Mutual Funds: Parallaxes and Taxes

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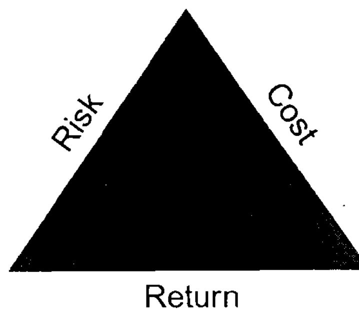
Often, a small change in vantage point can engender a large change in perception. So it is with the parallax, exemplified by the angle created by the 2 1/4 inch distance between our eyes, which enables us to visualize objects in three dimensions. Today, mutual funds are too often viewed on a two-dimensional basis—*return* and *risk*—so I'd like to look at a third dimension: *cost*. Included in costs are both fund operating expenses and portfolio transaction costs, *and* taxes paid by fund shareholders. "Parallaxes and Taxes" is my theme, not only because of its vaguely rhythmic quality, but because far too many mutual fund portfolio managers and fund shareholders ignore the third dimension: cost. Cost is part of what I call "The Eternal Triangle of Investing." In particular, fund investors ignore the impact of the cost of taxes on their returns. With an estimated $600 billion of capital gains on the books in mutual fund portfolios today, it is high time that the subject of taxes receives the exposure it deserves.



Given the remarkable increase in potential tax liability that has come hand-in-hand with the great 15-year bull market in stocks we have enjoyed, it's especially timely to discuss this third dimension of the Triangle. Indeed, as I'll discuss later, some $150 billion of this $600 billion gain will have been realized and largely distributed when 1997 comes to a close, and investors will be paying taxes on these payments in April of 1998.

It's important to point out, however, that the huge unrealized tax liability is a very volatile number, highly sensitive to changes in the level of the stock market. In a market decline, unrealized gains come right "off the

top." A 20% market decline, for example, would eliminate the industry's entire potential post-1997 tax liability, even as a 20% market increase would double it. Please bear this high leverage in mind as you consider the important subject of how taxes impact mutual fund investors.

In any event, these huge gains are a reflection—in fact, a muted reflection—of the gains the mutual fund industry has enjoyed by riding the crest of a bull market that is unprecedented in history. Equity fund assets, which soared from $50 billion in 1982 to $900 billion in 1994, have risen another 2 ½ times to $2.3 trillion in less than three more years. Fund managers now control some 33% of all U.S. common stocks, and fund cash flows are presently running at more that $15 billion per month, mightily contributing to the market's momentum.

But if "riding the crest of the bull market" is an apt description of mutual fund asset growth, it is far too strong a phrase to describe mutual fund performance. "Trailing in the wake" would be a better formulation. For even as funds have assumed their pre-eminent role in the market, their returns have lagged well behind market norms. From December 31, 1994, to October 31, 1997, for example, the Standard & Poor's 500 Index has risen 112% and the Wilshire 5000 Equity Index of the U.S. total stock market is up 106%, but the average domestic equity fund has risen by but 89%.

Booming Markets, but Lagging Alphas

How can it be that professionally managed mutual funds have failed to match unmanaged market averages? Simply put, it *can* be because it *must* be. Because mutual fund managers as a group *are* the market, and simply must, over the long run, underperform appropriately weighted market indexes by the amount of their costs. And their costs are large—and growing. Fund expense ratios have been rising for decades, and equity fund annual expenses now average more than 1.5% of assets. Fund portfolio turnover rates have also soared, presently running near 90% per year, with a consequent escalation in transaction costs, perhaps—although they are difficult to measure with precision—adding another 0.6% to the "fiscal drag" against an equity market in which frictional costs, in the abstract, do not exist. ("The market" as such has no advisory fees and no turnover.) That's a total expected annual shortfall of 2.1% *per year* for fund returns.

This shortfall—engendered importantly by costs—doesn't look like much when subtracted from a market providing a 30% annualized return—and, in fairness, probably wouldn't look like much if returns were, God forbid, "only" 20%. But, over time, it consumes fully one-fifth of a 10% return—to say nothing of confiscating four-tenths of a 5% return. Consider "Alpha," that vital measure of a fund's return relative to the stock market, adjusted to reflect the relative risk assumed by the fund. The statistics are quite clear (*Morningstar Mutual Funds*

is the best-recognized source), and they show that the average mutual fund has provided an Alpha—a risk-adjusted return relative to the market—of -1.9% per year during the past decade. This number roughly equals the industry's estimated annual costs of 2.1%. It is no accident that these figures are normally quite similar.

But alas (from the industry's standpoint), the news is about to get worse. To tell you why, let me move further along the parallax, and view the tax aspect of cost—a vital element in my own three-dimensional view of an industry that is too often looked at in only the two dimensions of risk and return.

Taxes: The Industry's Black Sheep

The tax issue is the black sheep of the mutual fund industry—like the cousin who can't get her life together or the uncle who drinks too much—best kept out of sight and out of mind. If the industry feels that way, however, the shareholder cannot afford to. For it is the shareholder who pays the taxes on a mutual fund's income dividends and capital gains distributions generated by the fund's constant staccato of portfolio sales, and—at least in these halcyon bull market days—the realization of enormous taxable capital gains. The dichotomy is that a portfolio manager's performance is measured and applauded on the basis of *pre-tax* return—never mind that the Internal Revenue Service confiscates a healthy share of it. But the fact is that most portfolio managers simply don't spend much time agonizing over the tax consequences of their decisions.

Ever since the industry began in 1924, it has essentially ignored the tax issue, and in the "good old days" funds were sold as much on the basis of "looking for more income" as on the basis of total return. (In the 1940s and early 1950s, stock yields averaged 8%, bond yields 2 1/2%. Imagine!) Indeed, the industry often sloughed over the difference between income dividends and capital gains distributions, adding them together to arrive at a "total distribution yield," a practice not legally permitted since 1950. In recent years, as tax-deferred IRA accounts and 401(k) corporate retirement plans have come to the fore, tax considerations have gotten even less attention. In fact, investors in tax-deferred accounts are now the driving force in industry growth, accounting for nearly 40% of the assets of equity funds as a group. Investors in these accounts need burden neither their minds nor their checkbooks with tax issues.

But the owners of the other 60% of fund assets do not have the luxury of ignoring tax considerations. Each year, they must pay taxes on the fund distributions they receive. Yet mutual funds do not provide adequate disclosure about the tax implications of their investment strategies, portfolio turnover expectations, and gain realization policies. Look under the "Dividends, Capital Gains, and Taxes" heading in a typical fund prospectus, and you'll find something like: "The fund distributes annually substantially all of its net income after expenses

and any capital gains realized from the sale of securities. Dividends and short-term gains are taxable to you as ordinary income; distributions of long-term capital gains are taxable to you as long-term capital gains." That is proper disclosure as far as it goes. *But it doesn't go nearly far enough.*

Portfolio managers, fund sponsors, and distributors *know* that funds don't pay much, if any, attention to tax concerns. Rather than ignoring this important fact, they ought to call it to the attention of investors. Here's my try at a much-needed prospectus disclosure: "The fund is managed without regard to tax considerations, and, given its expected rate of portfolio turnover, is likely to realize and distribute a high portion of its capital return in the form of capital gains which are taxable annually, a substantial portion of which are likely to be realized in the form of short-term gains subject to full income tax rates." (Some funds might modify the last phrase.)

There would seem to be only two reasons that the disclosure of that known fact doesn't find its way into the prospectus: one, inadvertence; two, some sense that it would hurt the fund's marketing campaign by encouraging investors to focus on the negative impact of excessive taxes on their total returns. Whatever the case, I believe that the sentence quoted should be included as a prominent part—if not the opening sentence—of the disclosure of fund tax considerations in the prospectus. Full disclosure *must* be the order of the day.

The problem—and it is a serious one—created by the relatively prompt realization of capital gains is that taxes must *also* be paid currently. Yet the truly massive value of deferring capital gains taxes seems almost universally ignored. To put it simply: a tax deferred is an interest-free loan from the U.S. Treasury Department, with a maturity equal to the number of years of deferral. Just imagine the value of a ten-year interest free loan—even a 25-year loan. Better still, calculate it. In fact, a $1.00 loan repayment deferred for ten years has a present value of 49¢ (a 25-year loan, 15¢). But perhaps as few as 5% of all fund holdings can expect to be held for ten years and gain that 100%-plus extra profit.

Today I estimate, very roughly, that mutual funds are carrying total capital appreciation of a cool $600 *billion* (25% of equity fund net assets), representing a potential nearby liability to taxable shareholders of some $90 billion. An estimated $450 billion of those gains have not yet been realized, but, holding market prices constant, will ultimately be realized and subject to taxes. Some, $150 billion of this appreciation has been or will be realized and distributed to investors and subject to tax in 1997. This mammoth distribution will be comprised of about $100 billion in long-term gains and $50 billion in short-term gains. Perhaps $60 billion of this $150 billion will be received by investors in tax-deferred retirement programs and $90 billion by taxable investors, carrying an estimated tax liability of more than $22 billion. I can only hope that on next April 15 they will be ready to pay it.

What is more, external circumstances could exacerbate the situation. A market decline which caused net liquidations would *increase* per share distributions. Conversely, rising markets, which bring in new money at ascending prices, *dilute* per share distributions. That is why mutual fund unrealized gains have been small relative to the rise in stock prices. Curiously, investors don't seem to mind paying $10.00 per share for a fund with a tax liability on, say, $2.50 in unrealized capital gains. In a down market, when share prices tumble, it is possible, if not likely, that new fund investors with unrealized losses would nonetheless receive substantial taxable capital gains distributions. (Fund accounting practices give rise to strange outcomes!) "Forewarned is forearmed."

With all this background, let's look at tax impact in a longer-term context. On the income distribution side, the tax impact is, in a perverse sense, beneficial. Equity mutual funds are today earning gross income—before expenses—at the rate of about 2.1%. (Their equity holdings yield about 1.7%; their 7% average reserve position 6%.) But fund expenses average 1.5%, meaning that equity fund investors receive a puny 0.6% yield on which to pay taxes. Expenses, in fact, are consuming 71% of fund income. In the paradoxical world of mutual funds, then, the higher the expense ratio, the more "tax efficient" the income component of total return. "Alice in Wonderland" writ large!

Alpha Takes Another Hit . . . From Taxes

The impact of taxes on the capital component is another story altogether. The tax blessing, as it were, in the income component of return is overwhelmed by the tax bane on the far larger capital component. To take a simple example: during the past fifteen years, the average equity fund enjoyed an average annual return of 14%—2% from income and 12% from capital. On the income side, the tax bite (assuming 33%) would take 0.6%. But on the capital side, the net asset value of the average fund increased by just 6% per year, leaving 6% accounted for by realized capital gains. Again assuming a 33% tax rate on short term gains (taxable as income) and 25% on long-term gains—and that 20% of the gains were realized on a short-term basis—the tax rate would have averaged 27%, and the capital return reduced by 1.8 percentage points, sharply reducing realized (and publicly reported) returns to 11.6%, all the while leaving risk unchanged. Thus, three-fourths of the tax bite of 2.4% is accounted for by realized capital gains.

The fact is, then, that taxes have a hugely negative impact on relative returns. Playing off the title of an outstanding article by Robert H. Jeffrey and Robert D. Arnott in *The Journal of Portfolio Management*, "Is Your Alpha Big Enough To Cover Its Taxes?", I'd say: "No, your Alpha is being eaten alive by taxes." That situation is made somewhat more dire by the fact that, as the past record I cited earlier showed, equity funds, largely because of their investment costs, already have had a *negative* Alpha of -1.9% annually over the past ten years.

On an after—tax basis, that negative Alpha in fact nearly doubles to -3.3%. Professional investors all know that successful investing is a tough game. Shareholders know—or should be told with candor—how much tougher it is when fund expenses and taxes are deducted from the managers' returns. For that 3.3% slice removed fully one-fourth of the stock market's return in the past decade.

It's important to recognize that what's happening here is largely the product of the inordinately high portfolio turnover rates of mutual funds. Twenty years ago, portfolio turnover averaged 30%; today it averages nearly 90%. While individual stocks may be held for decades (and by some managers—Warren Buffett comes quickly to mind—rather successfully) or even generations, mutual funds are rushing to buy and sell their stocks based on transitory changes in price, without concern for tax consequences. The fact is that this behavior sharply reduces the returns generated for their taxable owners. Further, some fund managers are so hair-triggered that many of the gains are short-term in nature (less than one year) and are taxed at ordinary income rates. Nearly 30% of fund gains fell into this category last year, and, with the end of the long-standing limitations on "short-short" gains under the new Tax Reform Act, this figure could well increase. Now, portfolio managers can feel free to realize an unlimited percentage of the fund's income in the form of gains realized in less than 30 days. The economic value to mutual fund shareholders created by this change in the law is not entirely clear to me.

It is highly unlikely that fund turnover will slow so greatly as to mitigate the gain realization issue. First, the fact is that reducing a fund's turnover from 150% to 100% simply doesn't matter. Substantially all gains are realized fairly quickly. Authoritative studies suggest that turnover rates would have to be reduced to 20% or less to make a material improvement in the tax burden. But the fact is that *any* turnover whatsoever, by giving up the value of that implied interest-free loan, has a negative impact.

What happens when the basic strategy of a fund calls for limited turnover? Something very good for fund investors. The tax bill falls, and the after-tax return rises accordingly. It *is* as simple as that. For as taxes are deferred, returns rise significantly with each additional year that an investor elects to hold fund shares. And through tax elimination—for example, if an investor's heirs receive the shares with a stepped-up cost basis at the time of the investor's death—after-tax return leaps upward.

Nonetheless, even if, as a policy matter, good intentions exist to reduce turnover, it obviously soars—and substantial gains are realized—when a new portfolio manager is brought in to manage a fund. This is an event that happens with increasing frequency in this era of *manager* turnover—most notably evident in the transient "superstar" managers who are lured away by huge stipends, entrepreneurial instincts, or the fact that the large asset

size of the funds they are leaving has impeded their ability to deliver outstanding returns. The fact is that today the average fund portfolio manager has an average tenure of just three and one-half years.

To say that these are especially critical issues for wealthy investors considering investing in mutual funds in the accumulation and distribution of their estates would be a powerful understatement of the issue. As James P. Garland, President of The Jeffrey Company, has observed, "Taxable investing is a loser's game. Those who lose the least—to taxes and fees—stand to win the most when the game's all over." In an article in *The Journal of Investing* [Spring 1997], Garland presents an imposing case, comparing the performance of two $100 investments over a quarter century: one in an idealized index—assuming no expenses, turnover, or taxes—and one in a mutual fund with an expense ratio of 1%, a turnover rate of 80%, a capital gains tax rate of 28%, and an income tax rate of 36%. The terminal market values are strikingly different: $1,721 for the index versus $706 for the fund. This example dramatically illustrates the powerful long-term impact of costs and taxes. By the end of 25 years, the government has consumed 47% of the optimal ending dollar amount, while the manager pocketed 12%, leaving the investor with only 41% of the investment on an after-tax, after cost basis. *And it is the investor who put up 100% of the initial capital.* In the fund arena then, just as costs matter, so taxes matter.

A Good Solution: The Index Fund

At this point, you are probably thinking either (a) that you should just forget about mutual funds for taxable accounts, or (b) that there must be a better way for them to achieve the valuable diversification that mutual funds clearly provide. Well, there *is* a better way, through which you can avoid suffering the negative consequences of both high costs *and* excessive taxes, and come as close as the law of the financial markets allows to achieving a positive Alpha. For there are a relative handful of funds that operate at a minimal cost and with a minimal tax burden. Most are market index funds, usually owning all of the stocks in a given arena (i.e., the Standard & Poor's 500 Stock Index, composed of large cap stocks that represent 70% of the value of the total market) or in a few cases the entire stock market (the Wilshire 5000 Equity Index). And they are working well, especially the latter, since significant changes to its composition simply do not take place.

Let's begin with a baseline: the after-tax return of the Standard & Poor's 500 Stock Index. We'll deduct income tax from the dividends, and assume no capital gain realization, deferring all capital gains taxes. With a pre-tax return of 16.7% over the past 15 years and an estimated tax impact of -1.6% (largely because of *income* taxes), it produces an after-tax return of 15.1%. The after-tax return amounts to 91% of the pre-tax return.

S&P 500 Index and Mutual Funds

	Rate of Return: 1981-1996	
	Before Taxes	**After Taxes**
Index Return	+16.7%	+15.1%
Average Mutual Fund	+14.3	+11.8%
Index Advantage	+2.4%	+3.3%
Funds Outpaced by Index	84%	92%

Now, we'll calculate the same figures for the average mutual fund: 15-year pre-tax return of 14.3%, taxes of 2.5%, and after-tax return of 11.8%. The flow-through is just 83%. The table reflects the critical fact that the index itself ranks in the 84th percentile on a pre-tax basis, but rises eight points to the 92nd percentile after taxes. The former figure is largely shaped by the high operating expenses of the typical fund; the latter by the heavy tax burden engendered in this typically high turnover industry.

In summary, during the past fifteen years—admittedly a good period for giant cap stocks—the absence of costs helped place the index just below the top, well, octile of mutual fund returns (84th percentile). The focus on tax minimization took it half way to the top (the 92nd percentile). Not too shabby, it seems to me for a passive index that didn't even have the putative advantage of a skilled portfolio manager.

Even these numbers overstate mutual fund rates of return to some degree, since poorer performing mutual funds drop out of the race, and thus out of the return calculations. And the impact that this "survivorship bias" has on reported industry returns is no trivial matter. Academic studies estimate that over fifteen years, the aggregate returns of mutual funds are overstated by as much as 1%, bringing the 11.8% after-tax return reported above to 10.8%, and raising the Index advantage to +4.3%—nearly a 50% increase (before compounding!). Adjusting the average mutual fund returns to correct for this bias, then, leads to even more dramatic fund underperformance than traditional comparisons show.

That said, I must in fairness state that the returns of index *funds* are also lower than the returns of the Index, because they are reduced by portfolio turnover and operating costs. No matter how modest they may be, these costs exist in the real world. During the past 15 years, for example, the Vanguard Index Trust 500 Portfolio had returns of 16.4% before taxes and 14.3% after taxes (compared to 15.1% for the Index itself), placing it in the 81st and 86th percentiles, respectively among the surviving mutual funds.

I should also note that the universally accepted use of the S&P 500 Index as the *de facto* indexing standard is subject to the criticism that it consists mostly of large-cap stocks, and represents "only" 70% of the entire market. The Wilshire 5000 Equity Index is, I think, a better basis for indexing, not only because it encompasses mid-cap and small-cap stocks as well as large cap stocks, but because a portfolio linked to the entire stock market can be expected to have the lowest possible portfolio turnover.

Yet while there is a high degree of certainty that the low cost advantage of indexing will persist, there is a somewhat lower level of certainty that the deferral of gain realization will persist. First, index funds, by virtue of their low turnover, build up their *unrealized* gains over time. Somewhere way down the road, those gains will inevitably be realized. Second, despite the intention of an index fund to avoid realization, it is susceptible to a run of shareholder redemptions that could force it to liquidate highly appreciated portfolio holdings. Nonetheless, given the value of tax deferral even for a limited period, it is difficult to visualize a circumstance under which the potential tax advantage offered by index funds, *relative to traditional actively managed funds*, will not persist.

A Better Solution: Tax-Managed Funds

In any event, in 1994 at least one fund group, interested in improving the tax efficiency of conventional index funds, developed a series of low-cost "tax-managed" funds. The most popular form is based on:

- A growth stock index (emphasizing lower-yielding equities in order to minimize the tax burden on income).

- Realizing losses, to the extent possible, on the sale of portfolio holdings that have declined in order to offset realized gains.

- Replacing the holdings sold at a loss after 30 days (engendering some very small lack of precision in matching the index).

- Minimizing the possibility of abrupt share redemptions by charging a penalty transaction fee—*payable to the fund and its remaining shareholders*—if shares are redeemed within five years of purchase.

So far, this system seems to be working well. Redemptions are a tiny fraction of industry norms, and speculative "market-timing" short-term investors have been conspicuous by their absence.

More recently, others in the industry have begun to respond, and six new purportedly tax-managed funds have been formed during the past year. But none follow an index strategy, and none, so far as I know, have taken steps to limit redemptions. Overall, save their "leaning against the wind" to avoid excessive turnover, their investment objectives seem to be conventional, as are their expense structures. Further, it is not clear what will happen when they experience the inevitable portfolio manager turnover. These limitations, in my view, will make it difficult for them to reduce either the tax bite or the bite that operating expense ratios take out of Alpha.

Properly structured, however, the tax-managed fund is, I believe, destined to become a strong force in the mutual fund field, made even stronger, I believe, by the reduction of taxes in the 1997 Tax Reform Act. Under previous law, the 28% capital gains rate was 12% below the 40% maximum marginal income tax rate. The new rate is 20%, or 20% below the 40% income tax rate. This change raises the long-term "tax discount" from 12% to 20%—fully 1.7 times. In addition, the Act has given a lesser relative advantage to gains on securities held for 12 to 18 months (28% tax), reducing the benefits of the new lower rate to high turnover mutual funds. In all, a soundly-structured low-cost tax-managed fund should be the best way to take most of the sting out of a negative Alpha.

A New Idea, Sixty Years Old

With all of the high-priced creative and imaginative talent in this industry, I find myself wondering why someone, somewhere, hasn't dreamed up a still better way to enhance after-tax mutual fund returns. Surely the opportunities abound. Let me describe my own idea. I start with a fund that simply buys a large sampling of high quality blue-chip growth stocks, and holds them unless fundamental circumstances change radically. Where, you ask, do we find the budding Warren Buffett to manage it? Honestly, I don't know. So, I shift gears. Why not a fund that buys, say the 50 largest stocks in the Standard & Poor's Growth Index universe? (That's nearly 30% of the capitalization of *the entire stock market.*) Simply hold them "forever" and don't rebalance as prices change. If there is a merger, keep the merged company; if a company is bought for cash, reinvest the proceeds, either in the next largest company or in the fund's other holdings (it probably won't matter which you do); if it fails and goes out of business, well, just realize that can happen.

Then, run the fund at an expense ratio of 20 basis points, just incurring bare-bones operating costs. Minimize exposure to shareholder redemptions with a stiff redemption fee and/or strong limitations on daily liquidity (i.e., open the fund for redemption only, say, on the last day of each quarter). These latter steps will, of course, make it difficult to attract quick-triggered opportunists. That's good! But—over time—they will make it

commensurately easy to attract serious long-term investors (today, an endangered species). The rewards for them should be far larger than the risks.

The potential rewards, in fact, are huge. In a stock market which averages a 10% pre-tax return, an average fund, assuming a 2% expense ratio, should provide a pre-tax return of 8.0% and an after-tax return of 6.5%. A low-cost buy-and-hold fund with a 10% gross return and expenses of 0.2% should achieve a net return of 9.8% before taxes and 9.0% after taxes. (This is a conservative hypothesis, with an after-tax spread of 2.5% that is well below the shortfall of 3.3% that actually existed between active funds and the Standard & Poor's 500 Index during the past 15 years.)

For the long-term investor, these numbers would be little short of dynamite. $100,000 invested at the outset would, after 25 years and after all taxes, have grown in the actively managed fund to $483,000. But the buy-and-hold fund would have almost doubled that amount to $862,000. I guess it's fair to conclude: "Yes, costs and taxes matter."

The potential risk to investors is small. Essentially, it's the risk that the 30% of the entire investment universe represented by the 50 largest growth stocks today would underperform the remaining 70% of the market by more than 3.0% per year *over the long-term.* (At that figure, the choice between the two funds would be indifferent.) The powerful forces of efficient financial markets would likely repel any such challenge, and such a defeat for our hypothetical fund could be accomplished, over the long term, only against all odds. The surprising, if simple, fact is that broad diversification makes it just as difficult to achieve significant *under*performance relative to the market as to achieve significant *over*performance. In short, the risk-return equation appears highly favorable, thanks simply to the minimization of the fiscal drag of operating and tax costs. (That's the three-dimensional view once again, as seen from this pair of eyes.)

Perhaps a look at history might help to evaluate the risk that growth stocks, purchased at notably high valuations, might under perform the market over the long-run. Jeremy J. Siegel, professor of finance at The Wharton School, has helped answer the question. He studied the performance of the famous Nifty 50 growth stocks of the halcyon Go-Go era of 1965-1972. In an article in *The Journal of Portfolio Management* [Summer 1995], Siegel shows that a frozen portfolio of these fifty high-priced stocks purchased at the start of 1971 in fact nicely outperformed the stock market over the next twenty-five years. Some of the fifty did well—Philip Morris was the champion, up 21%. With McDonald's (+18%), Coca-Cola, and Disney (each +16%) in close pursuit. Some did ill—MGIC Investment finished fiftieth, losing 4.3% per year, with Emery Air Freight (-0.9%) doing nearly as badly; Polaroid (+2%) and Xerox (+5%) also ranked at the bottom of the list.

But in aggregate, on a pre-tax basis, the portfolio of Nifty 50 stocks earned an average return of 12.4%, compared to 11.7% for the overall stock market, a positive margin of 0.7%. This relative advantage *grows* on an after-tax basis, as the spread between the two returns increases to fully 2% (9.8% vs. 7.8%). This example of long-term returns on a "static portfolio," oriented to growth but bought at a high price, is surely reassuring.

There is, Ecclesiastes tells us, nothing new under the sun. And that ancient maxim is in a sense true of my "new" idea. I may be one of a tiny handful of mutual fund historians who retain the memory of a similar fund formed in 1938, which provides further confirmation of the buy-and-hold idea. Structured as a fixed trust, Founders Mutual Fund originally picked an equal-weighted portfolio of 36 of the blue-chip stocks of the day, which it held, as it happens, until 1983, when the fund abandoned the strategy. And in fact, at the end of that 45-year period, *the fund held the same thirty-six stocks it had owned at the outset,* including IBM, Procter & Gamble, duPont, Union Pacific, and Eastman Kodak—not only durable (by definition), but successful, enterprises.

Prior to the change in its strategy (I couldn't locate a record of its first five years), the Fund earned an average annual return of 10.3% pre-tax, less than the return of 11.6% on the Standard & Poor's 500 Index, a gap predictably engendered in part by the Fund's operating costs of 0.5%. Interestingly, however, its return was virtually identical to the 10.6% return of Massachusetts Investors Trust, the largest (and lowest cost) equity fund throughout the entire era. While we could not precisely calculate after-tax returns, the record shows that Founders distributed only minimal gains during the period, while MIT distributed substantial gains. In short, it is certain that Founders Mutual won the after-tax race. A similar fund, Lexington Corporate Leaders Fund, formed in 1935 and invested in just 30 stocks, has impressively outpaced the Standard & Poor's 500 Index (16.0% vs. 15.6%) over the past 22 years (the earliest comparison available using Morningstar's database), further confirmation of the idea.

These comparisons prove one thing, and one thing only: that a fund selecting a fixed initial list of large blue-chip stocks *can* give a fully competitive account of itself on an after-expense, pre-tax basis, and by so doing, *can* generate a substantial margin of after-tax advantage relative to other funds. It is, it seems to me, a highly attractive option for the intelligent tax-conscious investor.

The Parallax View

I, for one, hope that investors will finally become mature enough to realize the importance of a new approach that considers all three dimensions of mutual fund investing—risk, return, and cost. And I hope that I will not have to wait long for the fund that I have described to see the light of day: a fixed trust owning a

diversified list of 50 U.S. blue-chip growth stocks. Indeed in this global day and age, it could well be accompanied by a sister fixed trust with a list of 75 of the largest growth stocks in the world. Both would be handsome-looking lists. But whatever stocks are chosen, the fixed trust must be operated at minimal cost, and structured to limit cash inflows and outflows.

I hope, too, that mutual funds will wake up to the critical issue of taxes, review their investment policies, and consider whether our 15 million taxable shareholders are getting a fair shake. We do not have a monopoly on investor affection. If fund managers persist in ignoring the tax consequences of their decisions, a diversified list of individual stocks, held directly, with realization controlled by the investor, can represent a fine alternative to a mutual fund.

Well, the ideas I've discussed with you today, however obvious and painfully simple, are fully consistent with my parallax view of the mutual fund industry today. And the new fund I've discussed is not just another transitory fad to capitalize on the strategy of the moment, like so many funds in the past few years, but a durable concept that capitalizes on age-old basics. Not just a focus on what's most marketable to speculative investors in the short-term, but on what's most serviceable to intelligent investors in the long-term. Sure, the timing of introducing such a fund is risky: all timing is, and all funds are. Yes, the markets of the world, particularly in the United States, look over-extended today. But as I've often said; "Never think you know more than the market. No one does." Impulse is your foe in the great quest for long-term investment success.

But in that great quest, time is your friend. Properly implemented, "buy and hold" is a wonderful long-term strategy, and is the surest possible way for those interested in wealth management to optimize their returns. We in this industry ought to have the wit and the wisdom to fully acknowledge that today's mutual funds, with hefty costs and high turnover rates, are not nearly attractive enough to taxable investors, and to exercise our creative ingenuity to do something about it. We owe a fair shake to our traditional base of taxable shareholders, investors who badly need our services, but only if our funds are properly structured. It's about time we moved in that direction, relying above all on a simple truth: "stay the course." It is as useful an axiom in investing as in navigating a great ship, and indeed as in life itself.