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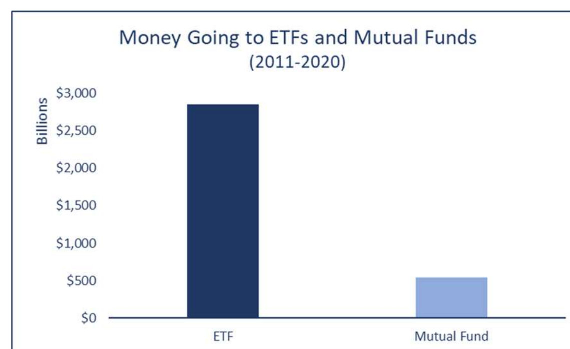
Shifting Investor Trends

Over the past decade, there have been two big shifts in the investment industry. People are trading in their high-priced mutual funds in favor of cheaper Exchange-Traded Funds (ETFs). Additionally, many investors have moved their money into funds (either mutual funds or ETFs) that passively track an index (the S&P 500, for example) as opposed to relying on an active fund manager to attempt to beat the market with superior stock-picking, which evidence shows does not work.

ETFs Versus Mutual Funds

Both ETFs and mutual funds are ways for investors to diversify their portfolios by owning small amounts of many different companies. However, some key differences help explain why many have shifted from mutual funds towards ETFs. First, ETFs are much more liquid since they trade on an exchange (hence the name!) and can be bought and sold whenever stocks can. Mutual funds, on the other hand, only trade once at the end of the day. Second, Mutual funds tend to be actively managed, and therefore have much higher fees. ETFs are usually passively managed to follow a simple index (again, like the S&P 500), which translates to much lower fees for the investor. Finally, mutual funds are prone to distributing capital gains, while ETFs have a structure that makes capital gain distributions rare. This means ETFs are more tax-efficient than mutual funds are for investors, which can have a meaningful impact on long-term wealth creation. Just take a look at how investors have voted over the last 10 years. While mutual funds have much more in absolute dollars, ETFs have brought in almost $3 trillion. Mutual funds have brought in a little less than one fifth of that.



Source: Morningstar; As of 12/31/2020

Active Investing Versus Passive Investing

Passive investing involves tracking a simple index, allowing investors to just capture “market” (or some other type of index) returns at a very low cost. Active investing, on the other hand, involves a fund

manager and a research team trying to beat the market with their own stock choices. This strategy often fails, partially due to the higher costs that come with an active management team and partially because of human error. As the chart below demonstrates, investors have gotten that message over the last 10 years – passive strategies have grown over 380% while active strategies have grown less than 90% (if we take away market returns, active growth is about flat).

Source: Morningstar; As of 12/31/2020

Why The Shift?

To put a finer point on the above discussion, actively managed mutual funds tend to be much more expensive than ETFs that follow a simple index. For example, the average actively managed US large cap mutual fund costs 0.7% as compared to 0.03% for an ETF that tracks the S&P 500*. That is more than 23 times more expensive – imagine if all those fees stayed in the investor's account and compounded for 10 years! Furthermore, there is plenty of research that demonstrates those actively managed funds cannot do any better than the much cheaper simple index in the long run. Standard & Poor's does a semiannual report called the SPIVA (Standard & Poor's Index Versus Active) report, which looks at how active managers fare against benchmarks. As of December 31, 2020, 94% of all large cap mutual funds had a worse return than the S&P 500 over a 20-year period.

Conclusion

While the financial industry benefits from all the dollars that remain in mutual funds, the investor benefits from the lower fees and superior performance in the case that they move to ETFs. We believe this is a trend that will continue for some time now, although it tends to happen more slowly for people that use financial advisors still using the old mutual fund model. As investors self-educate, they will eschew those advisors in favor of more evolved ones or simply do it themselves.

*Source: Morningstar and Vanguard

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