Fund Managers, Active Mutual Funds, & Capital Gains - Transcript

Tom Mullooly: Welcome to the Mullooly Asset Management podcast. I'm one of your co-hosts, Tom Mullooly. This is Episode 228.

Brendan M: This is Brendan Mullooly, the other co-host. I have a podcast episode that I want to lead off talking about today.

Tom Mullooly: Okay.

Brendan M: This was an episode, I think this week, of the Trillions podcast

Tom Mullooly: Oh, the Bloomberg, yeah-

Brendan M: ... Eric Balchunas.

Tom Mullooly: Right.

Brendan M: And so they were recently talking to Peter Kraus from Alliance Bernstein, who is starting this new type of company that uses performance fees for mutual funds. And I thought this was a really interesting discussion. So I wanted to share a little bit about it to start off today. But they were basically talking about this structure that they're going to ... They want to put it out. And it's performance fees for active managers, because nobody should pay a fee to get a closet index fund, because that's why these numbers look so poor for active funds, in terms of who beats the index after costs.

Tom Mullooly: Isn't it becoming more ... I mean if you're going to be an active manager like that, isn't it becoming more like a hedge fund.

Brendan M: We've got all these passive funds that mirror these indexes. I'm sure this isn't what you wanted to talk about. But if we're going to compensate the active fund managers for trying to beat yard sticks, then why don't you pay them two and 20. The unique thing that they talked about that I liked was that obviously these managers are still going to operate within a framework, because like you said, if you wanted like this go anywhere do anything just outperform, I don't care ... Like you either allocate to that as like a hedge fund, where you give them your money and let them do whatever they want, or if you're like an advisor putting together a portfolio for somebody, that doesn't really like, at least personally for me, that doesn't work. Like if I want to fill a role in the portfolio, I want to know like what you are going to provide me. Like are you a large cap value manager? Here's your benchmark and like outperform it. If you're going to do it by just like saying your large-cap value and then owning small cap growth stocks, then that's stupid.

Tom Mullooly: I think the problem is for a lot of individual investors they're going to be chasing the hot ticket. So last year small-cap growth, why would I want a large cap value guy this year. And so they're going to be-

Brendan M: Advisors will do that too.

Tom Mullooly: Advisors do do that. So they're going to be chasing their tail all the time. I think for clients that are sub $5 million, picking that number out of thin air, I don't know if they really want to get specific. I think what they really want, answering for them what they like, but I think it would be better if they had the idea of what an investment advisor is, and what a stockbroker in thought, used to be. Or people thought they were, is a manager of managers. Hey we're going to have different players on our team. We're going to have a large cap value guy. We're going to have a small cap growth guy. We're going to have emerging-market ... Right. We're going to maybe even drill down into specific niches of the market sectors. But they're not all going to shoot the lights out all at once. We'll have some guys that are in a slump. Some guys who are carrying the team. That's the way it works.

Brendan M: Yeah, again I think that that is the way to build a portfolio. And that's where, at that level, where you're looking to fill a role, do we want to be active or do we want to be passive? But their conversation was more like compensation structure of performance fees has been criticized in the past because it incentivizes the manager to take insane amounts of risk to be an arbitrary benchmark over a one-year time frame or whatever it may be, because they're not going to get paid if they don't outperform. So you're not going to get what you want. You're going to get more risk than ... They're going to take risks, and if they don't beat the benchmark, you are the one bearing the brunt of that for performance. And obviously they're not getting paid, but like that's a mismatch so their alternative to that was saying, you're going to get a performance fee, but it's going to be paid on a differed basis. So you have to outperform ... Like don't get to the fourth quarter of this year and be lagging your benchmark.

Load up, take a ton of risk, and then outperform for this year and then blow yourself up next February so you can do it all over again next year. Because then you're just taking double the risk of your benchmark, to do crazy crap with people's money. So if you defer it and say you need to have a long-term approach, because we are going to pay you based on performance that actually takes place over a long period of time. And if you're just taking insane risk to get it, we're not going to pay you. And you're not going to get the deferred payment. Because if you trail the benchmark by too much, we're going to be able to tell if you're just like loading up in the fourth quarter for the home stretch because that's ridiculous.

Tom Mullooly: On paper, makes sense. I just don't know if it would work in reality. Because first of all, this is a compensation driven industry. Fund managers, I don't think are going to stay-

Brendan M: They're going to lose their jobs anyway if they don't reinvent themselves.

Tom Mullooly: Okay.

Brendan M: These funds are closing.

Tom Mullooly: If they take a lot of risk and blow themselves up they're going to be out of a job. And they're going to move down the street to some other firm, and they're going to start all over again. Hey I was eight years doing this large cap value strategy. Okay so a couple of questions come into my mind. Who's going to stick around long-term? Because on that side of the ledger, not our side, but for the fund manager side, you're as good as your last trade. Or you're as good as your last quarter, right? Or even your last year. I don't think that that whole part of the industry is geared for that. And who's going to pay for that? Where's that bonus money coming from? It has to come from the extra cost, that you're going to pay. So why am I paying today, expense ratios that are higher than normal, for a guy who did great last year or two years ago, and now he's getting his deferred compensation?

Brendan M: I don't know exactly how they're going to structure it, but that's not how I understood it. Like you're going to pay the performance fee, and they're not going to pay it out to the person until like a year or two or three down the road, to make sure that they didn't just do some crazy shit, so that they could they could beat their benchmark for a quarter or a year. And they need to see that performance down the road to make it worthwhile.

Tom Mullooly: You didn't tell me there was a vesting schedule.

Brendan M: That's what I was trying to ... It was deferred compensation. I thought that's basically what I was trying to get at. But yeah, that's how it would work. And I thought that that was interesting because-

Tom Mullooly: It's different.

Brendan M: When you look at what active managers are being incentivized to do today, that's why we have so many index hugging active funds that charge high fees that they don't deserve. And I agree it's not going to be an easy sell. Telling somebody today who earns, who's fund charges one and a half percent and hugs the benchmark, that this is going to be the new scheme. But I think that what this guy was saying, he's starting this new thing, I don't think he's with Alliance Bernstein anymore. He was like we're starting this company because we want these like hungry active managers who want to like do work under this incentive structure. And we think that we're incentivizing them better than current active managers are incentivized to do their job.

Tom Mullooly: All right, so let's be clear, this guy is not going to be working for Kevin O'Leary and O'shares or anything like that?

Brendan M: No. It's just ... I thought it was a unique take. I don't know how much I agree with it or if I would definitely allocate money to these managers. But I think it's, the way that he was positioning it, and I think Eric and the other people on the trillions podcast felt similarly, is like active guys have to do something. So if they're not willing to move to this structure, they got to start thinking about how they're going to reinvent themselves-

Tom Mullooly: They really do.

Brendan M: These funds are closing down in droves. And it's not going to stop.

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Tom Mullooly: I think for the benefit of our listeners, it would be worthwhile to spend 30 seconds talking about what happens or what has happened in past years when you have an open end mutual fund that doesn't perform. What happens to it?

Brendan M: It could get closed. Or it could ... I mean we've even seen good mutual funds that have beaten their benchmark see outflows because of this migration to low-cost. Because if you're in some large-cap fund and it's not really doing anything much different than the S&P 500, sure that's a good way for the manager to just like mask like what they're doing. Like they're not doing anything bad, so they're not going to like blow anybody up and lose the business. But they're also not out there beating the benchmarks.

Tom Mullooly: Well I also think it's important you know for individual investors to understand that when you're comparing mutual funds, if there's a mutual fund out there that's been lagging its benchmark significantly, and for a long period of time, the fund managers going to be unemployed. And if it really continues, they're going to close the fund. And those shares will get merged into some other fund in the fund family. And then that whole track record disappears.

So when you're talking about mutual funds, and you talk about all these funds that can't perform, outperform their benchmark overtime, what's not included are all the funds that were closed.

Brendan M: They're not included in the studies. And this kind of ties in to another article that I wanted to talk about this week. Oftentimes, this is not to say that these are stupid people or like bad managers running the funds.

Tom Mullooly: Of course not.

Brendan M: Their job is really hard. When you layer on some costs to out preform an index, and I don't know, I think that the way the active industry is headed, there is a role in portfolios depending on what kind of asset class you're talking about, to have an active manager. But if you're going to pay somebody to be an active manager, you want to make sure that you're paying for, and being like compensated in return for what you're paying, for active management. And active management, the idea of that isn't that you're going to pay for this active manager and they're always going to outperform.

But like you want to know that they have a process and that they're filling a role in your portfolio and you should try to understand when it will or will not be, you know conducive to their style of management. And why you are going to persist through that? Why you're going to continue owning a fund through that. As long as the management remains consistent. And too often it's not that, it's just like oh, this other one's doing better. And you know, irrespective of like, yeah but that's like a small cap fund, why are you measuring that against the S&P 500? Or international stocks?

Tom Mullooly: It's Hatfield's versus McCoy's.

Brendan M: Right.

Tom Mullooly: It's totally different. And unfortunately I think that's where a lot of investors get tripped up. Like as I mentioned a few minutes ago, small caps did really well in the last 12 months, let's move money into small caps. What about buying some things that are out of favor? What about just owning a cross-section of all of these, because we can't tell you with accuracy when it's time to move into this or out of that. So let's just own different parts of the spectrum.

Brendan M: You come up with the degrees that you want exposure to different areas of the market. And that should be based off of hopefully a plan that you're putting together. And you need to have some reasons why other than just recent performance.

But kind of along the same lines, sticking with like the mutual fund trend here, there was a post ... This was a few weeks ago now, but it was from Jeff Ptak at Morningstar. And it was called Taking a Bath: Lessons from a big funds $9 billion capital gains distribution. And so this refers to a specific mutual fund. But before digging in, there was one study that kind of speaks to one of your earlier points about active mutual funds, and how tough it is for them to do their job, and outperform over regular periods of time.

Tom Mullooly: Right.

Brendan M: Jeff looked at US and foreign mutual funds. Institutional level share classes. So the cheapest ones you're going to get. And compared them to comparable ETF's in the same categories. Like post fees and taxes. Because this article is about tax ramifications of mutual funds. Which is a big deal.

Tom Mullooly: Okay.

Brendan M: So he started with basically 2000 mutual funds, in 1976. And this was over a 10-year period. So after 10 years, 1451 remained. So only three quarters make it through the 10-year period. So it speak to your point about funds getting closed or merged out of existence. Of those funds, you had 679 beat the comparable ETF's before their fees. So that's only 34%, beat a comparable ETF before they charged their fees. Which is obviously not what people got. So taking into account fees, 501, 25% of what we started with, beat their comparable ETF after their fees. And then to take it a step further, if you owned these mutual funds in a taxable account, not tax deferred, in a brokerage account, 325 beat their comparable ETF after fees and taxes. Over a 10 year period. That's 16%.

Tom Mullooly: Right.

Brendan M: That just illustrates how difficult it is for these people who are not stupid, they're smart people doing a good job, they just have a lot of things working against them here. And that's over a reasonable period of time. I'm not saying 10 years is the long term because I don't think it is, but for an individual owning a fund, 10 years feels like an eternity.

Tom Mullooly: Sure it is. For some people 10 minutes is an eternity.

Brendan M: Right. To move on to like the bigger point. So this article was specifically about this Harbor International fund.

Tom Mullooly: I know it well.

Brendan M: Right. Good fund, and Jeff highlighted that. That this fund is sitting on $4.5 billion in unrealized gains. Or was before this. That that is reflective of good management, low turnover, and a long-term approach. Which are all things that you want from an active manager.

Tom Mullooly: Exactly what you want.

Brendan M: You want all of those things.

Tom Mullooly: That's right.

Brendan M: But, when you own this mutual fund, and it has these unrealized capital gains, it has to do things like this year, the fund has seen outflows over the last couple years, like a lot of active funds, but they also decided to change management this year for whatever reason. I didn't really look into that too much. But combine those two things and it's paying out $23 to $27 a share, in distributions this year. Which is 38% of its NAV.

Tom Mullooly: Wow.

Brendan M: And so these are, if somebody owns this in a brokerage account, these are taxable events for them, that they have to own this year. And they're being basically punished for sticking with a good manager with a long-term approach to international stocks.

Tom Mullooly: Before we get into the other points of this, I just want to point out to individual clients or investors who get this, understand this, in the taxable account what happens, you get the $27, was that the distribution?

Brendan M: Yeah between $23 and $27 a share.

Tom Mullooly: So you're getting this large distribution, I mean 38% of the fund is being distributed to you. You're going to get a 1099, that's going to show this capital gain. If you're reinvesting it, it gets added to your cost basis. But you still have to pay the taxes even though you did not do anything. You've been sitting still with this long-term investment. It's going to be a significant tax bill.

Brendan M: And obviously, so like you eluded to, the benefit down the road is that you've paid out a large part of this, you have a higher cost basis. So when you do make that sell decision to move on, and do whatever you want with your money, you're not going to have as much of a taxable gain then, because you've paid it along the way.

Tom Mullooly: You've been paying along the way.

Brendan M: But the idea of not having control over when to recognize those taxes, is tough because you may not want to pay the taxes on this year, but if you own the fund, you don't really have a choice.

Tom Mullooly: That's painful. I mean the conversations we have with some of our clients that have taxable accounts, they're like I can't sell anything anymore, the rest of the year don't sell anything. Because I'm already paying too much in taxes. Wait till next year. We've got one hand tied behind our back when that happens.

Brendan M: Right.

Tom Mullooly: So in this case, this is a mutual fund that no one's expecting, unless it's, you know people like us, that are in the business, and we read this stuff or Jeff who wrote about it-

Brendan M: There are ways on ... So some of the things he talks about are obviously that ETF's do not have this issue. So in a taxable account, it may be better to find, if you wanted international stocks, to find an ETF that accomplishes the role that you were looking to fill in the portfolio, as opposed to an active mutual fund.

Tom Mullooly: Right.

Brendan M: Alternatively it's not as if this information is like-

Tom Mullooly: It's not a secret.

Brendan M: So like if you bought the fund right before this, shame on you kind of, or your advisor. Because like you can find this stuff out.

Tom Mullooly: Right.

Brendan M: So he was like look, if you're going to look for an active fund and you want to own it in a brokerage account, as uncomfortable as it may be, the best time to to do that in a taxable account maybe at like during or right after a bear market.

Tom Mullooly: Sure.

Brendan M: Because these people have probably racked up losses that they can use to offset gains. You can also look for funds that have good management structure, like people doing this kind of stuff, a long-term approach that has just been out of favor recently. Because they're also going to have losses to pair with gains that they are going to have in the future, and they can use that to not have as much of a tax burden on the end investor.

Tom Mullooly: So I know that we have disclaimers and disclosures wrapped around this podcast, but I think it's important to mention that if we're talking about a mutual fund, we're not soliciting orders. So we're not sending anybody our prospectus.

Brendan M: No, I just thought it was a good example and Jeff kind of used it as a case study in his post for Morningstar. I liked it and I thought it illustrated a good point, that we talk to investors about all the time. Which is you know these tax advantages of owning an ETF in a brokerage account. I mean cannot be overstated I don't think.

Tom Mullooly: Right. When the fund manager wants to ring that bell, it's really-

Brendan M: Often times it's not even their choice. Like as they're seeing outflows-

Tom Mullooly: They're getting requests for redemption, they got to go.

Brendan M: Yeah, and at some point if they are using ... They're obviously going to be intelligent about how they sell. They're going to pair gains and losses to the extent that they can. But eventually you reach a point where you can no longer do that. And your only choice is to sell appreciated assets. You have to sell some winners because if you have redemption's, it is what it is.

Tom Mullooly: You know that kind of raises another point. Totally out on a tangent. But something that we don't hear enough about, and we usually only hear about in a crisis point, is we talk about how these mutual fund managers will pair gains with losses to try and manage the tax hit to the mutual fund shareholders. But along the same lines, when the markets are in a panic, you know if you got clients that are on margin, or they're trading with razor-thin margins. Not that they're on margin. But usually the first things to go or not the worst investments. They're the most liquid things first. Which are usually the best investments. It sounds counterintuitive, but when you need to raise money in a hurry, you're not going to be saying okay I need to throw away this bond position that only trades by appointment, I can't get anybody to bid on it. So what else am I going to sell? Well I'll have to sell all the GE in the account. Because it's the most liquid thing and it's down for the year. And just throwing stuff away. And this is what we see in these runaway markets, on the downside, is that they're going to throw away a lot of the good stuff. Because they have to raise cash to meet redemption's or just to have cash on hand. So a lot of good stuff gets thrown away.

Brendan M: Yeah, and so I think, it makes me think of like these people who say that the next time the market crashes, it's going to be worse because of like index funds somehow. As if active managers don't also have to indiscriminately sell when they face redemption's. So if somebody's entering like a sell order on their active mutual fund, what's the difference between that and them going to the market and selling their shares of the S&P 500? The active manager probably owns most of the same stocks in similar proportions to the S&P 500 anyways. So the selling is going to be there regardless.

Tom Mullooly: Yes.

Brendan M: It's just a vehicle people are going to do it with. So people that I maybe have been losing assets to, ETF's or otherwise threatened by them, I think like to demonize them a lot or even just index funds in general, index funds and ETF's get like lumped together and said that they're going to somehow like cause a market crash. Which I think is just ridiculous.

Tom Mullooly: I think the concern for folks in the industry is the unknown number of, this is such a terrible phrase. Hot money traders or portfolio folks that are sticking money in a big index like SPY. S-P-Y. That's the S&P 500 ETF. Or the NASDAQ index, the Q's. So how much hot money is actually in those indices, and you know when they want to pull the trigger and raise cash or you know otherwise move on, you know how much of that is going to be up for sale? It's a good question.

Brendan M: I know you don't know the answer to this, but I'm going to ask anyway. But like where in the past was that money? Was it just like, did it not exist? Like was it not just in the stocks themselves or in like an active mutual fund? So like there's been hot money going back since the beginning of time. So I'm not sure that ... Like sure they're going to sell and it's going to sell, like if they're selling SPY it's going to send the S&P 500 down, because they're selling the stocks that make it up. But like they would be selling something regardless, and it would probably have ramifications on the index anyway. Wouldn't it?

Tom Mullooly: That's right. It's got to come from somewhere.

Brendan M: Yeah, just like I don't know how much I buy, that that's going to be ... I'm sure people will make the case, I just I don't think.

Tom Mullooly: Oh we'll read stories about it, that's a guarantee.

Brendan M: Yeah like ETF's cause the market crash or something like that. You should own my precious metals mutual fund instead or something ridiculous garbage.

Tom Mullooly: That's backed by cryptocurrency or something like that. And leverage with futures and options.

Brendan M: Right.

Tom Mullooly: Okay that's going to wrap up episode 228. Thanks for listening and we will catch you on the next podcast.