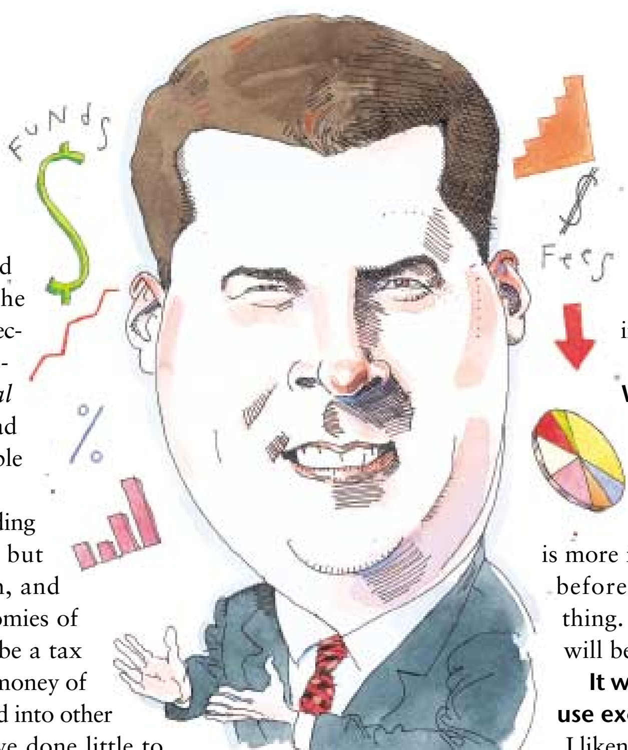
Is There a Tomorrow for the Mutual Fund?

If Morningstar's Don Phillips is correct, the long-intransigent mutual fund industry is nearly ready to make some concessions

Mary Rowland



I USED TO BE A BIG FAN OF mutual funds. For years I sang their praises in books, newspaper articles, and magazine columns. But by the time I revised the text for the second edition of *The New Commonsense Guide to Mutual Funds* (Bloomberg Press), I had changed my tune. I had trouble summoning much enthusiasm.

I had no trouble understanding why. My gripes were few but strong: funds cost too much, and they haven't passed on economies of scale as promised. They can be a tax nightmare. They've used the money of current shareholders to expand into other kinds of business. Funds have done little to redeem themselves in my eyes.

In fact, fund companies seem not to have noticed that it's possible to get along without them thanks to the exchange-traded funds (ETFs) on the American Stock Exchange as well as Internet services like Sharebuilder, Buyandhold, and Folio[fn], which allow investors to put together their own stock portfolios.

In an effort to rekindle the flame—or at least find out whether mutual funds have a future—I spoke last summer with Don Phillips, chief executive officer at Morningstar. Guess what? He thinks they do. But he also thinks that that future will bring some changes in the fund industry.

Shareholders are unhappy. When are mutual funds going to get the message?

I honestly believe that the fund industry's monopoly on the American investor's mind is more in jeopardy than it's ever been before, and I think that's a good thing. But I don't think that people will be giving up on funds.

It would be easy to do. We could use exchange-traded funds.

I liken ETFs to the change in the fund industry that happened when John Bogle introduced the Standard & Poor's 500 Stock Index Fund at Vanguard. Not everyone dropped actively managed funds for Vanguard's index fund. And not everyone will drop mutual funds for ETFs.

Before Bogle introduced the index fund, the alternative to mutual funds was to buy three or four stocks on your own. Now an investor can buy the entire market for pennies. The challenge of both of these changes raised the bar for active

Illustrations by Joe Ciardiello

managers, and I think that has been a net positive.

Too few of them are making it over the bar.

It's time to take the boots off fund managers. In the aggregate, they're smart people and they've added value. But it's time to think about some better ways of delivering their services. I heard Wally Weitz, president of Weitz & Co., say that he's had wonderful numbers relative to the competition, but when you net out the fees, it's just a market-level return. You hear a lot of managers saying that. Managers know they can't take bows anymore for giving broad-based diversification and market-level returns.

So the manager provides a good return. But the investor doesn't get the good return. What kind of delivery system do you have in mind?

That's something that makes me optimistic, the unbundling of the mutual fund. I don't know that we're paying too much for active management. But there are a lot of people eating at the trough, and you end up with a delivery mechanism that is not in tune with a lot of investors.

As a case in point, the elite financial planners are increasingly taking the view that retail mutual funds are not the right vehicles for their clients. One of the things that opened my eyes to this was John Rekenthaler's [stint] at John Nuveen & Co. He was able to share with me an insider's view of what the economics of the mutual fund business really are, how expensive small accounts can be, and how incredibly efficient and profitable large accounts can be. The beauty of the mutual fund for the small investor is its democratic nature. But that doesn't really reflect the economics of running money. *[Rekenthaler, former editor and publisher at Morningstar, left to serve as manager of investment strategies at John Nuveen & Co. and later returned to Morningstar as vice president of research.]*

A retail mutual fund is one-size-fits-all. But as the fund industry moves from first-time 401(k) investors to those clients of financial planners who used to be served by J.P. Morgan, that doesn't work. It's time to unbundle it and think about different distribution systems.

I'm for it if it means lower fees. What will it look like?

It could be separate accounts offered over the Internet with good disclosure and better tax treatment.

Like OpenFund?

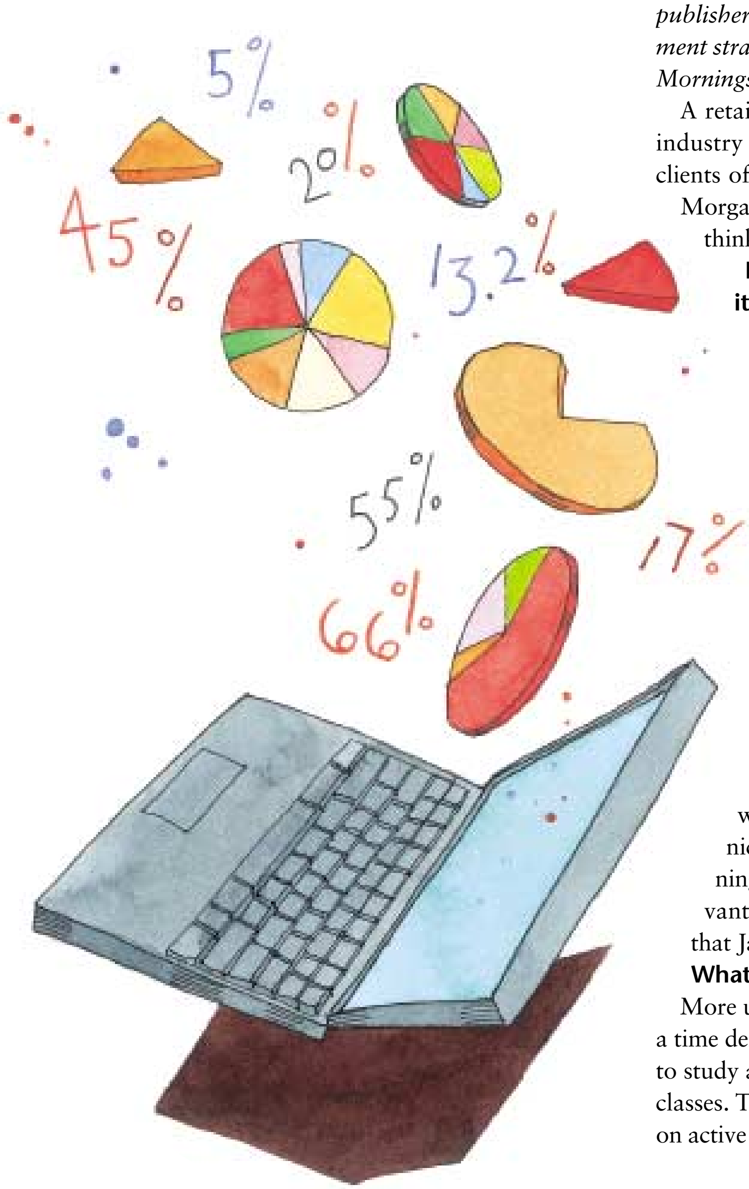
Not like OpenFund. OpenFund is a conventional fund, but what is open is a window on their activities. I'm thinking about different accounts for different investors. Wrap accounts have been a farce because there's a lot more talk about their tax advantages than there are actual advantages. But you can do that more effectively over the Internet, and the customers can come every moment and look at what's in their accounts.

Do you like the disclosure of OpenFund?

I like it for OpenFund, but I don't think it would work for Magellan or Janus. Instant disclosure is a nice principle; but the reality is that if you are running very big pools, it probably isn't to anyone's advantage. If Amazon moves, the word on the Street is that Janus is buying or Janus is selling.

What would you like to see in terms of disclosure?

More uniform and systematic disclosure, even if it's with a time delay. One of my pet peeves is there is no laboratory to study active management. Academics simply study asset classes. They say it's too difficult to get all that information on active managers. But in the days of the Internet, it would



Right now the fund industry is dramatically overcharging the big accounts, and wealth managers are saying, wait—these are my clients

be quite possible to get a paper trail of who owned what. Then we would have real accountability; and if you wanted to go back and look at how the dot-com companies collapsed last winter and see which managers were buying during January and February, you could do it.

So how often do you want disclosure and with what kind of a lag?

I'd like to see monthly disclosure, and it wouldn't bother me if the lag were two or three months.

Well, I need to get back to fund bashing. Do you think funds have been complacent because of all the 401(k) money coming in?

I don't know that funds have been complacent, because they have very actively been moving out and adding services aimed at a larger audience. The sophisticated, self-directed investor is a very small slice of the pool. The fund industry said, okay, we could stay here with the small segment of the market we have—the very sophisticated planner elite and the smart individual investors—but it would mean lowering our fees, and lowering our fees, and lowering our fees. Or we could reach out and leave our fees the same and reinvest these profit streams that we're getting to create services for the broader market.

I know the answer. They chose the broader market.

I'm agnostic about whether that was the right or the wrong thing to do. If I were running a fund company, it's probably what I would have done. But you've got the financial-planning elite and sophisticated individuals saying that funds are not serving our club anymore. Instead you could say that they've got more people investing than ever before and there's a social good in that.

Come on, Don. Paying taxes for the social good is one thing. But paying three times the fees for the social good? No, I don't buy that. I think they made the decision for their own good rather than for the social good. They're taking our money and using it to expand into the 401(k) business, for instance. This is a business decision that our club doesn't like.

True. We have funded the industry's move into these newer markets, and that's why I'm saying it's time for unbundling.

I agree. Do you see any signs of it?

I do. We've talked to a whole slew of entrepreneurs who have ideas along these lines, and you could argue that Folio[fn] is potentially an unbundling of the fund concept. Right now it doesn't have active managers, but it's not hard to imagine that happening. EInvesting, which was bought by E*Trade, is working on that, and there must be 40 different people around the country in garages with banks of computers working on this idea. Managers don't like all those layers of fees. They know it just makes their record look bad. Many of them recognize that their take is 70 basis points today, but in the future it may be 30.

Are we talking about the small, independent fund companies? Wally Weitz and Longleaf and Dodge & Cox?

The Schwab no-transaction-fee program showed you don't have to get everyone on board to change the world. Schwab started out with seven who would say yes. Scudder said no and so did T. Rowe Price and Strong and Fidelity and Vanguard. So none of the really big players said yes, and yet it changed things in a really big way.

Schwab started off as a noble revolution, charging 25 basis points to distribute funds and saying it would go to 15. But instead it went to 35. A lot of managers are not happy with that. They get knocked every day for having such a big expense ratio, and a third of it is going to Schwab. If they could go directly to the public and have their track record look better, they'd do it in a minute.

What's the first change we can expect?

We can expect to see new classes of shares like the Vanguard Admiral shares, which offer lower fees to the biggest customers. Right now the fund industry is just dramatically overcharging the big accounts, and that's where the wealth managers are saying, wait—these are my clients.

Remember a couple of years ago when Harold Evensky, principal of advisory firm Evensky, Brown & Katz, raised that issue, and he got criticized by the press because he didn't want to bring all fees down, just the fees for his clients? I might have been in the group criticizing him. But Harold said he had a fiduciary obligation to his clients, not to all of America.

So we'll see how the fund companies respond to the demand by financial planners for lower fees for their clients. I guess I shouldn't have expected to get Don to say mutual funds are finished. I'll have to be content with his prediction that they're going to be responsive in some way.

Still, I don't hear a song coming on just yet.

Mary Rowland is the author of Best Practices for Financial Advisors *(Bloomberg Press). She speaks regularly to financial advisers on issues of practice management.*