluded that low portfolio turnover can be a factor in improving a fund's after-tax performance.⁴ Jeffrey and Arnott compared the performance of large, actively managed equity mutual funds with a passively managed equity index fund from January 1982 to December 1991. They found that only 21 percent of the funds, 15 out of 72, outperformed the index fund on a pretax basis. *Only 7 percent of the funds, 5 out of 72, outperformed the index fund after taxes were considered.* Clearly, it is very difficult for a mutual fund to add value through active management, especially on an after-tax basis.

There is yet another tax problem associated with actively managed funds, which became evident during the stock market crash of 1987. After the crash, many mutual fund managers cleaned house and sold many stocks that had appreciated during the bull market of the early 1980s. This resulted in higher than normal turnover rates for the year, and very large capital gain distributions for shareholders. For example, if you had invested \$100,000 in Fidelity Magellan on December 31, 1986, you would have lost 8.7 percent of your principal as of December 31, 1987. However, despite the loss, Magellan made capital gain distributions during the year. If you were in the 20 percent tax bracket, you would have owed \$1,057 in capital gains taxes even though your account declined in value, adding insult to injury.

3. Low Trading Costs

Trading costs are composed of commissions, bid-ask spreads, and market impact costs. While trading costs are much greater for smaller stocks than for larger stocks, they can be significant for both. In the case of small-cap stocks in particular, trading costs can exceed management fees.

For an example, let's examine a trade that a mutual fund might execute in the over-the-counter market. If the spread on a stock is 5 percent, say \$10 ask and \$9.50 bid, the manager would have to buy it at the ask for \$10 and sell it at the bid for \$9.50. This results in a \$0.50 cost, assuming no market impact, which represents a 5 percent cost of trading. If 80 percent of the portfolio turns over during the year, this amounts to a total hidden annual cost of 4 percent (80 percent times 5 percent).

4. Consistent Asset Allocation

Most investment advisors agree that the largest determinant of performance is asset allocation-how money is divided among different asset categories. However, you can only accomplish effective asset allocation if the mutual funds in your portfolio maintain consistent asset allocation. That is, the funds you use need to stay within their target asset classes. Unfortunately, most actively managed funds change their asset class exposures over time. Equity funds, for example, may change their composition by moving across size or value dimensions and sometimes even across different markets, such as from domestic to international securities. In addition, most funds increase or decrease their cash balances based on cash flow conditions and market fluctuations. This can significantly change the overall allocation of your portfolio.

In effect, if you use these funds you have relinquished control of your asset allocation to the managers of the mutual funds. The managers do not know the particulars of your situation; therefore, they make allocation decisions based on their needs rather than yours. Fortunately, institutional asset class funds consistently maintain their market segment exposures. This keeps you in control of your allocation.

Since management fees on these funds are far less than on traditional funds, it is unlikely that many mutual fund sponsors will be offering these funds any time soon. However, by working with an independent

⁴ Jeffrey, Robert H. and Robert D. Arnott, "Is Your Alpha Big Enough to Cover Its Taxes?" *Journal of Portfolio Management* (Spring 1993).

James N. Whiddon, CFP[®], MSFS

Lance Alston, CFP[®]

JWA Financial Group, Inc. • 6200 LBJ Freeway, Suite 180 • Dallas, TX 75240 • (972) 661-3355 • www.jwafinancialgroup.com

This article is intended as general information and not as advice to specific individuals.

JWA Financial Group, Inc. is a Registered Investment Advisor

advisory firm such as JWA Financial Group, Inc. you may gain access to institutional asset class mutual funds that are otherwise not available to the general public.

James N. Whiddon, CFP[®], MSFS

Lance Alston, CFP[®]

JWA Financial Group, Inc. • 6200 LBJ Freeway, Suite 180 • Dallas, TX 75240 • (972) 661-3355 • www.jwafinancialgroup.com

This article is intended as general information and not as advice to specific individuals.

JWA Financial Group, Inc. is a Registered Investment Advisor