Pitfalls of Actively Managed Funds

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The recent stock market decline can have important consequences for shareholders of actively managed mutual funds and exchange-traded funds. Let's look back at the Savings and Loan ("S&L") Crisis of the 1980s and 1990s (that was the worst financial crisis since the Great Depression) for perspective. According to Investopedia, in 1982 President Ronald Reagan signed the Garn-St. Germain Depository Institutions Act, which eliminated loan-to-value ratios and interest rate caps for S&Ls and allowed them to hold 30% of their assets in consumer loans and 40% in commercial loans. No longer were S&Ls governed by Regulation Q, which led to a tightening of the spread between the cost of money and the rate of return on assets.

What transpired was these entities taking on riskier commercial real estate and junk bonds. This strategy of investing in riskier projects and instruments assumed that they would pay off in higher returns. Of course, those returns did not materialize. This combination of deregulated lending and capital requirements along with a taxpayer-funded guarantee backstop created an enormous moral hazard in the S&L industry. Finally, the Resolution Trust Corp. was founded to wind down these risky ventures and forced them to sell their dodgier holdings. Those markets - particularly property and junk bonds - entered a period of crisis. Essentially, high yield bond fund managers were experiencing record redemption levels in a market where buyers were nowhere to be found that resulted in the forced selling of securities at record low levels. Imagine selling a bond that normally would mature at par ($100) for $12!! The selling snowballed and fed into bigger price declines leaving the fund's net asset value (NAV) below the price of the securities in the fund.

This liquidity problem is compounded in the stock market. When an aggressive stock fund with a phenomenal track record experiences large price declines in the securities it holds, shareholders begin to get concerned. The worry increases when the price of a fund's shares falls by 30, 40 and even 50%! Even prior performance cannot stem the flow of withdrawals as the manager is forced to sell good stocks and hold illiquid ones. Stocks are priced on a real time basis and those illiquid stocks can experience major declines due to selling pressure resulting from increasing redemptions. History documents that many hedge funds have closed because such declines undermine the ability of fund management to avoid downside pressures due to withdrawals.

Investors who hold individual stocks can experience part of the pain of seeing declines in their stock holdings. Yet, investors in individual shares are not forced out at the bottom as fund shareholders may be in an environment where a fund freezes redemptions. The individual investor who holds common stocks can weather near term volatility and benefit from a subsequent market recovery whereas illiquid holdings of mutual funds can end up at a fraction of their implied value. The bottom line is that investors should be sensitive to the prospect of mechanical failures in the market relating to the valuation of mutual or exchange-traded funds as opposed to the advantage of holding on to individual stocks in a volatile stock market environment.