3 Reasons Why Stocks Beat Mutual Funds

Description

For some time, the investment management and advisory industry has been trumpeting the benefits of investing in mutual funds over investing in stocks. However, despite the many hackneyed lines trotted out over the years outlining the benefits of mutual funds, including diversification, expert management, and convenience, I will demonstrate how investing in stocks is clearly superior.

1. No need to pay excessive return-destroying fees

Many investors don't realize it, but a key reason investment advisers and managers encourage investments in mutual funds is the huge fees they earn from managing your money.

These fees include front-end fees, which can be as high as 5% just for the privilege of investing in a mutual fund. Then there are ongoing management fees, which are paid annually on the balance of your mutual fund, purportedly to cover the investment manager's expenses for managing your money. Finally, if you invest in a fund that doesn't have a front-end load, also known as an upfront fee, you may have to pay an exit fee when you wish to redeem your money. All these fees can add up, reducing your initial investment and significantly hampering returns.

Even worse is that many of those fees are used as a means to generate revenue, which investment managers use to pay benefits to financial advisors so that they recommend their mutual funds in preference to other investments.

If this alone doesn't turn you off investing in mutual funds, then the next fact will stun you. In a 2013 report, mutual funds rating specialist **Morningstar** found that Canadians were paying through the nose to invest in mutual funds. The majority of management fees are well over 2% for a large number of funds, particularly those investing in Canadian stocks, and are significantly higher than those of a number of other countries, including the U.S.

While on initial appearances this may appear to be a relatively low fee, paying 2%, or even more, every year on your account balance soon adds up, and over the long term can amount to a huge chunk of your investment, impacting your overall returns.

Clearly, investors in mutual funds are being gouged by the institutional investment industry, potentially losing up to 5% of their investments before they even start to grow.

In contrast, you can invest in stocks for as little as $9.99 per trade, using one of the many online platforms available, and this fee only applies when you buy or sell stocks. Furthermore, there are no ongoing fees payable when owning stocks. This means that every cent you invest is working for you and not lining the pockets of greedy advisors or investment managers, thus generating solid returns.

2. Access to superior tax benefits

The next is a double whammy for investors in mutual funds. Many of the fees you pay when investing in a mutual fund aren't even tax-deductible, yet the brokerage you pay to buy and sell your stocks is tax-deductible when you record a capital gain and is factored into the cost base of acquiring the investment.

Even more troubling, whenever a mutual fund manager decides to sell a stock and realize a profit, capital gains tax is payable and this tax liability is passed on to investors. These events occur more regularly than you think, with investment managers forced to rebalance investment portfolios to ensure that they comply with investment mandates and trust deeds.

However, when investing in stocks it is you, the investor, who makes the decision about when to buy and sell, or when to take profits or losses and therefore trigger a capital gain. This gives you greater freedom and flexibility in managing your investments and tax affairs.

On a side note, let's not forget that dividends by stocks classified as eligible dividends are treated favorably for tax purposes, making them an important means of obtaining a low-cost, tax-effective income stream.

3. You can invest in a diversified portfolio of stocks with as little as $10,000

A pet peeve of mine is the investment industry's claim that investors with less than $100,000 have insufficient funds to invest in stocks because they can't access the benefits of diversification. This claim appears to make mutual funds the only viable investment opportunity for those seeking exposure to the stock market, leaving investors trapped to pay the excessive fees mentioned above.

However, as I will show, investors with as little as $10,000 can construct a diversified income-paying stock portfolio with solid growth prospects. Let's take a closer look at a sample portfolio constructed from 10 stocks, assuming that you've invested $1,000 in each, selected from Canada's 60 largest companies, each with solid economic moats, strong growth prospects, and juicy sustainable dividend yields.

Company	Industry	Market Cap	% Change 1 Yr	Dividend Yield	P
Bank of Nova Scotia (TSX: BNS)(NYSE: BNS)	Banking	$89.5B	26%	3.5%	
Fortis (TSX: FTS)	Electric Utils	$7.1B	2.3%	3.9%	
Husky Energy (TSX: HSE)	Integrated Oil & Gas	$33.5B	11.6%	3.5%	

Sun Life Financial (TSX: SLF)(NYSE: SLF)	Insurance	$25B	23%	3.5%
Potash Corp (TSX: POT)(NYSE: POT)	Ag Chem	$32.5B	3.4%	4.1%
Canadian Oil Sands (TSX: COS)	Oil & Gas	$11.5B	17.5%	5.9%
BCE (TSX: BCE)(NYSE: BCE)	Telco	$37.8B	16%	5.1%
TransCanada (TSX: TRP)(NYSE: TRP)	Oil & Gas Pipelines	$39.55B	20%	3.4%
Canadian Imperial Bank of Commerce (TSX: CM)(NYSE: CM)	Banking	$39.2B	28.3%	4%
Rogers Communications (TSX: RCI.B)(NYSE: RCI)	Telco	$21.6B	2.7%	4.3%
Average			15%	4.1%

Sources: Yahoo! Finance, The Globe and Mail, and company filings

Although past returns are no guarantee of future returns, you can see that this portfolio has grown by a healthy 15% over the last year, has an average dividend yield of 4%, and is diversified across eight industries.

Furthermore, companies such as **BCE** (TSX: BCE)(NYSE: BCE), **Bank of Nova Scotia** (TSX: BNS)(NYSE: BNS), and **TransCanada** (TSX: TRP)(NYSE: TRP) hold dominant market positions. This gives all three solid growth potential, which will cause their share prices continue to appreciate and lead to further dividend hikes.

Improved fundamentals in the energy patch are also acting as a tailwind for oil stocks, seeing **Canadian Oil Sands** (TSX: COS) and **Husky Energy** (TSX: HSE) set to boost their performances, which may even see further dividend hikes.

Clearly, the investment management industry has a vested interest in perpetuating the myth that mutual funds are superior to stocks, particularly when the tremendous earnings the industry generates from fees are considered. Even more galling for me as an industry insider is how the revenue from those fees is used to incentivize financial advisors to recommend mutual funds in preference to stocks, all to the detriment of individual investors.

CATEGORY

1. Investing

TICKERS GLOBAL

1. TSX:BCE (BCE Inc.)
2. TSX:BNS (Bank Of Nova Scotia)
3. TSX:TRP (TC Energy Corporation)

Category

1. Investing

Date
2025/09/13
Date Created
2014/07/28
Author
mattdsmith