Number 4

The winner's curse: Why successful mutual funds are bound to fail

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Every January we see the same picture: Performance statistics for mutual funds are published for the previous year. Every time these show that approximately 80% of the European equity funds have an investment result that is worse than their respective benchmark index. The results of US-American funds are mostly a little better; nevertheless, only approximately 30% of them normally outperform their benchmark index.

Speed Read:

- ***Empirical evidence shows that some mutual funds are able to outperform their benchmark for a few years, but only very seldom for a longer period.***
- ***Mutual funds are burdened with many different costs. Our estimate for the cost load of an average equity fund in Europe is approximately 3.5% of its net asset value (NAV) p.a. Net of costs, active fund managers generally add value.***
- ***The widely used terms to describe the cost load of a fund, such as "total expense ratio (TER)" or "ongoing costs" can be misleading because they only include fixed costs, but no transaction fees or hidden costs.***
- ***Due to herd behaviour of investors especially high-performing funds are exposed to high inflows and big redemptions. For them, the hidden costs become the most important factor.***
- ***This explains why the performance of popular mutual funds turns sour when many investors redeem their shares from a fund. They are burdened with an unsustainable cost load, making it impossible for them to outperform in the long term.***

If performance comparisons are made for a period of several years however, the number of outperforming funds drastically decreases. If periods of more than 5 years are taken into account, only few mutual funds perform better than the market index. Furthermore, if risk is considered, the result is even worse. A recent study by Barras, Scailant and Werners came to the conclusion that between 1975 and 2006 only 1% of US mutual funds were able to outperform their benchmarks on a risk-adjusted basis.

A further observation is that in most categories the average annual performance of mutual funds consistently lags behind the benchmark index by approximately 2%. Although there are some exceptions, similar results are repeated annually.

What are the reasons for this phenomenon? Are fund managers basically incapable? This seems hard to imagine because so many highly qualified specialists are attracted by this occupation and have preferential access to many sources of information. Or are the followers of the theory of efficient markets right in stating that security prices are not predictable because all information is captured immediately in the price? If so, fund managers

would be making a hopeless effort in their attempt to do better than the markets. Indeed, practical experience holds against the theory of efficient markets in the financial world. In particular the crisis of 2008 has made drastically clear how inefficient the global financial markets actually are. Besides, there are some investors who have been clearly able to outperform their markets for a long period of time, for example, John Maynard Keynes, Warren Buffet, Peter Lynch or Bill Miller. However, the question is: why are there only so few? And, if they have been successful for some years, why do so many fail dramatically after their fortune turns?

It is also a striking observation that only Buffet, who invests via a holding company (Berkshire Hathaway), has been able to outperform the markets for more than 20 years. Keynes – who managed an endowment fund – unfortunately died after a winning streak of 15 years. The mutual funds of Peter Lynch and his successors (Magellan Fund) as well as Bill Miller (Legg Mason Value Trust) were very successful for some 15-20 years. Then their fortune turned and their funds severely underperformed. Have their recipes for success suddenly turned sour? Or is the success of a fund more dependent on the inspiration of a manager - which may suddenly fade – rather than on the investment methodology? Or were there other factors at work? Does Buffet, who is not dependent on the dynamics of the mutual fund industry, enjoy a structural advantage?

An obvious explanation for the disappointing development of most mutual funds is the cost load. But its actual size is very hard to grasp. To analyse the cost burden of mutual funds, it is necessary to make a distinction between the direct or visible costs, on the one hand, and indirect or hidden costs that are not seen at first sight, on the other hand.

Direct costs

The visible costs for an investor in mutual funds comprise his own transaction costs caused by the purchase (and sometimes also by the sale), the transaction expenses within the fund as well as the current expenditures arising from management and administration fees.

The transaction costs of acquiring a mutual fund can be relatively high compared to other forms of investing. If a fund is bought directly from an investment company, a financial distribution network or a bank, an upfront fee is mostly charged, which can amount to as much as 5% of the investment amount. However, today many funds are traded on stock exchanges and can be bought at expenses that only amount to a fraction of the upfront fee. Nevertheless, the investor must carefully analyse the bid-ask spread in the market makers' quotes in order to estimate his real trading costs.

The costs of buying a fund, however, are not shown in the performance statistics. This reflects the fact that these costs cannot be influenced by the fund management, but arise from the marketing of the fund. Furthermore upfront fees and other transaction costs are heterogeneous and increasingly become less important. Direct banks reduce or remit them completely. The upfront fee is a matter of negotiation with big private investors; institutional investors do not pay such fees.

Direct costs within the funds arise from the transaction expenses, the management fee for the fund manager as well as from other administrative expenditures.

The transaction expenses depend relatively strongly on how often a fund reallocates its holdings and whether it has many inflows or redemptions of investors' money. The influence of reallocations is measured by the turnover frequency. For long-term funds without in- or outflows this factor is, as a rule, approx. 20% p.a.; in other words, the average holding period of a security is 5 years. However, empirical evidence shows that most funds have a turnover frequency of about 150% to 200% p.a. Therefore, the transaction costs can become very relevant for the performance of these funds.

Many transactions can be attributed to so-called "enhanced indexing", currently the dominant investment style of many asset management companies for their mutual funds. The investment objective of a fund is defined by the choice of a market index as a benchmark. The objective of the fund manager is to generate additional performance by making risk-controlled deviations from the benchmark index. The problem is that the performance of fund managers is judged not only over the long term, but it is also measured and evaluated for short periods such as weeks or months, in some fund asset management companies even daily. Therefore, they struggle when irrational market movements or sudden price variations take place. If the fund has negative short-term performance divergences from the benchmark index, pressure is immediately applied by internal risk managers and department heads to readapt the fund to the index-like structure and to avoid further underperformance. Therefore, a lot of promising bets are pulled back prematurely. The consequences are raised transaction costs and the acceptance of value losses.

However, some fund managers accept their failure to generate outperformance and completely renounce significant divergences from the index. This, however, does not stop the asset management companies from charging high fees for active management, even if it doesn´t really happen anymore.

Program trades have become an important instrument for decreasing transaction costs. Big share baskets are traded with brokers who hedge the risks through derivatives. Therefore they are able to guarantee favourable fees as well as good execution prices. In particular index funds make use of program trades. In the meantime, it has also become common for most active funds to use program trades for reallocations or to manage in- and outflows.

Banks originally created asset management subsidiaries to supply their trading departments with orders. However, in the meantime, due to the competitive pressure of independent asset managers, many of the big investment companies belonging to financial institutions have become emancipated. They are not pressured anymore to generate commission income for a linked trading department. At some smaller banks, however, the picture remains different. Here the fund management still has the task of producing a continuous flow of fee income and, hence, could be tempted to undertake many superfluous transactions.

Indeed, thanks to the increased use of program trading, the significance of explicit trading costs has decreased in recent years. In general, commission has shrunk to less than 0.1 percent. For asset managers belonging to a bank, however, it can still be a little higher. All in all, the assumption of an annual load for funds caused by direct transaction costs at a rate of 0.1% to 0.3% seems realistic. In special cases, however, it can be much higher.

The most important part of direct costs comprises the management fees. They are charged as a payment for the fund manager. However, the decreasing importance of upfront fees for the sales network has resulted in these upfront fees being substituted by a participation of the distribution network in the management fees.

As a rule of thumb it is possible to conclude that annual management fees currently amount to about 1% to 2% of the net asset value. Approximately half of this generally remains with the asset manager and the other half is paid to the distribution network.

The distribution network's participation in administrative costs has had two positive effects. First, it is involved in the long-term success of the fund. Therefore it has a basic incentive to sell very good funds. In the past, the distribution network's remuneration in the form of upfront fees often caused advisors to persuade customers to make superfluous transactions. This is avoided with a participation in the management fee. Second, marketing costs are included in the performance calculation, making performance statistics more meaningful and comparable. However, it also has to be pointed out that the distribution network's participation in management fees has led to a structural rise in the basic costs, which is particularly disadvantageous for long-term investors.

Another relatively constant component of direct costs is the administrative costs. They include reimbursement for custody services. Furthermore, costs are included which arise from the obligations of the fund asset management company to comply with legal standards, e.g. preparing the financial statements of the fund, or obligations to inform clients in regular publications about the activities of the fund. These costs serve to protect the investors and are absolutely necessary. Therefore no recent cases of significant misappropriations of money are known to us in the mutual fund industry, whereas in other more weakly regulated areas, such as hedge funds or managed accounts, severe cases of fraud appear over and over again.

An increasingly more controversial issue is the so-called performance fees, i.e. the additional fees charged when the fund performs particularly well. The basic idea behind performance fees seems right, because mutual fund managers should also be financially incentivised to produce extremely good results, as is the case for hedge funds. However, practical implementation in many asset management companies is problematic. First, performance fees are generally calculated only on the basis of one year's performance. However, this is too short for long term-investors, particularly as the price development of shares can be very volatile. Such a short-term orientation of the calculation may also encourage managers to take short-term risks to ensure short-term outcomes while neglecting potential long-term losses. While hedge funds generally calculate their performance fee according to the absolute value change, most mutual funds charge a fee based on the relative development compared with the benchmark index. This may be fairer for the fund manager who follows an "enhanced indexing approach", aligning himself to a benchmark. However, it can result in the customer having to pay performance fees also during years of absolute losses. Furthermore, there are not sufficient rules allowing for compensation between years in which a performance fee has to be paid and years in which the fund does not meet its performance target.

The so-called total expense ratio (TER) is often used as a measure for the cost load. It comprises all costs arising from the ongoing management of the fund. These costs are determined for a business year and divided by the average net asset value of the fund during the year. However, transaction expenses and indirect costs are not included. In some countries, performance fees are also not included in the calculation. In this respect, the concept can actually be very misleading, because 1) it may include only part of the fixed costs and 2) it only comprises a fraction of the actual costs in funds with a lot of transactions.

In the UK the term “ongoing charges” has replaced the total expense ratio and will soon be used in other countries as well. This term includes only the ongoing costs, but explicitly no performance fees or stamp duty. Its name may be less misleading than the TER, but it gives even less information on the real cost load.

In the USA the cost load caused by administrative expenditures is basically lower than in Europe, which can be attributed to the higher cost-awareness of investors. In addition, more investment money is administered by the fund asset management companies independently of banks. In my experience, they put more emphasis on minimising costs than do the banks. These factors explain relatively well why American funds perform generally a little better than their European peers. However, this should not tempt a European investor to prefer American funds. The big American asset management companies have launched special European tranches of their funds with "European" fees in order to benefit from the low level of competition in Europe.

Indirect costs within a mutual fund

Indirect costs are factors that are a burden for fund performance. They arise from the market environment or result from actions of the fund or the investors.

They include the indirect trading costs resulting from the difference between the bid-ask spread of securities traders. However, these vary greatly depending on the liquidity of the security. Currently, they might be as important as the openly stated transaction costs. The bid-ask spread may even be the most important factor for small and illiquid shares. A study by the American professor Richard B. Evans estimates that in the USA the cost load caused by bid-ask spreads is on average approximately 0.13% per transaction and therefore about as high as the cost load caused by direct transaction fees. In Europe this figure may be a little higher.

A further type of indirect cost is the so-called market impact. Orders made by big funds change the demand-and-supply relationships in the markets. If securities traders spot that a big fund is on the buyer's side they raise their prices. The reverse happens with sell orders.

The market impact of shares in very small companies can also be used by fund managers to manipulate prices. In the past, there have been occasional examples of small cap funds which enhanced their performance by influencing the prices of their holdings. However, these manipulations only work out in the short term, and have, as a rule, a fatal impact on the long-term performance. This effect is very important for explaining the fate of some small cap funds, which showed above-average performance when they had inflows, and used them to bid up prices in some of their illiquid holdings. This had the opposite effect with redemptions. They had to sell their illiquid shares, with disastrous consequences for their performance.

The problem of market impact has intensified during the past years as a result of the autonomous trading programs of high-frequency traders. Currently, there are algorithms that systematically search the stock markets for price patterns arising from big orders. These algorithms try to identify a short-term trend generated by a big order and therefore reinforce the market impact. The reward for the algorithm is that the fund has to absorb the raised indirect trading costs; the fund’s investors are damaged.

Richard B. Evans determined a magnitude of 0.49% for the market impact of an average transaction in US equities. Also here it seems reasonable to assume a slightly higher figure for the less liquid European markets.

According to the findings of Professor Evans, the market impact is about twice as important as the sum of the open transaction costs and the bid-ask spread.

Other indirect costs are the charges arising from the indirect effects of inflows and outflows on the fund performance. This is because investors cause costs with their decision to invest in a fund or redeem money from a fund. However, these costs are not charged to the originator, but to the fund (and therefore to all owners of the fund) and also with some delay. The importance of these costs – and therefore their impact on performance – depends on the size of the in- and outflows in relation to the magnitude of the fund's assets.

The impact of these costs is further complicated by the fact that fund prices are determined at a specific moment and this evaluation is independent of the time and the costs involved in investing or redeeming the money. The valuation of a share in a fund arises from the net asset value at the valuation time divided by the total number of shares. The figures for purchases and returns of funds shares are collected daily and then transmitted to the fund manager. This can take up to one day. If an investor acquires new shares, the fund manager usually invests the new money with a certain delay. In the same way, he can create liquidity for repayments only with a delay when an investor returns his shares.

As investors often behave pro-cyclically, i.e. they buy when prices are rising and sell when prices are falling, the fund manager generally has the problem that he has to execute customer orders at prices that are less favourable than the valuation prices. Then the direct and indirect transaction costs have to be added.

If an investor buys shares in a fund, the costs of entering the fund are distributed across all share owners of the fund. The earlier an investor is involved in a fund, the more he has to bear the costs of other investors. This effect is especially strong with new funds, where inflows are generally very high relative to the net asset value. Investors therefore can always be advised against buying into a new fund.

This effect can also seriously affect performance if a fund experiences high inflows in the context of rising markets. In my professional practice I have documented an example of a popular mutual fund for European growth stocks that had strong inflows during a year with rising stock prices. At the same time, there was an identically allocated pension fund which registered no in- or outflows. The performance difference of these structurally very similar funds at the end of the year was 11.5%. The performance comparison showed that in particular during the months with strong inflows the performance divergence was considerably higher, while in times with low inflows both funds performed similarly. Only approximately 10% of the performance differential at the year end can be explained by the smaller management fee of the pension fund. About 90% of the divergence was due to transaction costs and indirect costs. Unfortunately, the single factors cannot be further broken down analytically. But because mainly relatively liquid shares were traded, the direct transaction costs and the market impact probably played only a minor role. Indeed, it is to be supposed that the main cause for the difference in performance was that stocks had to be bought into a rising market, i.e. the fund manager almost always had to invest at higher prices than the prices at the time the fund's shares were sold.

If the fund manager had invested in illiquid small caps, however, he could have been able to outweigh the negative cost effect by using the market impact of his orders to bid up the stock prices of his holdings. But this means that the performance only improves if new money is coming in; when the money flow stops or reverses, performance drops off sharply.

The effect of indirect costs can get even more serious when money is redeemed from a fund, especially if the outflows are extensive. In the case of outflows, the valuation and repayment of a fund's shares occur before the resulting stock sales are carried out by the fund. Therefore, the direct and hidden costs are completely passed on to the remaining investors in the fund. Its performance deteriorates; however, the former owner of the fund, as the originator, is not charged. The larger the number of redemptions, the higher this effect is. High rates of redemption can cause a vicious circle for funds - they influence performance negatively, causing more and more investors to jump off. If the redemptions become bigger and bigger in relation to the fund volume, then the performance problem is further exacerbated. In the case of small cap funds, the downward effect is reinforced, because now market impact and indirect costs work in the same direction.

The high indirect costs caused by inflows and redemptions might be the main reason why many successful funds run into serious performance problems after several years. When short-term investors start redeeming their money, the performance of these funds drops and the risk of further redemptions increases. In addition, funds with high inflows sometimes become too big and inadaptable. Then transactions easily reach a volume that strongly influences the price of the traded stocks. Then the success of the past becomes a curse for these funds. First the inflows make the funds too big and erode the foundations of their success; later the redemptions lead to a vicious circle of increasing hidden costs and finally destroy their performance.

This development is reinforced by the habit of many investors of investing preferably in funds that have performed above-average in the recent past. This behaviour is encouraged by press reports, the marketing of the financial distribution networks and the performance analyses of investment consultants, which take past performance as an indicator for future performance. Basically the principle of placing your bet on winners rather than losers is right and has proved itself in many areas of life. However, with funds a problem arises because investors and fund managers act interactively. If investors reward good performance with inflows, at the same time they worsen the conditions for maintaining outstanding performance. Impatient investors can significantly damage performance with their redemptions. The greater the amounts of in- and outflows are in relation to the funds net asset value, the more improbable it becomes that the manager is able to maintain a good performance.

Some older empirical studies from the USA and Great Britain have shown a link between the past and future performance of mutual funds for the time before 2000. Nevertheless, today this link seems to be lost. According to our supposition - unfortunately, no figures are publicly accessible to prove or disprove our thesis - this is especially due to the growing influence of “fund-of-fund” asset managers, who shift the invested capital increasingly rapidly between the different funds and therefore incur immense direct and hidden costs.

“Fund of funds” should enable small investors to benefit from the advantages of professional investment management. However, empirically it cannot be proved that the average “fund of fund” is able to generate added value. On the contrary, the results of these “fund of funds” are generally slightly worse than balanced funds with a similar asset allocation. As a rule, the performance difference is very similar to the additional costs incurred by the “fund-of-fund” management.

Indeed, “fund of funds” have an interest in shifting their holdings much more often than normal private investors. This stems from the fact that fund-of-fund managers have a high incentive to carry out unnecessary transactions. If they implement an asset allocation within their fund of funds for the long term, they actually

make themselves obsolete. To justify their existence to employers and clients, they are therefore regularly forced to make up new reasons for reallocating funds.

Furthermore they move very big amounts of money in very short spaces of time. If their actions are not announced in advance to the management of the funds they are trading in, the management of flows can get difficult and the use of program trades may become impossible. As a result, the fund manager can no longer feasibly control liquidity.

In my professional practice I have experienced a case in which a fund of fund, which held approx. 70% of the net asset value of an investment fund, redeemed all the shares in this fund in one day. Although the redemption was announced beforehand, the timing was extremely unfortunate because it was performed on a day when the markets were very nervous, during which the stock prices fell sharply. The fund manager was forced to sell in falling markets for significantly lower prices than the redemption price valuation. The performance of the mutual fund experienced a strong setback on that day, both in absolute terms and relative terms compared to the benchmark index. The costs of the redemption were completely burdened on the remaining investors. The track record of the fund manager was ruined for years, although he was not responsible.

The decreasing importance of upfront fees has also had one unfavourable side effect with respect to in- and outflows: mutual funds are enjoying rising popularity with short-term investors. If a trader, for example, buys some stocks and sells them again three days later, this has no consequences for the traded stock. If a fund is traded, however, the fund manager acts in reaction to the in- and outflows. He has to buy equities for the new money and then sell them again only three days later. The direct and indirect costs from these transactions are charged to the fund asset base and performance is damaged. This damage caused by trading is hardly discernible, but it can add up, in particular if bigger volumes are concerned.

The problem of direct and hidden costs has been defused for exchange traded index funds, because investors and asset management use a market maker as an intermediary. They acquire or redeem funds in big blocks. The asset management company therefore can manage in- and outflows through program trading. The market maker buys and sells funds to investors in smaller units and hedges his market risk with derivatives.

The vicious circle of mutual funds

One of the most famous books on investing is “Winning a loser’s game” by Charles D. Ellis. If we consider the impact of costs on the performance of a popular fund, the motto “losing a winner’s game” seems more adequate to describe the fate of a lot of fund managers.

A mutual fund manager who nowadays tries to beat his benchmark index resembles a marathon runner with additional lead weights attached to his body. If he wins a section of the track, he gets additional weights attached; if he falls back strongly, he gets additional weights attached, too. If a trend towards mediocrity arises, this should actually surprise nobody.

At the moment the visible fixed costs for European equity funds might amount on average to approximately 2% p.a. Transaction costs caused by fees, bid-ask spreads and market impact rate of approximately 0.5% to 2% p.a. can be added to this. The implied costs of inflows and redemptions vary strongly. However, as a rule

of thumb: the more successful a fund has been in the past, the higher the movements of money and the stronger it is burdened with costs. Reliable estimates or measurements are not available. However, on the basis of interviews with fund managers we estimate these costs to be between 0.5% to 2% p.a. for a normal mutual fund. For very popular funds, like in the example mentioned in the text, however, they are much higher.

To judge the quality of a fund manager, it has to be taken into account that he has to overcome a cost burden of at least approx. 3.5% of his fund volume every year - practically an impossible task. If we take an average underperformance of 2% p.a., this means that at least approx. 1.5% of outperformance has been saved before deduction of the costs due to the achievements of fund managers.

For popular funds the cost load is much worse. The herd behaviour of many investors caused by the pro-cyclical mechanisms of the mutual fund industry – fund-of-funds investment processes, prevalence of short-term investors, tendency to invest only in the latest outperformer – causes large movements of money between these funds and therefore also high costs. The cost load for successful funds is also increased by the habit of some asset managers of charging performance fees.

All in all we think it is realistic to assume average costs of 5.5 % annually for a successful mutual fund facing significant inflows. These costs still allow the fund manager to outperform, if he identifies the market trends correctly. Also the market impact might serve to bid up prices of illiquid stocks in the fund. This incurs costs for the long-term investor but helps short-term performance figures. Then actual costs are accounted for as value increases, which is reminiscent of the creative accounting techniques known from financial scams.

Some asset managers also charge performance fees. We assume 1.0%, taking the cost load up to 6.5%, but occasionally this charge can be much higher.

Estimates for the cost load of a European mutual fund for equities (in % of NAV)	range	average fund	popular fund with strong inflows	popular fund with strong redemptions
One-off costs				
Upfront payments, trading costs	0%-5%	2,00%	2,00%	2,00%
Annual expenses:				
Direct costs:				
administrative costs [1])	1.5%-2.5%	2,00%	2,00%	2,00%
performance fees	0%-5%	0,00%	1,00%	0,00%
direct transaction costs	0.1%-1%	0,15%	0,25%	0,50%
Hidden costs:				
bid ask spread	0.05%-1%	0,15%	0,25%	0,50%
market impact	0.2%-2%	0,60%	1,00%	2,00%
costs caused by valuation effects	0%-10%	0,60%	2,00%	5,00%
Total annual expenses (excl. perf. fee)	2%-20%	3,50%	5,50%	10,00%
Total annual expenses (incl. perf. fee)	2%-20%	3,50%	6,50%	10,00%

[1]) = approximately 0.5%-1% lower in the USA

With redemptions, however, the picture is worse. Hidden costs are much higher and they are charged to a shrinking asset base. Our estimate for the total cost load is 10% p.a., an unsustainable figure for every fund manager.

The effect of hidden costs caused by redemptions can explain why some formerly outstanding funds performed disastrously after the vicious circle of outflows kicked in. Bill Miller's Legg Mason Value Trust was famous for outperforming the S&P500 for 15 consecutive years, from 1991 to 2005. Up to 2007, the fund's volume increased to US$ 27 billion in assets, an almost unmanageable amount. Then the fortunes turned, markets slumped and redemptions started. Bill Miller had to sell into falling stock prices with disastrous consequences for the fund's performance. After calling him "the greatest fund manager of all times" (Fortune, 2006), the press turned against him in 2008. Miller made some mistakes (maybe due to overconfidence, maybe due to the changing market conditions that were bad for his approach) and these were broadly discussed in public, causing more clients to jump ship. When Miller resigned unnerved in 2011, the fund's assets were down to US$ 2.8 billion.

The story of Peter Lynch´s Magellan fund is more complicated, as it continued to have big inflows even after he left in 1990. But returns were more volatile and outperformance was no longer consistent. Between 1994 and 1997 the fund underperformed. It was then closed to new investors in 1997 and enjoyed 3 years of outperformance, making the Magellan fund the biggest equity fund in the world with assets of approx. US$100 billion. However, after the bursting of the stock market bubble in 2000, redemptions started to accelerate, causing the fund to underperform until 2007. It was opened up again in January 2008, following good returns in 2007. But this was just before the financial crisis and the fund drastically underperformed again in 2008. Since then, the performance has lagged behind the market; the net asset value is down to US$ 11.9 billion.

A model with the typical phases in the rise and fall of a popular fund can be described as follows:

1) A fund manager finds a way to outperform his markets. He achieves leading performance statistics and attracts the attention of potential clients and consultants. Inflows begin to accelerate.

2) The fund grows in size and popularity. The press starts to publish articles about the fund and its manager. The fund is still not too big to be managed successfully. Therefore the outstanding performance continues.

3) The fund grows quickly in size due to high inflows by short-term investors and "fund of funds" attracted by past performance. However, the performance begins to falter. There can be many reasons for this: the fund may have become too big, the manager overconfident, the markets may have turned and the former recipe for success may not work as well as before.

4) Short-term investors move out and cause significant cost problems. The fund starts to underperform.

5) Long-term investors grow disappointed and redeem their money. The fund shrinks in size; the performance effect of redemptions becomes more and more painful because they are charged to assets that are rapidly diminishing. Occasionally the fund manager gets replaced or leaves voluntarily.

6) After a prolonged period of underperformance, redemptions fade out and the performance may stabilize again.

Contrary to widespread prejudice, fund managers are able to create added value for their customers. However, this is not generally sufficient to make up for the cost load. The industry's performance could only be improved if banks' financial advisors and asset management companies stopped using mutual funds as milking machines for their customers' money. However, the arrangement of performance fees in recent years does not indicate that this is the case; indeed, it suggests the contrary. Performance fees are a good example of how practical arrangement can make a good idea turn bad. Another example of counterproductive implementation of a good idea is "fund in funds". It is basically justified to offer small investors financial instruments that include a service to coordinate diversification and asset allocation of investments. However, many "fund in funds" compare unfavourably with the performance of traditional balanced funds with similar asset allocations. "Fund in funds" have a tendency to perform obsolete transactions which ruin their own performance, incurring unnecessary costs for the funds they invest in.

The basic problem that the costs of inflows and redemptions are charged to the fund's asset base and therefore to other investors than those causing them can be solved. But it would mean charging entrance or exit fees, which would be credited to the fund's assets. Moreover, it would presuppose a cultural revolution among distribution organisations and investment companies. At the moment, it is absolutely inconceivable for them not to keep the fees for themselves.

If funds get too big, an obvious solution could be that the asset management company closes the fund to further inflows. While this is common practice for successful hedge funds, it happens only very seldom in mutual funds. The fee structures still give asset management companies a greater incentive to amass assets under management than to act in the interest of the client's long-term performance.

The problem of indirect costs could be substantially defused if the distribution of all mutual funds were organised like it is for exchange traded index funds already today. A market maker could act as an intermediary between the fund manager and investor. This would allow the fund manager to synchronize transactions induced by the in- and outflows with the evaluation of the fund. Besides, cost-saving program trades could be used more often. The only reason why this is only common for exchange traded index funds and still the exception for normal mutual funds is that this is not in the interests of the traditional distribution networks for mutual funds. The involvement of market makers would basically make them obsolete.

Furthermore more transparent information on the subject of cost would be advisable. We consider the term "total expense ratio" to be misleading as it only includes a fraction of the real costs. It should be renamed "basic costs ratio" or skipped entirely. "Ongoing charges" is also a useless measure alone, because it contains even less information then the total expense ratio. It could only be useful, if all the other costs were made transparent as well.

Moreover, to make all costs visible, a fund manager could also be obliged to have a virtual portfolio parallel to the actual portfolio. This should include all reallocations, but no in- and outflows. Reallocations should be included at the prices which are used for the daily evaluation of the fund's shares. Transaction costs, however, should not be included. The performance of this virtual portfolio (incl. dividends, subscription right proceeds, etc.) would have to be certified by a chartered accountant to counteract manipulations. At the end of a year, the actual cost load could be measured based on the performance divergence between the actual and the virtual portfolio. Then the indirect costs could be determined relatively simply by deducting the fixed costs

and the transaction costs from the performance divergence. In addition, the virtual portfolio would enable a better evaluation of the achievement of the fund manager.

However, the question remains: why isn´t the asset management industry doing this already? Maybe it isn´t really interested in greater transparency. Indeed, "incapable" fund managers can be used as scapegoats for the dismal performance of mutual funds, distracting from the real reasons.

Richard Saunders, chief executive of the IMA (The Investment Management Association; the trade association for the investment management industry in the UK) explained in a recent interview with the Investors Chronicle why he objects to including trading costs in performance comparisons. "Adding trading costs to the ongoing charges figure would be positively misleading for investors." The reasoning is: "Trading costs cannot meaningfully be separated from the impact on investment returns of the associated trading. Lower trading costs can only be achieved by reducing trading, and that may result in lower returns, not higher ones." In our opinion, this logic is flawed. Investors are not too stupid to understand costs. "A lot of trading will only make your broker rich" is an old saying, which describes the impact of trading on performance better than Mr Saunders. Transactions costs never work in favour of investors. At least the IMA is not refusing to give information on trading costs because it “is not to say investors do not have a right to know these costs.”

What are the consequences for the individual investor?

1. Get as much information on costs as possible

   If investors are considering buying a mutual fund, they should try to find as much information as possible about the cost load. Currently, asset managers generally only give information about the “total expense ratio” or “ongoing costs”. However, these numbers do not tell us much. Some asset managers also disclose a figure for their transaction costs in their annual reports. As a rule, this figure only contains the directly stated trading fees. However, it can deliver a useful indication for the cost load. According to the results of Professor Evans it seems realistic to assume that the entire load caused by transaction costs, bid-ask spreads and market impact is about 5-6 times as high as the stated transaction expenses. The indirect costs from inflows and redemptions, however, cannot be derived from publicly accessible sources of information.

2. Avoid mutual funds with performance fees

   Mutual funds with performance fees rarely treat their customers fairly. In their current forms, they don’t align the interests of clients and asset managers; on the contrary, they incentivize excessive risk taking. The easiest solution is to stay away from funds with performance fees. This only slightly alters the choice of funds, as they are still an exception in Europe.

3. Always keep in mind that funds and investors are interdependent

   You and other people buying or selling a mutual fund invoke costs for this fund. The more people that are trading a fund, the higher the costs. In particular the funds that are promoted in the media or advocated by financial marketing and investment consultants are affected. They are the most likely to attract "hot

money" and, in turn, collapse as a result of redemptions. Funds sustaining an outstanding performance for several years are particularly endangered.

4. Check the net asset value of your fund regularly. If it either grows too fast or declines, take it to be a warning sign.

   If your equity fund grows to a net asset value above US$ 1 bil., you need to be alert. If it has a lot of small caps, sell it outright. If the net asset value is higher than US$ 5 bil., sell it no matter the size of your holdings. Somewhere over US$ 5 bil. a fund gets unmanageable, and don't wait until this point is reached. If you see redemptions in your mutual fund accelerating, get out as soon as possible.

5. Only buy conventional mutual funds if you are convinced by the fund manager or specific investment process. If not, buy index funds.

   Index funds deliver a performance close to index. However, investors should keep in mind that they also have a cost load which can amount to 0.5% - 0.7% p.a. However, the investor is generally much better off with them than with the regular underperformance of approx. 2% p.a. of the average mutual fund. But sometimes index funds are not available for a specific investment requirement. If an investor wants to invest in a certain theme or a specific asset class, or favours a certain fund manager or specific investment style, common mutual funds are the only alternative.

   Conventional mutual funds that are structured similarly to a market index are a complete nuisance for investors. They basically deliver a passive performance, but charge management fees for active management. In general, asset managers do not disclose their investment processes. The only way to identify these funds is to analyse how close these funds track the underlying index.

6. Avoid traditional distribution networks

   One reason for the cost advantage of exchange trades index funds is that the negative effects of direct and hidden costs can be controlled much better than in mutual funds, because a market maker is used as intermediary. The trading of actively managed funds has begun at some stock exchanges, but is still a big exception. However, at the moment it seems to be the best way to avoid unnecessary costs.

7. If you are looking for a multi-asset structure, shun "fund of funds"

   Some investors – especially smaller ones – are looking for just one fund to invest in. Fund of funds generally cause more damage than benefit to the investor. The few good ones can be recognised by the fact that they reallocate only very little. Nevertheless, because of their higher costs, even they are normally inferior to multi-asset funds with similar asset structures.

Sources:

This report is based on my own experiences in the mutual fund industry and interviews with current fund managers. I would also like to thank people who are active in investment organisations in Frankfurt and London who gave me useful hints and comments to help prepare this paper.

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Karl-Heinz Thielmann holds a degree in Economics from the University of Cologne. His professional career started in 1990 as an Analyst of European stock markets with Dresdner Bank Investment Research. In 1993 he joined Deutscher Investment Trust DIT (today: Allianz Global Investors) as Fund Manager. During his time at DIT, Karl-Heinz Thielmann developed many successful products, e.g. the DIT Wachstum Europa, the first German equity fund to invest explicitly in quality growth shares. Furthermore he received numerous awards for outstanding performance, notably for DIT Großbritannien, a fund dedicated to investments in stocks of the United Kingdom. Since 2001, he has mainly worked as an independent consultant for companies, asset managers and private individuals on matters regarding the capital market. During his years working as an independent adviser, he has helped almost all of his customers to achieve a considerably above-average investment result. Furthermore, he is lecturer for Global Economics at Karlshochschule International University in Karlsruhe.

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