

What's Wrong With Mutual Funds?

Buy an index fund. Approximately 80% of mutual funds underperform the average return of the stock market. Here's what else you need to know about mutual funds.

We know you probably don't want to spend hours learning about the intricacies of mutual fund investing. Even if you've cleared your calendar for some quality fund study time, we don't need to dominate your afternoon with this topic. **So, here are four words that'll serve as the foundation -- heck, make that the foundation, walls, roof, and wall-to-wall shag -- for your long-term success in investing in mutual funds:**

Buy an index fund.

There you have it! Thankyouverymuch, ladies and gentleman! We're here every Friday. Please remember to tip your waiters and waitresses.

Still here? All right. You caught us trying to sneak out of work early on a sunny day. Mutual funds are a hot commodity with individual investors and financial institutions. In fact, there are more mutual funds in existence than there are individual stocks -- that's more than 8,000, for those of you taking notes. That amounts to more than \$7 trillion invested in these things.

With so much money riding on the success of mutual funds, how can we be so pat with our breezy summation? Well, the **fact is that most investors are probably best off buying an index fund** -- which is simply a mutual fund that tracks some stock market index, whether it's the Standard & Poor's 500 Stock Index, the entire stock market index, or some other performance measure of a like group of stocks.

Before we get into that, first, a little background.

What are mutual funds?

A mutual fund is simply a collection of stocks and/or bonds. Mutual funds are financial intermediaries -- they are set up to receive your money and then make investments with the money. Most mutual funds are "actively managed," meaning the mutual fund shareholders, through a yearly fee, pay a mutual fund manager to actively buy and sell stocks or bonds within the fund. When you buy mutual fund shares, you are a shareholder -- an owner -- of that mutual fund, with voting rights in proportion to your ownership of the fund.

The price of "active management"

Though you would think that mutual funds provide benefits to shareholders by hiring "expert" stock pickers, the sad truth of the matter is that over time, the vast majority -- approximately 80% -- of **mutual funds underperform the average return of the stock market.**

Why the underperformance? Are these MBAs in dapper suits the world's worst stock pickers or what? Did someone forget to carry a decimal? No and nope. Quite simply, the majority of mutual funds fall short because of the fees they charge you to be a shareholder. You pay for the privilege of active management. You pay for a fund's sales force, slick marketing, Super Bowl halftime ads, trading costs, and the fund manager's cloth-napkin business lunch and weekend home in the Hamptons. The costs of being in the average actively managed mutual fund over time are, put simply, very, very severe. (Get a load of [what "sales loads" can do](#) to your fund's performance.)

What does this mean for you?

Here's our oft-repeated fact that you should get through your head: The average actively managed stock mutual fund returns approximately 2% *less per year* to its shareholders than the stock market returns in general. That means that before your dollar even gets to the fund manager to invest, his company has already taken two cents off the top.

Although 2% may not sound like that big of a deal when the market is returning roughly 20% per year as it did from 1995 through 1998, the standard returns for the stock market historically are closer to 10%. Consider whether this is severe enough for you: over 50 years, a \$10,000 investment will compound to \$1,170,000 at 10% returns per year, but to only \$470,000 at 8% per year.

At 11% annual growth, \$1 surrendered in year one is over \$23 less for your retirement in thirty years. Add those dollars up, and you've handed over a lot of cash.

Uh-oh, now what?

You need to pick your funds carefully. For the most part, picking a fund is just like investing in individual stocks. We'll tell you that, by purely quantitative measures, there is no reason to buy anything but an index fund. But what if your 401(k) doesn't offer an index fund? Or what if you already own an index fund but want to add some diversity to your portfolio? Or, perhaps you wonder: "I've heard plenty about mutual funds that beat the pants off your namby-pamby index fund. How do I get me one of those?"

Well, there are some funds -- or, more precisely, some fund managers -- whose services are worth paying for, because they are superior investors who are simultaneously fee-conscious. You just have to find them and know what the heck everyone is really talking about.

Pick a Winner!

All there is to picking the right mutual funds is learning what to look for. We offer some general guidelines, as well as some hands-on resources, to help you find winning funds for your portfolio:

- As if we need to repeat it: If you are in the market for a mutual fund, DO NOT OVERLOOK the [index fund](#). (Click that link already!) It is quite simply, hands down, no questions asked, your best bet.
- If you don't have an index fund in your 401(k) or have a hankering for higher returns, head this way to find out how to pick the best mutual funds by using our [Fool-Friendly Fund criteria](#). When you're ready to get into the specifics, check out our How-To Pick the Best Mutual Fund Guide where we walk you right up to some Foolish mutual funds.
- If you already own a mutual fund, there are some things that you need to think about before you dump a stinker fund. Even if you aren't selling, you need to do some regular maintenance -- rotate the tires, check the oil, manage your capital gains, etc. For a quick rundown, head to the [mutual fund owner's manual](#).
- As you read our sacred words (ahem), don't get thrown by the jargon. Check out our [mutual fundese translations here](#).

As you make your way through the fund area, if you find your attention waning at any time, just remember our four-word summation and you'll already know a lot more than most mutual fund owners: Buy an index fund.