Chapter 9:
Investing in Investment Funds

Introduction

1. One course open to the defensive investor is to put his money into investment-company shares.

   Mutual fund (open-end funds)

   Close-end funds

2. Fund classifications:

   1) by the broad division of their portfolio: “balanced funds” & “stock funds”

      other varieties, such as “bond funds,” “hedge funds”, funds,” “letter-stock funds,” etc.

   2) by their objectives, as their primary aim is for income, price stability, or capital appreciation, “growth funds”

   3) by their method of sale: “load funds”, “no-load funds”

3. Most of the companies operate under special provisions of the income-tax law, designed to relieve the shareholders from double taxation on their earnings. In effect, the funds must pay out virtually all their ordinary income—i.e., dividends and interest received, less expenses. In addition they can pay out their realized long-term profits on sales of investments—in the form of “capital gains dividends” - which are treated by the shareholder as if they were his own security profits.

Introduction – cont.

4. Many of the companies that state their primary aim is for capital gains concentrate on the purchase of the so-called “growth stocks,” and they often have the word “growth” in their name. Some specialize in a designated area such as chemicals, aviation, overseas investments; this is usually indicated in their titles.
5. In this chapter we shall deal with some major questions:
    1) Is there any way by which the investor can assure himself of better than average results by choosing the right funds? (Subquestion: What about the “performance funds”?)
    2) If not, how can he avoid choosing funds that will give him worse than average results?
    3) Can he make intelligent choices between different types of funds—e.g., balanced versus all-stock, open-end versus closed end, load versus no-load?

Investment-Fund Performance as a Whole

Table 9-1 gives some calculated results for 1961–1970 of our ten largest stock funds at the end of 1970.

TABLE 9-1 Management Results of Ten Large Mutual Funds[a]

	(Indicated) 5 years, 1961–1965 (all +)	5 years, 1966–1970	10 years, 1961–1970 (all +)	1969	1970	Net Assets, December 1970 (millions)
Affiliated Fund	71%	+19.7%	105.3%	–14.3%	+2.2%	$1,600
Dreyfus	97	+18.7	135.4	–11.9	–6.4	2,232
Fidelity Fund	79	+31.8	137.1	–7.4	+2.2	819
Fundamental Inv.	79	+ 1.0	81.3	–12.7	–5.8	1,054
Invest. Co. of Am.	82	+37.9	152.2	–10.6	+2.3	1,168
Investors Stock Fund	54	+ 5.6	63.5	–80.0	–7.2	2,227
Mass. Inv. Trust	18	+16.2	44.2	– 4.0	+0.6	1,956
National Investors	61	+31.7	112.2	+ 4.0	–9.1	747
Putnam Growth	62	+22.3	104.0	–13.3	–3.8	684
United Accum.	74	– 2.0	72.7	–10.3	–2.9	1,141
Average	72	18.3	105.8	– 8.9	–2.2	$13,628 (total)
Standard & Poor's composite index	77	+16.1	104.7	– 8.3	+3.5	
DJIA	78	+ 2.9	83.0	–11.6	+8.7	

[a] These are the stock funds with the largest net assets at the end of 1970, but using only one fund from each management group. Data supplied by Wiesenberger Financial Services.

Investment-Fund Performance as a Whole – cont.

1. We find that the overall results of these ten funds for 1961–1970 were not appreciably different from those of the Standard & Poor's 500- stock composite average (or the S & P 425-industrial stock average). But they were definitely better than those of the DJIA.
2. A second point is that the funds' aggregate performance as against the S & P index has improved somewhat in the last five years, compared with the preceding five.
3. We do not think the mutual-fund industry can be criticized for doing no better than the market as a whole. Their managers and their professional competitors administer so large a portion of all marketable common stocks that what happens to the market as a whole must necessarily happen (approximately) to the sum of their funds.

“Performance” Funds

1. In the first place, and on this very point, nearly all these brilliant performers were young men—in their thirties and forties—whose direct financial experience was limited to the all but continuous bull market of 1948–1968.
2. Secondly, they often acted as if the definition of a “sound investment” was a stock that was likely to have a good rise in the market in the next few months. This led to large commitments in newer ventures at prices completely disproportionate to their assets or recorded earnings.
3. The foregoing account contains the implicit conclusion that there may be special risks involved in looking for superior performance by investment-fund managers. All financial experience up to now indicates that large funds, soundly managed, can produce at best only slightly better than average results over the years. If they are unsoundly managed they can produce spectacular, but largely illusory, profits for a while, followed inevitably by calamitous losses.
4. But these have been scarce exceptions, having most of their operations in specialized fields, with self-imposed limits on the capital employed—and not actively sold to the public.

Closed-End versus Open-End Funds

1. Almost all the mutual funds or open-end funds, which offer their holders the right to cash in their shares at each day's valuation of the portfolio, have a corresponding machinery for selling new shares. By this means most of them have grown in size over the years.
2. The closed-end companies, nearly all of which were organized a long time ago, have a fixed capital structure, and thus have diminished in relative dollar importance.
3. Open-end companies are being sold by many thousands of energetic and persuasive salesmen, the closed-end shares have no one especially interested in distributing them. Consequently it has been possible to sell most "mutual funds" to the public at a fixed premium of about 9% above net asset value (to cover salesmen's commissions, etc.), while the majority of close-end shares have been consistently obtainable at less than their asset value.
4. Thus we arrive at one of the few clearly evident rules for investors' choices. If you want to put money in investment funds, buy a group of closed-end shares at a discount of, say, 10% to 15% from asset value, instead of paying a premium of about 9% above asset value for shares of an open-end company. Assuming that the future dividends and changes in asset values continue to be about the same for the two groups, you will thus obtain about one-fifth more for your money from the closed-end shares.

Investment in Balanced Funds

1. It would appear more logical for the typical investor to make his bond-type investments directly, rather than to have them form part of a mutual-fund commitment.
2. The better choice for the bond component would be the purchase of United States savings bonds, or corporate bonds rated A or better, or tax free bonds, for the investor's bond portfolio.