Where do I put my money? Mutual funds versus exchange-traded funds

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Let's start with a disclaimer. Despite going to business school, neither of us is sitting on a beach living off investments; so please, take our comments bearing that in mind. In the current column, we explore two commonly used vehicles for investing in broad asset classes. They are exchange-traded funds (ETFs) and mutual funds. These assets are broadly held by plastic surgeons and by the investing population. We suspect that most readers hold both of these products within their portfolio.

DIVERSIFICATION

Every investment advisor's favourite word is 'diversification'. For those of us who work with statistics on a regular basis, this is really just a sample size issue. Predictions based on small samples from a large population are fraught with error. As the sample size increases, the utility of conclusions increases (hence, the threshold for statistical significance). The same is true for investing. When we consider a portfolio of investments, the more broadly that portfolio is distributed, the more amenable it is to prediction. Furthermore, as the portfolio becomes increasingly diverse, it becomes less susceptible to individual fluctuations in the market. This is the core justification for diversification. Investment advisors suggest a strategy that is diversified in many ways. These include geographical diversification across economic sectors and diversification across productions (bonds, stocks, options, etc).

The core of most portfolio management strategies is to maximize predictability through diversification. Most statistical analysts suggest that for risk mitigation to be effective through diversification, a portfolio should hold between 25 and 50 securities broadly sampled from across the economy (sound familiar?).

As financial markets have matured, various products have emerged to provide diversification to investors. These products charge fees for managing the money, increasing the value of the investment and mitigating risk. Two of these diversification strategies are mutual funds and ETFs.

MUTUAL FUNDS

Mutual funds were the first attempt to provide diversified investment products. Instead of purchasing individual securities, investors could purchase a basket of securities to mitigate risk. The Dutch established the first mutual fund in 1774. The first fund outside of the Netherlands was established in London (United Kingdom) in 1868. Since that time, their popularity has increased. At the end of 2011, there were more than 14,000 mutual funds in the United States, with an asset value of more than \$13 trillion. This represented 23% of household financial assets.

Mutual funds are characterized by active management. This means that a fund manager picks securities from the infinite options available and determines which assets should be included in the fund. The fund is then a group of assets that trades on an exchange. Securities are bought and sold by the fund manager. Essentially, the investor is relying on the acumen of the fund manager to determine the appropriate basket of securities to be held in a portfolio.

Fund managers charge fees to investors to select these securities. Fees can be front loaded, back loaded or annualized. Front-loaded fees are charged to the investor at the time that shares in the mutual fund are purchased. Back-loaded funds are charged to the investor at the time that the shares are redeemed. Annual management fees are almost always imposed while the investor retains ownership of shares in the mutual fund. Most such fees are dependent on the value of assets under management. All fees ultimately detract either from the principal available for investing (front loaded) or the returns (annual management fees, back-loaded fees). Most funds will provide the investor with a value known as the total expense ratio (TER). This specifies the proportion of invested capital diverted to management and fees.

In most mutual funds, the TER varies between 0.5% and 2.5%. This often depends on the nature of the fund, the location of the fund and the value of assets under management by each individual investor. It is critical to understand that these fees are a direct reduction in the returns available to the investor.

To summarize, mutual funds represent a strategy in which a fund manager purchases a basket of securities. The manager is actively engaged in distributing these assets across multiple sectors, countries and asset classes in an effort to mitigate risk through diversification. The investor then purchases this basket of securities. In exchange for the expertise of the fund manager, the investor usually pays a proportion of earnings to the fund. Such payments usually represent between 0.5% and 2.5% of the value of invested capital.

ETFs

ETFs offer a more passive approach. The theory is that because investment risk is mitigated by diversification, and diversification is achieved by holding multiple securities in a portfolio, then as long as a portfolio is sufficiently diversified no active management should be required. All that the investor should do is buy a basket of goods that best approximates the entire market. As the market appreciates, the value of the fund will appreciate and no active management is necessary. As a consequence, no fund manager needs to do any work and the management fees imparted to the investor can be reduced.

In this scenario, the active management component of the investment strategy is eliminated. All that is needed is an explicit strategy to track a given index. This could be a geographical index, a sector-based index or a very broad index. The fund is then calibrated to simulate the performance of the basket of goods contained in that index. To take the broadest example, the fund could hold thousands of securities and could approximate the performance of the entire economy as a whole!

The first such fund was established in 1989, which closely tracked the Standard & Poors 500 index (a basket of securities on the American Stock Exchange). Since that time, these products have exploded in popularity. In 2013, there were more than 1500 ETFs in the United States with a total value of more than \$3 trillion.

This is a significantly more passive management strategy and there are commensurate reductions in fees. The TER for these funds tends to range between 0.05% and 1%. This represents an ignorant reduction in expenditures compared with actively managed funds.

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IS THERE VALUE TO ACTIVE MANAGEMENT?

This forms the core question posed to financial consultants and investors. It also represents an unresolved debate both in practical terms and in academic terms. The degree to which active management can outperform the market is unclear but increasing scholarship is beginning to emerge.

There are now multiple studies suggesting that, after fees and expenses, mutual funds as a class have underperformed the market over the past 20 years. This suggests that the diversion of capital away from investment toward money managers has reduced the return to investors. This is clearly not the case for every individual mutual fund. The most famous example of this would be Berkshire Hathaway. This is essentially a basket of assets owned and managed by Warren Buffett. Over a 25-year period, this asset achieved annualized returns after management expenditures exceeding 21%. However, when analyzed as a class, mutual funds tend to erode value relative to the market.

There is reason to expect that ETFs will have a significant role in this space. They offer the same advantages in terms of mitigating risk at a much lower management cost. Furthermore, transaction costs are more easily contained and the transparency of the asset class within the fund is often higher. We suspect this is an important factor in the rapid proliferation of ETFs.

WHAT DO I DO?

Every investor needs to make decisions about the best assets to hold. These decisions are dependent on myriad personal and professional factors. There are three core features of these products that should be considered.

The first factor is that both mutual funds and ETFs are risk mitigation strategies. They seek to reduce the likelihood of capital loss through diversification. The second feature is the role of active management. In mutual funds, active management is typically a prominent feature while in ETFs it is not. Each investor needs to assess her preference. We suggest that there is emerging evidence to discount the role for active management. The third feature is fees. All diversification vehicles have management fees. These are typically significantly lower in passively managed products (ie, ETFs). However, newer products are constantly emerging and each investor should carefully consider these fees.

We do not have all of the answers, but the role of diversification, fees and returns should frame the decision for investing. And here's hoping the next column is written from the beach!