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Comparing Mutual Funds To ETF's And SMA's

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In two of my recent columns, I described the questionable behaviors of mutual funds and the costs of mutual funds. I presented a lot of bad news. Sorry about that. But I also promised to discuss alternative ways of investing. I am going to do that now.

When it comes to investing your money, you of course have choices. One of those choices is whether or not to invest in mutual funds, exchange traded funds (ETFs), or separately managed accounts (SMAs). These investments can be quite different, and it can be hard to know which might be right for you. So, here's what I've done. I have identified six investment criteria that I think you should consider. For each of the six criteria, I will identify a winner. Ready? Here we go.

Criteria #1: Tax efficiency

Mutual funds can suffer from an embedded capital gains problem. This problem occurs because when you buy a mutual fund, you are not directly buying the securities in the fund. Instead, the fund directly owns those securities for you, and you just own shares of the fund. This means that the cost basis of the fund's securities (used for calculating taxes) is not determined by when you purchased the fund, but instead depends on when the fund purchased the security. This sounds kind of confusing, so I will use an example. Imagine that you buy a mutual fund today, and it contains stock XYZ which is currently valued at $100 per share. A few weeks later, XYZ stock has fallen to $80 per share. Therefore, the value of your mutual fund has declined (assuming all else stays the same). If the fund decides to sell stock XYZ, then it may have to pay a capital gains tax. Why? The fund may have purchased the stock at $50 per share some time ago. So, because the fund will realize a capital gain when it sells XYZ stock for $80, it has to pay a capital gains tax. Because you are a part owner of the fund when XYZ is sold, you share this tax burden, even though the value of your mutual fund investment has declined. Does this seem fair to you? I do not think so. ETFs can also suffer from some tax inefficiency, because if an ETF portfolio manager decides to change the ETF's portfolio composition, then the ETF may realize capital gains. Like a mutual fund, the cost basis used for those capital gains is determined based on when the ETF purchased the security, not when you purchased the ETF. But in my experience, ETFs' embedded gains are smaller and less frequent than mutual funds'. With SMAs, you can avoid embedded capital gains altogether. When you invest using an SMA, you are directly purchasing the securities. The cost basis of the securities in SMAs are based on the day and price that you purchase them. **The winner for this criteria: SMAs**

Criteria #2: Tax loss harvesting on individual securities

When the value of your stocks goes down, you can either hold onto them or sell them. There can be an advantage to doing the latter. When you sell stocks at a loss, you reduce your aggregate capital gains and can reduce your taxable income (up to a limit). This is known as tax loss harvesting. However, investors in mutual funds and ETFs cannot tax loss harvest on individual securities because mutual funds and ETFs are bundled investments. For example, if stock ABC in a mutual fund or in an ETF suffers a huge loss, you are not able to strip off stock ABC from the fund to realize your loss on ABC. But when investing in SMAs, because you directly own those securities, you have the ability to sell just ABC to take advantage of the tax savings. **The winner of this criteria: SMAs**

Criteria #3: Hidden costs due to commingle investors

When you buy a mutual fund, you don't directly own the securities in the fund. Instead, the mutual fund owns those securities for you and also for all of the other investors in the fund. This means that you are a commingled investor, which can be a problem. When the mutual fund trades on behalf of its other investors, it can impose hidden costs on you. For example, when other investors in the fund buy or redeem fund shares, the mutual fund typically has to make trades to satisfy those transactions and pays brokerage commissions on those trades. Because you are a part owner of the fund, you share in the cost of these commissions even if they are incurred because of other investors. (There are other sources of hidden costs, too.) ETFs and SMAs do not suffer from these hidden costs. The only trading costs that you will incur in an ETF or SMA is when trading is done directly on your behalf. **The co-winners: SMAs and ETFs**

Criteria #4: The possibility of outperformance

It has been well documented that mutual funds tend to underperform. The reasons for the underperformance include mutual funds' tendencies to suffer from over diversification, agency conflicts, institutional pressures, and hidden costs. I won't go into the details of these reasons because, after all, I think what really matters to you is that mutual funds simply underperform. Disappointing performance is probably why many investors are switching from mutual funds to ETFs. However, you should keep in mind that ETFs are often explicitly linked to a benchmarking index. This means ETFs are unlikely to outperform, simply by design. For example, an ETF based on the S&P 500 is not trying to outperform the S&P 500. Oddly enough, however, there is some evidence that ETFs can even underperform their benchmarks. But SMAs can outperform. Because SMAs are professionally managed and do not suffer from hidden costs, it is possible for them to beat benchmarks. Indeed, for many years, investing via SMAs is how some institutional investors and the extremely wealthy have been able to obtain outperformance in their investments. **The winner of this criteria: SMAs**

Criteria #5: Questionable behavior

There are many, many mutual funds out there. And they are all competing for your business. So, it may come as little surprise that many mutual funds have been caught engaging in questionable behaviors while competing for your investment dollars. I have previously written on this topic. For example, mutual fund managers can mislead you about their funds' past performance. One way this can be done is called incubation. Mutual fund companies can create a bunch of random portfolios to see how they perform, and then only market those that performed well. Much of the time the outperformance is key to their marketing efforts, but the outperformance is often not due to skill because, as in baseball, if you swing enough times you're bound to get a hit. Another trick that mutual fund managers may engage in something known as window dressing. Here is an example. Right before a mutual fund reports its quarterly holdings, it can buy stocks that had good performance and sell stocks that had bad performance. Please understand that picking past winners does not mean that the fund gets those past returns, and that selling past losers does not mean that the fund did not suffer those losses. But a fund may engage in this kind of behavior so that it will look like it had picked winners all along while hiding that it had actually picked losers. I am not aware of any evidence that managers of ETFs or SMAs engage in this kind of questionable behavior. **The co-winners of this criteria: SMAs and ETFs**

Criteria #6: Excluding stocks for ethical or moral reasons

Some people feel so committed to their morals and values that they wish to invest in a way that is consistent with those beliefs. For example, maybe someone who is strongly opposed to drinking and driving does not want to own stock in firms that sell alcohol. Or, maybe someone who is against underage smoking does not want to own stock in firms that sell cigarettes. People who wish to invest according to their values and conscience cannot request the exclusion of specific holdings when buying mutual funds or ETFs. This is because mutual funds and ETFs are bundled investments. However, with SMAs, this kind of portfolio customization is possible. Investors in SMAs can often exclude alcohol firms, tobacco firms, or other specific firms. **The winner of this criteria: SMAs**

So what should you do?

In the 21st century, investing in flawed mutual funds can be a thing of the past. The historical problem was that you had to be super wealthy to have access to SMAs. While that might have been true in the twentieth century, that’s not true anymore. Ask your financial advisor about investing in SMAs, so that you can start investing like institutional investors and the super wealthy. If your financial advisor cannot give you access to SMAs, then maybe you have to take it upon yourself to find advisors that can. After all, it’s your financial future that we are talking about here.