Investors: Avoid Mutual Funds and Canada's Mutual Fund Stocks

Description

Over the last decade, the shift from active to passive investing has been nothing short of remarkable.

ETFs were very much a thing back in 2006, of course. There weren't nearly as many as today, but even Canadian investors had access to dozens of different ETFs, tracking all sorts of sectors and asset classes. And if that wasn't enough, they had access to hundreds more in the United States.

But at the same time, mutual funds were still going strong. Companies such as **IGM Financial Inc.** (TSX:IGM), **CI Financial Corp.** (TSX:CIX), and **AGF Management Limited** (TSX:AGF.B) were doing well, reporting increasing assets under management and solid earnings for their shareholders.

Things are very different a decade later. Shares of all three of these companies haven't done particularly well. CI Financial is down 17%. IGM Financial is down 27%. And AGF Management shares have done the worst of all, falling more than 77%.

At least all of these companies pay dividends.

I just can't see life getting better for any of these wealth managers. Here's why each of these companies will never end up in my portfolio–unless big changes are made.

Better fee disclosure

One of the reasons why investors were so tolerant of mutual funds over the years is because they did a wonderful job hiding fees. Many investors didn't even know they paid management fees on their funds. And out of the ones who did, most didn't realize just how much 2% or 3% per year added up.

Not only have countless journalists, bloggers, and pundits let investors know just how dangerous fees are to long-term returns, but now the funds will be required to do so as well.

New industry regulations require fund companies to tell investors the cost of management fees in dollar terms. Percentages aren't going to cut it anymore. Suddenly, an investor with $500,000 at work in mutual funds paying 2% a year will be made aware management fees are $10,000 a year.

That 2% doesn't sound like much–but $10,000 sounds like a whole lot more.

Low rates

Low interest rates are really starting to affect managers of bond funds.

A basket of medium- to long-term bonds yields approximately 3% today. If a fund manager charges 2% of assets to manage this portfolio, suddenly the yield investors are left with is only 1%. Giving up 66% of your yield to pay a fund manager simply isn't acceptable.

Bond mutual funds are being forced to cut fees, but it isn't doing much to stem the steady stream of money flowing out of these funds and into passively managed alternatives. It's hard to compete with ETFs that charge 0.2%.

Dividends at risk?

AGF Management already cut its dividend back in early 2015 from $0.27 per share quarterly all the way down to $0.08 per share. That's still a generous 6.5% yield that is covered by earnings of $0.49 per share.

Both IGM Financial and CI Financial have similarly high yields with payouts of 6.1% and 5.5%, respectively. Additionally, both companies can afford to pay out their dividends, with payout ratios of about 70%. Besides, CI Financial just raised its payout from $0.11 per share on a monthly basis to $0.115.

But at the same time, if I were in charge of any of these companies, I'm not sure I'd be paying out such high dividends. The future of the asset management business isn't high-fee mutual funds–that much is obvious. I'd be getting ahead of my competitors and offering low-cost ETF portfolios with a reasonable management fee attached.

Robo-advisors will certainly capture part of the asset management market. But many people crave human interaction. They want a person reviewing their portfolio and telling them things will be okay during bad times.

The capital needed to expand into this business is available by cutting dividends. Unless these companies want to keep getting squashed by low-fee alternatives, they have no choice but to go down such a path.

Conclusion

High-fee mutual funds are a bad deal for investors. It's that simple. Until they truly embrace a different business model, these companies won't get anywhere near my portfolio.

CATEGORY

1. Dividend Stocks
2. Investing

TICKERS GLOBAL

1. TSX:AGF.B (AGF Management Limited)
2. TSX:CIX (CI Financial)
3. TSX:IGM (IGM Financial Inc.)

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