A Case for the Mutual Fund
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Often the proponents of various investment vehicles are extremely vocal in their support of their chosen approach to investing – and often very critical of the traditional active mutual fund as an investment vehicle. Given the amount of scorn that has been heaped upon the venerable mutual fund, is it safe to assume that it is no longer a relevant choice for modern investors? Are there still reasons to consider the mutual fund as a valid option for investment? The answer to such questions is not a simple "yes" or "no" – the fact remains that there are advantages and disadvantages to each type of investment platform. Actively managed separate accounts (SMA's) have some advantages over mutual funds, but for reasons discussed below, separate accounts are not practical for accounts with smaller total balances. But because separate accounts are impractical or even impossible to run for amounts under a certain size, mutual funds are one of the only ways to get access to professional active management for some investors – and while their structure does have some different costs that separate accounts can avoid, the mutual fund structure also has some advantages of its own.

The investment vehicle that is generally referred to as a "mutual fund" is actually a type of platform within the general family of "investment company." As the annual report of the Investment Company Institute for 2016 tells us, "The largest segment of the asset management business in the United States is made up of registered investment companies." Investment companies can be thought of as companies whose entire business model revolves around constructing portfolios of securities for their customers inside pooled vehicles called funds, and charging a fee to those who choose to invest in those particular funds. Customers invest in these portfolios by purchasing shares of the fund which contains the portfolio of securities, from which they can receive capital gains and in some cases income in the form of dividends and interest. Because a fund is a pooled vehicle, investors in the fund receive capital gains, dividends and interest in proportion to their percentage of ownership in the entire pool.

There are many different categories of investment funds offered to investors. What is typically referred to as a "mutual fund" is more formally known as an "open-end investment company fund" or simply an open-end fund. Other investment company structures include closed-end funds, unit investment trusts, and exchange-traded funds. For a variety of technical and legal reasons, the open-end fund or mutual fund is the category of fund that is most conducive to allowing ongoing active portfolio management. According to the 2016 edition of the Investment Company Institute Fact Book, out of the $18.1 trillion under management by investment companies at the end of 2015, $15.7 trillion was in open-end funds (that is to say, mutual funds), $2.1 trillion was in exchange-traded funds (usually simply called ETFs), $0.26 trillion was in closed-end funds, and $0.09 trillion was in unit investment trusts (UITs). Obviously, the mutual fund structure remains the most popular form of investment company vehicle in the US, despite the rapid growth of ETFs.

Investing in an open-end mutual fund is one way for an investor to pay someone else to actively manage a portfolio. The fund pools all the investments together and then the pooled account (the fund) purchases securities in accordance with the directives of the fund manager or management team. One advantage to pooling the money of all investors is scale. Imagine an investor who wishes to invest a relatively small sum of money such as $500 in a portfolio of stocks. If the investor or a portfolio manager hired by the investor wanted to own fifty stocks in the portfolio, those stocks would have to have pretty

low prices per share – on average, $10 per share or less – so that the investor or manager could buy them all with the $500. Even so, the portfolio would really only be able to own a single share of each company in most cases, which would make for a very uneven portfolio (stocks would take up a percentage of the total portfolio based on their stock price alone – it would be impossible to own, for instance, exactly 2% of each stock).

Furthermore, in such a scenario, many stocks would be out of reach for such a portfolio, based upon their per-share price alone! A portfolio with only $500 could not afford to buy many stocks with share prices above $10 if the investor wanted to own fifty stocks, because it would run out of money before purchasing all fifty. If all the stocks selected cost in the range of $100, then such a portfolio could only own five different stocks. Because some stocks may cost $500 per share or even more than that, such an investor would not be able to buy any of them, which means that stocks of companies such as Amazon or Google or Apple or many others would currently be out of the question. The pooled nature of the mutual fund overcomes this limitation for smaller investors. When the investor sends the $500 to a mutual fund, it goes into a single account along with the investment money sent in by all the other investors in that fund. In this way, the investor who sent in just $500 can still have access to a portfolio owning fifty different companies (or more) with stock prices of well over $500, because the total assets in the account may be several hundred million or even several billion dollars, in some cases.
In contrast to a fund, in which investments are pooled into a single vehicle that owns the securities, separate account managers select companies which are held by each investor individually in their own separate account. Obviously, for the reasons just described above, investing in separate accounts is more appropriate for accounts containing larger amounts of money, typically many hundred thousands of dollars or more.

Mutual funds do have costs to consider, including annual fees and transaction costs. The biggest cost is due to the fact that the behavior of other investors causes activity in the fund. If other investors cause the portfolio to make more trades by making big withdrawals, for example, then all the tax consequences will be shared around proportionally to everyone invested in the fund, even those who did not do any withdrawals in a given year. Therefore, the separate account structure can be more tax efficient for investors who want professional management and who have enough money in their account to have it managed separately.

However, mutual funds did not get to be such a big portion of the investment picture in the United States for no reason. They have several of their own advantages – chief among these being the fact that they are by far the most practical way to gain access to professional management for investors who do not have enough money for separately managed accounts. Their pooled structure makes it easy to get started with very small amounts – and also to add very small amounts at periodic intervals and have those contributions gain immediate access to the entire portfolio in the fund. Furthermore, because the fund itself can have hundreds of millions of dollars of assets, it may be able to get trading costs that are lower than the investor would get for himself or herself (placing a trade for tens of thousands of shares might get a better “per share” price to trade than an individual investor might be able to get for placing a trade

for ten or even a hundred shares).

Another important point to raise is the fact that without using mutual funds, there would really be no way for many people to have access to the investment management of someone else. Those who wanted to invest would be left with the choice of making all the investment selections for themselves. Even investors who might wish to pursue so-called "passive" investing by holding shares of every company in a particular index or sector would need to have a huge sum of money in order to replicate the index in their own account (and enough time to stay on top of any changes in the index), unless they were able to pool their money with that of other investors in a fund.

We happen to believe that "just owning the index" is not necessarily the best way to invest, because we believe there are companies that are likely to do better than the average company, and that with careful research and a good idea of the characteristics you are looking for, it is indeed possible to identify companies with better prospects. Therefore, we strongly believe in active management, in spite of all the publicity put out by parties who may or may not be completely unbiased which claims that it is impossible to know which companies might have better prospects. Anyone who wants access to professional active management by someone else generally either needs to have enough money to justify separate account management, or use a mutual fund in order to get access to professional active management. The other alternative is to perform the duties of the investment manager for oneself, but few are able to devote the majority of their time and energy to such an endeavor, and probably even fewer would really want to do so.

For all these reasons, we believe that the mutual fund remains a valid way for millions of people to gain access to professional active investment management. We freely admit that the pooled structure does create some drawbacks versus a separately managed account, but also note that unless one has enough money to make separate accounts practical, the mutual fund is the best alternative. Further, there are a few ways that mutual funds have an advantage – chiefly in the fact that an investor can start off with just a few hundred or a few thousand dollars with a mutual fund, and can send in small amounts that immediately get exposure to the entire portfolio of securities. The mutual fund structure's long history, continued popularity, and inherent strengths for certain purposes all argue that it remains a relevant vehicle for investment today.

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