Casey Mullooly: Welcome back to the Mullooly Asset podcast. This is your host, Casey Mullooly. I'm joined by Tom and Brendan this week. And boy, do we have a good one for you. We're going to talk about a recent piece of research from our friends over at Morningstar about fees. And we just want to remind folks, we're going to talk about some specific investments and some specific investment products in this episode, so none of the securities that we mention in this podcast should be taken as investment advice or recommendations. Just wanted to clear that up ahead of time. And without further ado, episode 372 of the Mullooly Asset podcast.

Tom Mullooly: Years ago, so now over 20 years ago, we used to have a package of mutual funds at a former broker-dealer that I used to work with, and you could basically pick from the menu of funds, but one thing that we noticed in the C shares and the B shares, so C shares, you pay an annual 1% fee, the B shares had their own expense ratios. But among the fund choices you could pick from, from the menu was an S&P 500 Index. So it dawned on me one day, where instead of trying to pick small cap value or mid cap growth or something like that, I was like, I should probably just own the index. But once I started putting clients into it, I started to realize, wow, we are continually lagging behind the index. We own an index fund. Why is this happening?

Tom Mullooly: And then you see the internal expense ratio was 150 basis points. That's one and a half percent per year. So if you have a fund that returns 10%, but the internal expense ratio is one and a half percent or 150 basis points, the best you could do in a 10% market is eight and a half percent. There's no way to keep up when you've got expenses that are just stripping away. Return's at 10%, that's pretty good. You're going to have some years where you get no return or negative return, and then it just compounds in the wrong direction.

Brendan Mullooly: Then it's even worse, yeah.

Casey Mullooly: That's a great place to jump off, to start talking about a recent research piece put up by Morningstar, titled How Low Can Fund Fees Go? And the answer is pretty low. Morningstar found that the average expense ratio for all ETFs and mutual funds has been cut in half since 2000, which 20 years, but that's not really that long of a time for it to be cut in half. So I just wanted to start out. You got into it a little bit there, but what is an expense ratio and why is it important for investors to pay attention to it?

Tom Mullooly: I'll take the lead, but Brendan, whatever I miss, add on. Mutual funds and exchange traded funds do not work for free. So the people who work for these organizations have to get paid. So built into your annual management expense ratio is the cost of paying the salaries for everybody who works at Vanguard, Franklin, iShares, Morgan Stanley. They have to get paid. The fund manager gets paid. The advertising gets paid. The trading commissions, I know commissions have been reduced greatly, they have to be paid through your ongoing expenses. So it costs money to organize and run these funds. Plus they have to do their annual filing with the different exchanges like the SEC.: Yeah. I mean, you pretty much nailed it there. These funds cost money, but they can cost different amounts, I guess, is what we've seen over the last 20 years. Maybe some streamlining going on within the industry and changes that have caused those fund fees to drop.

Tom Mullooly: So one of the things, and I'm not picking on this company in particular, but over the past

20 years, more so 10 to 20 years ago, we had to deal with the discussion that we had with Contour. Why wouldn't I just deal with Fidelity or Vanguard? Because those things are no load. They're no load in the sense that load is a bad term for a sales charge. There's no sales charge that comes with Fidelity or Vanguard funds, but again, they don't work for free. So even no-load funds have expense ratios built into them, and some of them have not been cheap. Now they're, like you said, Casey, in the Morningstar piece, they're all coming down. The entire industry is coming down, finally coming to their senses.

Casey Mullooly: So these funds essentially make money by people having their money in the funds.

Tom Mullooly: In a sense, yeah. I mean, they want to be competitive, so they want to keep their costs low, but they have to pay salaries and pay for the lights, and they've got to get paid somehow.

Casey Mullooly: I guess you alluded to it with, you're going to underperform if you have a higher expense ratio that eats into your performance, and then you're not keeping up with the market. Investors have slowly become aware of these fees eating into their returns over the last 20 years. The Morningstar article gives a lot of credit to individual investors doing their homework and paying attention to these things. The article said that that was the biggest pressure, is why we've seen these fees come down, is because people have been voting with their dollars, in a sense, and putting their money into funds that have these lower expense ratios, which in turn has forced the companies with the higher expense ratios to bring them down just in order to compete. So, kudos to everyone doing their homework out there.

Tom Mullooly: Well, you're right in the sense that people march with their feet or march with their pocket book. I'll also tack on another old line that I've used many times. Money goes where it's treated best. So that's really important.

Brendan Mullooly: Not only are the fees coming down, so it's a compounding effect where more and more people are just piling into the lower fee products, because absent everything else, all else equal, you would prefer a lower fee over a higher one. However, some might be willing to do a higher fee if there were better performance to cite as a result of it, which there's very little evidence of these high fee managers, even before their fees are accounted for, beating something like an index. And then after you include their higher expense ratios, fees that are included to pay the people who are trying to outperform whatever their benchmark is, on an after fee basis, the results are even poorer. And you can look on rolling 1, 3, 5, 10, 20 year basis, and advisers like us have seen this research, individual investors have seen it. So it's not only just, hey, I'd like to pay less. You're paying less also because there's no reason to pay more because there's no promise about performance just because you're paying more for something. That's not how it works with investing.

Casey Mullooly: Which has to be a big difference from when you first started in the business, in the '70s and early '80s.

Tom Mullooly: So I went through, I'm listening to Brendan's comment and I'm thinking back to when I went through the Shearson training program. We actually had to prepare pitches to bring to class on why you should invest with this particular mutual fund manager because he's got a great track record at picking great stocks and posting fantastic returns. And you're right in the sense that they could charge a little more because they had to pay this superstar fund manager.

Brendan Mullooly: Yeah, sell the sizzle.

Tom Mullooly: Right. And it just never really seemed to work out that way. I also think that looking back over the past 20 years, the emergence of exchange traded funds has just made the mutual fund industry, and a lot of them are the same players, has made the entire industry wake up and say, you cannot continue to charge 150 basis points for this product that we can now get for 15 basis points. And I apologize to the listeners, when we talk about expenses, we talk many times in terms of basis points, but 100 basis points is 1%, 150 basis points is one and a half percent. So 15 basis points is 0.15. It is a huge, huge reduction in the annual costs.

Casey Mullooly: So do you think that this has anything to do with information just being more available to people, or is there some sort of these fund companies have always had to do disclosures? Correct me if I'm wrong on that, but they've always had to disclose that these fees are there. So is it just as technology's increased, as things like ETFs have come out, people have more information at their fingertips and just decide based on that?

Brendan Mullooly: We still, just to caveat, the trends that we're setting here, we still come across people that are in super high fee portfolios. So for all the changes that have occurred over the last 20 years, there's still a ton of people with money in high fee products that usually don't even know it, because if they did, they probably wouldn't be in them anymore.

Casey Mullooly: Good point.

Brendan Mullooly: So there's still a lot of money hanging out in high fee stuff. Yeah. The information is out there, so people can go and see, hey, for instance, if I bought this mutual fund that's an active fund charging me 1%, and it's because I thought that the manager had a really good pitch and had a decent track record. They can pull the track record now. They don't have to rely upon their advisor to get on the phone and cite the three year track record. They can look at it in black and white and consider for themselves whether the performance has been worthy of saying that the manager is good or worth paying extra for. And when it isn't, then they can make the decision with the click of a button to change to the index that that person was trying to beat, for instance, and save themselves a percent a year right off the bat.

Tom Mullooly: So I think that you asked why this has all been happening the last 20 years. I was going to say because of the internet, but I think even before that, it started with these TV channels, these financial TV channels that get on there and they start talking about our business and talking about our industry and talking about how these products are constructed and what's put into them. The internet has only made the information more accessible to everyone that's out there.

Casey Mullooly: It's interesting though, because I feel like back in the day and in the '80s and '90s, these fund managers would go on and show off a little bit and maybe tell tout performance. Then it was great and they probably saw inflows from that at first, but then the curtain got peeled back. The more they talk about it, the more the curtain gets peeled back, and the more people realize, like you said, Bren, that I can just go somewhere else with this.

Brendan Mullooly: I don't know if it's a short term trend thing, because so what you're saying is true in the sense that dollars not only are making wise decisions in terms of going where the fees are lower, but they're going where the performance is too, because you could look and see that being in index based investments puts you a pretty good chance to be top quartile investments over any time period. Meaning you're going to be-

Casey Mullooly: 80%, yeah.

Brendan Mullooly: ... a 75th percentile or higher on a 1, 3, 5, 10 year basis by basically throwing in the towel and saying, "I'm going to own the index." I don't know. I've heard it argued that part of the proliferation of index based investments, lower cost funds is a bit of performance chasing, meaning the performance has been so good for index type investments, that some of it is not only, hey, I'd like lower costs, but also I'm chasing the good performance that's been around. I've seen that for 10 years now and I haven't seen the trend revert. I've yet to see a year where, oh, wow, 50% of managers beat the index last year. I've still yet to see it. So I think that's a trope that's just trotted out there by people who have money to make by saying indexes are just a fad right now and people are chasing performance. I'm not sure the dollars are coming back out of the index funds to go back into higher fee funds, just because of maybe a year or two where more active managers are able to clear the hurdle than not.

Tom Mullooly: I also think that the way that ETFs have been constructed, what Brendan's referring to with the mutual funds, you've got some superstar stock picker or bond manager putting together this magic portfolio with exchange traded funds. They track an index. And I think what happens, I don't know this for sure, but I think what happens is when individuals hear we're going to track the index or this ETF tracks the index, they think it's the S&P because that's all they hear, but in order to create as many exchange traded funds that have been created, they've also created new indices. So, trying to buy the small cap 600 10 years ago was difficult. It was hard to do. It was hard to find a product that matched that, or even came close to managing that. Or the mid cap 400. How do you do that? What if you wanted to buy the Home Builders index? Well, now there is one. What if you wanted to buy semiconductors? Well, there was always the Philadelphia Semiconductor index, the SOX, but you understand what I'm saying in that there was never a biotech index to buy.

Tom Mullooly: When I got started in the business, if you wanted to buy the semiconductors, or sorry, a biotech stock, instead of buying one individual stock, a biotech stock, you had to buy, I'm going to name a product, the Franklin Biotech fund. It was the only one out there. And it was the-

Casey Mullooly: Not a recommendation.

Tom Mullooly: Yeah, it was the gorilla in the biotech space. It was the only one to buy. And then they had the Health Sciences Trust. Also not a recommendation. But this was the only way that you could buy these things. And they came with a 5% sales charge and 150 or 175 basis points in annual expenses. But you know what? If those funds owned Genentech or some other crazy biotech stock that doubled or tripled in value, you were along for the ride.

Casey Mullooly: Yeah. There's just more choices now.

Brendan Mullooly: And part of what they're doing too, is instead of having the star mutual fund manager, you can deconstruct what these managers are doing and see, oh, okay, they were just targeting value stocks or they were doing momentum under the hood. And then you can systematize that and create an index that replicates what the manager was doing, and actually it probably does it in a more consistent manner than a human being who has to push the buttons because they have feelings and can do different things. So, you can create basically robot versions of these managers, and then instead of paying them 1% a year to run a mutual fund, you can charge 10 basis points for an index that tracks a value stock picking methodology, and just cut the person out and get the same results.

Tom Mullooly: But I think this is, again, the next step in the evolution of investing for folks, because we're going back 100 years, 1910s, 1920s, they had unit investment trusts, and it was basically a basket of stocks. Unit trusts are still around today, and you can buy a basket of stocks or a basket of bonds the same way. If you want to pay a sales charge to do that, God bless you. But you don't need to do that. And then in the '30s, they came out with closed end funds, which traded on an exchange, limited number of shares. They almost always trade and traded at a discount. There was a lot of scandals that happened through the '30s. So closed end funds basically got shut down. And then in the '40s, when we had the 1940 Act, that basically opened the door for mutual funds as we know them today, these open end mutual funds.

Tom Mullooly: So I think exchange traded funds are just really the next step in the evolution. Closed end funds came back in the '80s as products to sell. I know I did a ton of them. But ETFs, I vividly remember telling clients in 2004, 2005, that ETFs, exchange traded funds, are going to overtake mutual funds in probably the next 20 or 25 years, because they're a little more tax efficient. They have lower costs. You can get the diversification that you need without really laying out a lot of money.

Casey Mullooly: How are ETFs more tax efficient than mutual funds?

Tom Mullooly: Well, I guess the answer to that is with a mutual fund, they have to account for each of the positions that they own. So you may buy a mutual fund. We're recording this in September. You may buy a mutual fund in September, and then before the end of the year in the fourth quarter, the fund unloads a position, say IBM. Now they may unload this thing entirely. They bought that stock 20 years ago at a much lower cost. So the entire capital gain for 20 years gets fed to you as a mutual fund shareholder. Even though you may have only owned shares in the mutual fund for 30 or 60 days, you get this long-term capital gain out of nowhere that you have to report and pay taxes on. Very, very few exchange traded funds are in that position. There are some where you will get a capital gain distribution, but it's pretty minimal. Would you agree?

Brendan Mullooly: Yeah, I mean, at least from my understanding, it seems like kind of a loophole that ETFs are able to use and I think it should be extended to mutual funds too. I don't see why they should be treated any differently. So that would set them on a level playing field. So, I've heard that argued before, and I tend to agree with it. I don't know why they are treated differently, but that is the difference there. If you're talking about a retirement account, then there's no difference, and I think that's part of the reason why ETFs have yet to surpass mutual funds. I don't think that they probably will until and when ETFs become a part of retirement plans, meaning 401(k)s, 403(b)s, 457 plans. I don't know why they would. There's no reason to, at this point, when you can ...

Brendan Mullooly: As long as the 401(k) plan menu is using index-based mutual funds, meaning your Vanguards, Fidelitys of the world. The Fidelity 500 Index or the Vanguard 500 Index that costs two or three basis points, that's no different than owning the ETF version of the S&P 500. Just as good, and in a retirement account tax efficiency is moot.

Casey Mullooly: I know the article also mentioned that target date funds in retirement plans is another potential reason why we're seeing these fees coming down. It's just because all the funds are wrapped up in another fund.

Brendan Mullooly: Yeah. Well, so we come across that though, where people have used the target fund from their retirement menu, because they didn't know what to put together on their own. So they figure, all right, I'll use whatever year is closest to my targeted retirement and do that. And honestly, you could do way, way, way worse than that, so I am all for it. However, under the hood of target date funds, it varies in terms of what the costs are because it's fund to funds. So you could get an index based one, like Vanguard's target funds are four funds. It's a blend of their total stock, international stock, total bond and international bond funds, balanced to be a good mix, but then you could get some other fund families, one that has 12 different funds, all of which costs 75 basis points or 1%.

Casey Mullooly: You can't just throw a blanket over and say, "Target date funds are cheap."

Brendan Mullooly: Yeah, because they're not.

Tom Mullooly: Yeah, they're all different.

Casey Mullooly: So it depends. But I just wanted to share some numbers from the article quickly, because they're pretty eye-opening. So we were talking about active funds versus "passive funds" before. So active fund expense ratio has peaked in 2000 at around 1%. Now the average active fund expense ratio is down to 0.66%.

Tom Mullooly: Well, I think it's important that people understand the difference between active and passive. So active means that there's someone actually, there's the guy behind the curtain like in the Wizard of Oz. There's a stock picker there, and it might be a committee, but there's someone in who's making-

Casey Mullooly: Or a formula now.

Tom Mullooly: Right. Who's making active changes.

Casey Mullooly: Algorithm.

Tom Mullooly: Yeah.

Brendan Mullooly: The whole thing gets blurred though, because you have a person at an active mutual fund. That's very cut and dried. That's an active fund. Passive fund is S&P 500 Index fund. However, as I stated before, we now have these ETFs that are using a systematic value process, and people will call that an index and call that passive.

Tom Mullooly: But it's not.

Brendan Mullooly: I would say it's probably somewhere in between. So it's active in the sense that it's not tracking a plain vanilla index. However, the fees are more similar to passive in most cases. So I think the big distinction, which I'm borrowing this from somebody else, is low fee versus high fee, rather than active versus passive.

Tom Mullooly: That's Meb Faber.

Brendan Mullooly: Right.

Tom Mullooly: He just said that on the podcast.

Brendan Mullooly: So people are choosing lower cost funds, and it's not necessarily because they want plain vanilla S&P 500 Index. They might be doing something different, but they would rather pay 10 basis points for a low cost value strategy than 100 basis points for a mutual fund manager who is also running a value strategy.

Tom Mullooly: Right. So I think that when you look at a value strategy or a momentum strategy, somebody, whether it's an algorithm or some investment committee, has to be making changes based on their rules. Like, hey, we're going to reconstitute this portfolio once a quarter or twice a year or once a year.

Casey Mullooly: Right. So rules-based is passive.

Tom Mullooly: It's considered passive, but I really kind of think it's leaning more towards active. Don't you? Because there are changes coming, even in the S&P 500-

Casey Mullooly: Right. So truly passive is just you own one stock and you hold it forever and you don't do anything with it.

Brendan Mullooly: Yeah. I don't even like the moniker of active or passive because I don't really know.

Tom Mullooly: It's misleading.

Brendan Mullooly: Well, passive is the S&P 500 or the Dow, which are both run by rules and/or committees or things anyway.

Tom Mullooly: So they're making changes.

Brendan Mullooly: Right. I don't know. And it doesn't matter. It doesn't actually matter if it's active or passive. It matters how the strategy is run. Meaning systematic is repeatable, low cost is better than high cost.

Tom Mullooly: I think sometimes when people in our industry and close to our industry hear active management, they think of someone who's on CNBC making portfolio changes week-in and week-out. Active means, well, hey, we're doing something. And like you said, I agree. I don't think it's really relevant to focus on, well, this is active versus passive.

Brendan Mullooly: Yeah. I think active as the other end of the spectrum from passive is more so you have system on one side versus discretionary on the other. And I agree, if that's actually what people are thinking when they're saying active versus passive, then I agree that most people should want to be passive, because I don't think it's worthwhile to pay somebody to do discretionary stock picking and pay them a high fee for doing it. Doesn't make sense to me. Low cost system, because I know what I'm getting and I'm paying next to nothing for it.

Casey Mullooly: So passive funds, their fees have always been lower. Well over the last 20 years, at least, according to the Morningstar research. 20 years ago, the average passive fund cost 35 basis points and now it is down to just 12 basis points.

Tom Mullooly: Yeah, we've seen some index funds that are three basis points, four basis points. So yeah, 12 basis points is an average and that's really cheap.

Casey Mullooly: It's a big difference from the "active funds", but it's clear that more people are paying attention to these expense ratios. I mean, we've seen, I don't have the numbers in front of me, but more inflows, so more money flowing towards low cost, I guess you could call it, passive investing. So, we'll see if that trend continues. If the lower expense ratios go, I think that's only better for investors. So this is a trend that we'd loved to see play out, and hopefully it continues to go from there.

Casey Mullooly: That's going to do it for this episode of the podcast. We hope you got some good takeaways and now have a better understanding of why investment fees and expense ratios for investing products are so important to the long-term investor. We want to thank you again, as always, for listening, and we'll see you on episode 373.