CAPITAL MANAGEMENT

WHY MUTUAL FUNDS ARE THE WRONG WAY TO GO

When I first graduated from the University of California Santa Barbara in 2004, my dream was to work for a large investment firm so that I could learn the business and move up the ladder. When an opportunity came around for me to work at the Vanguard Group, which is one of the largest mutual fund companies in the world came around; I jumped at the opportunity and moved out to Scottsdale, Arizona, where the position was available.

As far as mutual fund companies go, Vanguard is a great one that is known for its low fees, but during my short experience there I became extremely disillusioned with the mutual fund industry, and I feel that a tremendous amount of savings and retirement funds are squandered, as a result of the relatively poor performance and opportunity costs that come with investing in mutual funds. Below I'll describe why I don't recommend mutual funds, why most funds underperform the indices, and why most investors in mutual funds do even worse than the actual funds.

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Most mutual funds are totally over-diversified. It is very common for mutual funds to hold sixty to one hundred different positions in them. Statistics show that if you throw a dart thirty five times against a wall containing all S&P 500 stocks and hold on to that portfolio, that your returns over time would track the S&P 500 within 3%. By holding a large amount of securities within a specific guideline, most mutual funds are basically closet-indices, which makes it extremely difficult for them to outperform. Mutual fund companies are obviously aware of this, so they invest a tremendous amount of money and time to market themselves and build relationships with clients. Poor performing funds are often shutdown and new funds are created to make for an easier sales pitch. The reality is that most market participants would be more successful in an index fund than with an active mutual fund manager. There are some notable exceptions such as Bruce Berkowitz's Fairholme funds, Martin Whitman's Third Avenue funds, among others, but in general market participants can do better in an index fund.

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Mutual funds can have costly fees despite the generally lackluster performance. Typically fund fees average between 1.3-1.6% annually, while many also have "front end" load fees, as well as "back end" load fees, also called redemption fees. Clearly, there are costs to managing money and handling the heavy regulatory burdens that exist in the mutual fund industry, but when performance is generally poorer than the overall market, these fees cannot be justified. If you are investing in an overly diversified mutual fund that is also charging these fees, like most mutual fund investors do, you are almost assuring yourself of underperformance. Understanding this was a big reason that I determined that a career in the mutual fund industry was not in the cards for me, because I know how hard people work over entire careers to accumulate assets, and putting those assets in funds that are likely to underperform is just not something I could ever promote.

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Psychologically, fund managers investment performance is measured against a particular index. Even short-term significant underperformance can be a career ending problem for most mutual fund managers, so there is a tendency to mimic the indexes as much as possible to reduce the risk of that. We've already showed that this is a recipe for long-term underperformance. In addition, most managers feel compelled to chase hot-performing sectors and stocks to keep up with their competitors.

Let's say that Apple has doubled over the last year and is a glamor stock that is known my most investors, if a underperforming fund manager doesn't own the stock there is often a fear of how that is perceived by the fund investors, since "everybody knew that Apple would go up." This is why it is well known on Wall Street that fund managers do "window dressing" at the end of quarters where they will often buy hot-performing securities, because when they report the holdings to the investors, they want to show that they have been in these exciting stocks even if they were just added to the portfolio. This is obviously highly counterproductive to solid investment success in that often these hot-performing securities are overvalued, and fund investors stand the chance to pay the price when the stocks go down, without having previously received the benefit of the appreciation when the stock ran up.

Fund managers are forced to retain a reasonable portion of cash to handle fund redemptions. The amount could be as low as 3% to as high at 20%. This cash can be a weight dragging portfolio performance down in that it is money that is not invested in the markets. Astute fund managers tend to hold a lot of cash when securities are overvalued, but holding cash due to institutional needs such as redemptions is just another negative for fund investors. Especially in today's record-low interest rate environment where cash gets paid very little, having only $95,000 out of a $100,000 investment invested in the markets can represent a significant opportunity cost.

Many mutual funds have very high turnover, which can increase the costs of the fund and also increase the amount of short-term gains in the fund. Even worse, many fund investors have to deal with the burden of "phantom gains" where new investors to the fund are forced to pay for gains made by the fund on positions that existed prior to them joining the fund. For example, say an investor puts money in a fund on October 15th and Apple is trading at $500 per share at the time of the fund purchase. Even if the stock were to drop to $475 by the beginning of November, if the fund were to exit the position, the new investor could get stuck with a short-term gain of $100 per share assuming a cost basis for the fund of $375, even though the stock has actually dropped $25 since the investor owned the fund.

By this time, hopefully we have established why the odds are stacked against most mutual fund investors. Just as many professional investors, tend to have psychological issues which cause them to chase performance, individual investors in mutual funds tend to do the same thing. Many mutual fund investors base their investment decisions on past performance, which often means that the investors are buying high and selling low. Even the best money managers underperform over short-term periods of time, so leaving a manager based on a poor short-term track record can often be a costly mistake.

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Conversely, even a blind squirrel finds a nut sometimes, so a fund that has a strong short-term performance record might have stocks that are temporarily in favor and are destined for a decline. Industry-centric funds such as technology, energy or financials can go in and out of favor, so chasing performance can be a very dangerous proposition.

This article would be incomplete if I didn't offer a better alternative to this depressing discussion that plagues many investors' portfolios. Warren Buffett has become one of the three richest men in the world using a deep value based investment strategy. He buys stocks and businesses that trade at deep discount to intrinsic value. The intrinsic value of the businesses can only be determined by performing extensive research and analysis. There are a good number of investors that use the same method that have also been extremely successful. Value investing makes a lot of sense and if you don't have time to perform the rigorous analysis yourself, than it is helpful to find a professional that can do it for you. At my firm T&T Capital Management (TTCM), we specifically tailor our clients' investment portfolios based on their objectives and risk tolerance, and we employ a deep value approach.

We focus our investments on securities that offer the best risk-adjusted returns, which means that we will have different performance than the indices. This can lead to periods of short-term underperformance, but we believe that is an easy price to pay for the potential of outsized long-term performance. We don't just use stocks but we also invest in other securities such as bonds and warrants when attractive opportunities come up. In addition we will intertwine stock option strategies such as covered calls and cash-secured puts, which put the odds in your favor and can allow you to potentially outperform in flat and down markets as well.

If you don't go with us, we'd also recommend the Fairholme fund run by Bruce Berkowitz and Third Avenue funds run by Martin Whitman. These are great investors with excellent long-term track records and a process that is likely to be repeated successfully, regardless of the market climate. We have no relationship with these funds and receive no compensation for recommending them, so if you have any questions or are looking for additional recommendations please feel free to give us a call.

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Why T&T Capital Management

Focused Portfolios

We build focused portfolios based on maximizing risk-adjusted returns, as opposed to the overly-diversified approach others take. We do not allocate our clients into cookie-cutter asset allocation models as we only invest in attractive opportunities with risk return parameters.

Thoroughly Researched

Every investment is hand-picked and thoroughly researched based on deep-value principles. On a daily basis T&T Capital Management is actively managing your positions to adjust accordingly and to find new opportunities as they pop up. We utilize our sophisticated investment and trading strategies to constantly add value in order to help grow your portfolio. The bottom line is that your money should be working far harder than you are and no service exemplifies this as much as the T&T Capital Management managed account program.

Unique Strategies

We use proven strategies of selling covered calls and cash-secured puts, which can potentially generate returns in poor market conditions, and which generally result in less losses in bear markets. This is another way we add substantial value to our clients and it gives them a unique competitive advantage. Always Expect Excellence from T&T Capital Management

Investing with T&T Capital Management involves risk, including loss of principal. T&T Capital Management is less-diversified, meaning it invests in a smaller number of securities in comparison to index funds and, therefore, is potentially exposed to greater volatility than a diversified fund. T&T Capital Management may invest in special situations involving out of favor securities which may entail greater volatility risk. T&T Capital Management focuses on minimizing the risk of permanent losses of capital but is willing to take short-term mark-to-market risk, which we deem to be temporary in nature. The composition of T&T Capital Management's holdings and sector weighting are subject to change and should not be considered recommendations to buy or sell any securities. Current and future portfolio holdings are subject to risk. Past performance is not indicative of future results. Options are not suitable for all investors.

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