

The Ambachtsheer Letter

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THE \$300 BILLION 'HAIRCUT':

HOW MUTUAL FUNDS SHRINK PENSIONS

"Responding to the question 'why did you invest in a mutual fund?', 85% replied they were persuaded to do so by 'someone who provided me with advice and guidance' ...".

A Pollara Survey, 2006

An Absurd Situation

It has been another banner sales season for America's mutual funds. The industry reports Americans now have an astonishing \$11 trillion invested in mutual funds. Unfortunately, this good news for America's mutual fund industry is not such good news for its clients. Why? Because at today's levels of mutual fund fees and equity prices, mutual fund investors can likely earn the same return investing their hard-earned dollars in risk-free bonds as they can investing in risky mutual funds.

Some simple arithmetic confirms this absurd situation. U.S. Treasury bonds are yielding 4.5% today. The dividend yield on a global portfolio of stocks is about 2%. Add a realistic long term dividend growth projection of 4.5%, and a long term equity return expectation of 6.5% results. Subtracting the risk-free 4.5% from the risky 6.5% leads to a prospective equity risk premium of 2%. Unfortunately, an equity mutual fund management fee is often also 2%. Ergo, while American equity mutual fund investors today bear the equity risk, the mutual fund industry will collect the equity risk premium without taking any risk at all. A very good deal for the industry; a bad deal for its clients.

Admittedly, this arithmetic is based on expectations. Can it be shown that the typical American mutual fund investor is getting a raw deal from the mutual fund industry based on historical rather than expected future results? Yes it can. It was done recently in a paper titled "The Performance of US Pension Funds: New Insights into the Agency Costs Debate" by Bauer, Frehen, Lum, and Otten.