



All that's hot in the mutual fund industry

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New Book Rips Fund Industry's 'Failure'

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The for-profit mutual fund industry has failed investors. That's the premise of a new book by Yale University chief investment officer David Swensen, titled *Unconventional Success: A Fundamental Approach to Personal Investment*, out today from Free Press.

This "fundamental market failure" stems from an unavoidable conflict between fund firms' financial interests and their fiduciary responsibilities, according to Swensen, who produced 16.1% per-year returns in his first two decades running money at Yale.

"Inevitably, fund-management company profits reduce fund shareholder returns," Swensen writes. Through a spokeswoman, Swensen declined to be interviewed for this article.

Only not-for-profit fund firms like **Vanguard** and **TIAA-Cref** are able to serve investors' needs without conflict, Swensen maintains in his book, disclosing that he serves as a TIAA trustee. Publicly traded companies and fund subsidiaries of larger financial services firms are potentially the most investor-unfriendly, according to Swensen. "Serious investment operations do not belong under the umbrella of multiline financial services organizations," he observes.

Elsewhere in the book, Swensen takes aim at such now-familiar industry bogeymen as 12b-1 fees, "pay-to-play" arrangements, soft dollars and portfolio churning. He argues that fund firms, not investors, have benefited from economies of scale, noting that no-load fund fees dropped only three basis points and load fund fees actually increased as assets grew from \$51.7 billion in 1979 to \$4.5 trillion in 1999.

Meanwhile, fund performance has trailed market benchmarks, according to Swensen. He cites a study finding that the average fund underperformed the Vanguard 500 Index by 2.1% over the two decades ending in 1998. He also comes out in favor of index funds, saying that actively managed funds "consistently fail" to beat their passively managed peers. Still, he points out that even index fund fees vary widely from firm to firm and even from share class to share class.

"Overwhelmingly, mutual funds extract enormous sums from investors in exchange for providing a shocking disservice," Swensen writes.

Nor can average investors count on regulators for protection, according to *Unconventional Success*. Swensen criticizes the SEC as "chronically understaffed and constantly overburdened." The SEC's required disclosures are rarely read and, even then, rarely useful, he contends.

"At the agency's best, it responds to a high-profile problem, fashions a solution, addresses industry concerns and implements a watered-down reform," Swensen writes. An SEC spokesman declined to comment.

However, Swensen underestimates the variety of investors' needs and interests, according to Brian Reid, chief economist for the Investment Company Institute. He notes that 80% of investors who invest outside of 401(k) plans use an advisor. Their fees are inherently higher due to this additional service.

"Mr. Swensen has a very deep understanding of portfolio management theory and has a very deep understanding of the institutional market," Reid explains. "The retail market is quite diverse, far more diverse than the institutional market. There are many fund firms out there, and all of them are trying to provide the vast range of services that shareholders demand and need."

New research issued today by the ICI explains the reasons for the variation among index fund fees, Reid says. S&P 500 index funds are not commodities and, in fact, have very significant differences that may account for fee discrepancies, according to the ICI. An index fund's expense ratio depends on several factors, including bundled advice, assets under management, average account balances, low-balance fees and fee waivers.

In response to another of Swensen's points, Reid says that looking at asset growth and fees industrywide, rather than

on a firm-by-firm basis, is insufficient. He points to the new distribution channels and services that have emerged in recent decades.

Swensen's thesis points to a fundamental issue for the industry, according to Niels Holch, executive director of the Coalition of Mutual Fund Investors, a Washington, D.C.-based investor advocacy group. That is, are funds trusts to be managed for shareholders' benefit, or products to turn a profit?

"As the industry has evolved over the years, it seems to outside observers like Mr. Swensen that the fund has really become a product for large financial institutions as opposed to a trust," Holch says. "He raises quite correctly the dilemma that the individual investor has."

At the same time, Holch notes that some for-profit fund firms have taken shareholder-friendly steps.

Many of Swensen's contentions have been voiced by the likes of **Vanguard** founder John Bogle or **Morningstar**, according to the firm's managing director, Don Phillips. But he cautions against wholesale condemnations of the for-profit fund industry.

"You do need to go back and look at the very big picture," Phillips says. "It takes a lot to motivate people and get them saving and investing. The fund industry has succeeded in that."

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