Eslick Financial Group
How wealth works.™

M WEALTH PERSPECTIVE

December 2015

Mutual Fund Landscape

Eslick Financial Group, Inc. provides sophisticated insurance and wealth management services to families, business owners, corporate executives, professionals, and other successful high income and high net worth individuals. Our team of professionals utilizes a customized process of defining, understanding, researching, evaluating, and informing our clients of innovative and uniquely integrated solutions tailored to their diverse financial goals. Our desire is to help make the otherwise complex, more understandable as it applies to your unique situation.

M Financial Group™
Member Firm

Mutual funds have become a popular investment vehicle, offering investors professional management, diversification, market liquidity, periodic reporting, and access to many global investment styles and strategies.

Some believe that successful mutual fund investing is simply a matter of choosing a fund with a winning track record. The financial media advance this view with features about top-performing funds and their star managers. With research available to tell us which funds have delivered benchmark-beating returns over time, it can be easy to find managers with impressive track records. However, past performance is rarely a reliable indicator of future performance. This is, in part, due to the rapid increase in market competition. Competition drives prices toward fair value, which challenges fund managers to gain an informational advantage over other market participants.

An annual study done by Dimensional Fund Advisors illustrates a representative sample of the U.S. mutual fund industry at the end of 2014, showing the number of U.S.-domiciled equity, international equity (including emerging markets), and fixed income funds in operation. This study examines a sample of U.S. funds totaling more than 5,200 managers and represents about $10 trillion in assets by the end of 2014. Since 2000, assets have grown more than 213% and the number of funds increased by 46%.

The sheer size of the current mutual fund landscape highlights its importance as a conduit between investors and global financial markets, but also presents a challenge for fund evaluation and selection. The following sections will help outline some of these challenges in more detail.

A Case of Disappearing Funds

The rising fund count and annual growth in assets masks the fact that many funds disappear each year, primarily due to poor investment performance. Exhibits 1.1 and 1.2 below, illustrate how difficult it can be to survive and outperform.

The gray boxes in Exhibits 1.1 and 1.2 represent the number of U.S.-domiciled equity and fixed income funds in operation at the beginning of four unique periods—starting three, five, 10, and 15 years ago. For example, an investor trying to select a mutual fund at the start of the three-year period (2012) could have chosen from 4,277 equity funds and 909 bond funds.

How many of the funds that began each period still existed at the end of 2014? The striped areas show the proportions that survived. During the three-year period, 85% of equity funds and 88% of fixed income funds survived. Over time, fund survival rates dropped sharply. In equities, the 5-, 10-, and 15-year survival rates were just 75%, 56%, and 42%, respectively. The numbers were only slightly better in fixed income, with 79% of funds making it five years, 57% surviving 10 years, and 41% surviving 15 years.

The blue and yellow areas show the proportion of equity and fixed income funds that outperformed their respective benchmarks. These outperforming funds are certainly in the minority. Over both short and longer time horizons—and for both equities and bonds—the deck is stacked against the investor seeking outperformance.

Exhibit 1.1 Survivorship and Outperformance—Equity Funds
Performance periods ending December 31, 2014

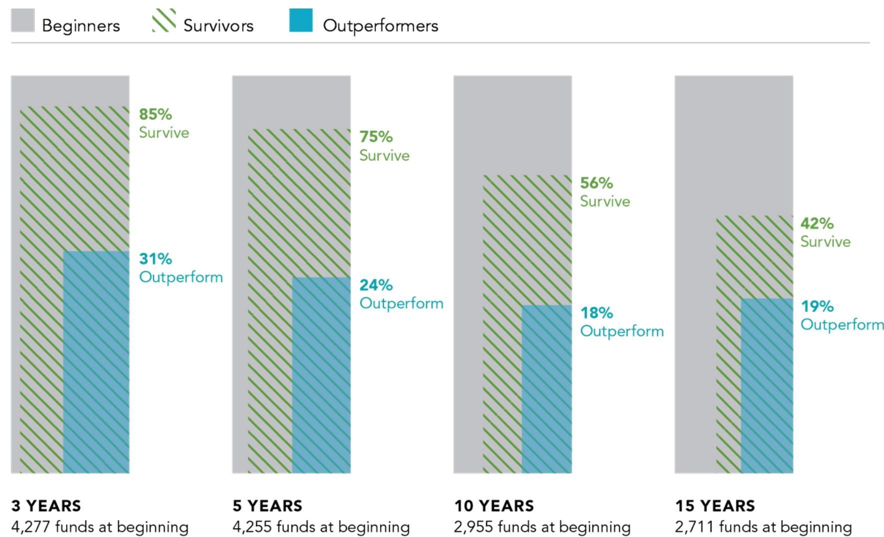
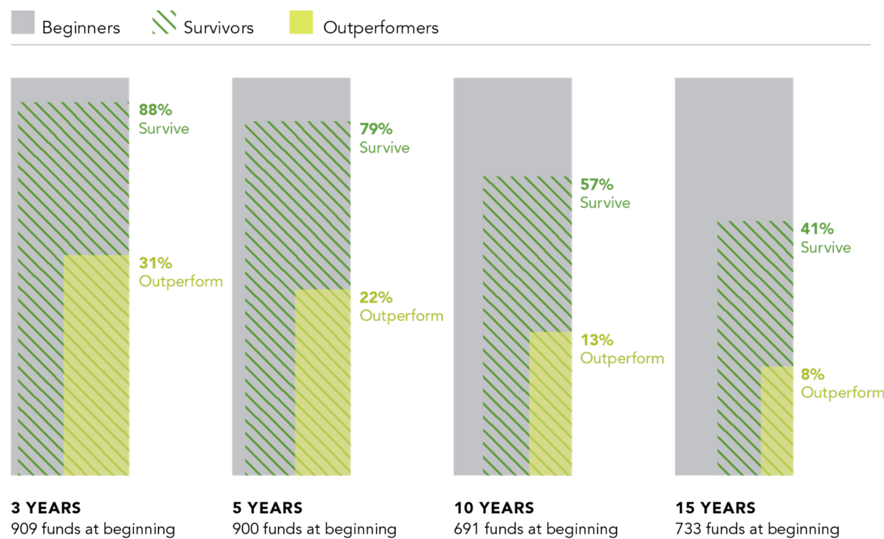


Exhibit 1.2 Survivorship and Outperformance—Fixed Income Funds
Performance periods ending December 31, 2014



The Search for Winners

As mentioned earlier, the competitive landscape makes the search for future winners a formidable challenge. Confronted with so many fund choices—and lacking an investment philosophy to inform their search—some investors may resort to using track records as a guide to selecting funds, reasoning that a manager's past outperformance is likely to continue in the future. Exhibits 2.1 and 2.2 below, demonstrate how that can be a poor assumption.

These exhibits illustrate the lack of persistence in outperformance. Three-, five-, and 10-year mutual fund track records are evaluated through the end of 2009, and funds that beat their respective benchmarks are reevaluated in the subsequent five-year period ending December 31, 2014.

Only a small percentage of the beginning equity funds outperformed in the initial periods—and subsequent performance was not much better. For example, only 25% of the equity funds with past outperformance during the initial three-year period (2007–2009) continued to beat their benchmarks in the subsequent five-year period (2010–2014). The results for both winning equity and fixed income funds show that past outperformance is not a reliable indicator of future outperformance. Even past winners are likely to underperform in the future.

Lack of persistence among winners suggests that gaining a consistent informational advantage is very difficult. Many smart professionals are striving to gather morsels of information to help them identify pricing mistakes. However, in

a competitive environment, public information is quickly reflected in market prices, leaving few opportunities to exploit the knowledge for profit.

Choosing a long-term winner involves more than seeking out funds with an impressive track record. Determining past performance is only one way to evaluate a mutual fund. Investors should consider other variables, including a mutual fund's underlying market philosophy, investment objectives, and strategy. They should also consider a mutual fund's total costs, including trading costs, which may be impacted by the manager's approach. Some fund managers might be better than others, but they are hard to identify in advance using track records alone. Stock and bond returns contain a lot of noise, and impressive track records often result from good luck. The assumption that past outperformance will continue often proves faulty, leaving many investors disappointed and with lower portfolio returns than those with a long-term strategic approach.

Exhibit 2.1 Most Past Winners Do Not Keep Winning—Equity Funds
Past performance vs. Subsequent performance

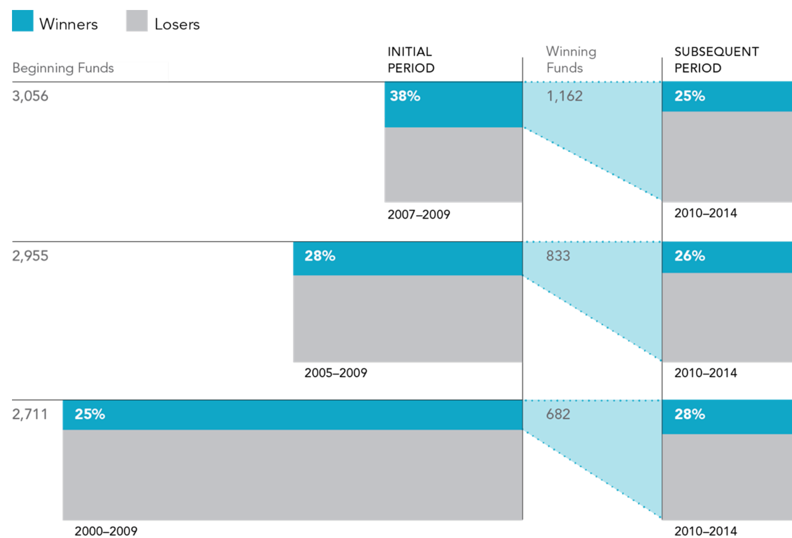
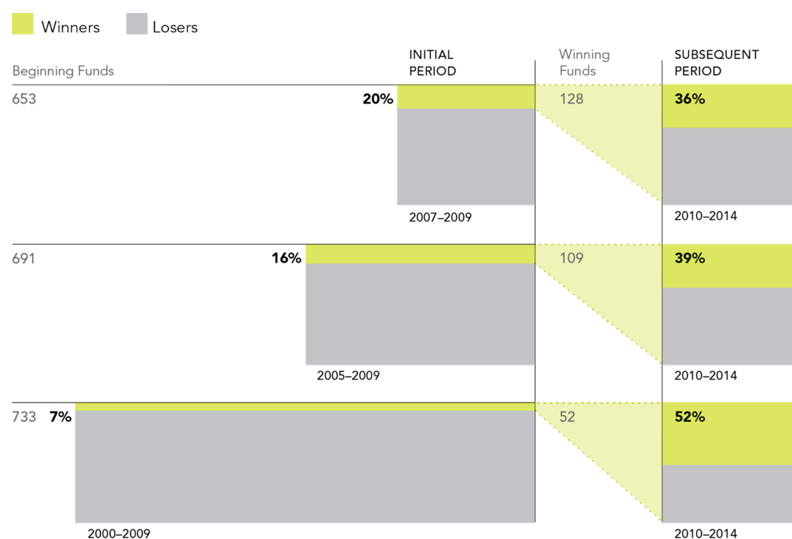


Exhibit 2.2 Most Past Winners Do Not Keep Winning—Fixed Income Funds
Past performance vs. Subsequent performance



This information has been taken from sources we believe to be reliable, but there is no guarantee as to its accuracy. It is not a replacement for any account statement or transaction confirmation issued by the provider. This material is not intended to present an opinion on legal or tax matters. Please consult with your attorney or tax advisor, as applicable.

For More Information

For more information on the services offered by M Wealth, please contact:

Dennis L. Eslick, ChFC®, RICP®, CLU®
deslick@eslickfinancial.com
319.833.5555

Kevin M. Eslick
keslick@eslickfinancial.com
319.833.5555

or visit the M Wealth website at:

www.mfinwealth.com

Eslick Financial Group, Inc.
999 Home Plaza, Suite 201
Waterloo, IA 50701
319.833.5555
www.eslickfinancial.com