1 Expensive Wealth-Destroying Mistake to Avoid in 2020

Description

Financial advisers, banks, and investment managers are aggressively selling mutual funds to retail investors on the basis that they are lower-risk investments than individual stocks that are managed by educated and trained professionals. Many inexperienced investors with small investments are eschewing stocks in favour of mutual funds. While they readily provide the opportunity to invest as little as $500 in a diversified portfolio of stocks or other assets, there are significant costs that can substantially impact investment returns.

Return-destroying fees

A problem with investing in mutual funds is that fees are payable to the investment manager. According to industry data, the average fee for an equity mutual fund is 2.35%, which is deducted from the fund's returns and is payable, even if it makes a loss. Over the long term, that fee represents a significant chunk of investment returns.

Industry sources claim that over the life of an average investor, Canadians are paying $323,000 or more in fees. Not only does that demonstrate the considerable costs incurred by investors, but it illustrates that investing in mutual funds can prevent them from creating wealth and achieving their financial goals. Entry and exit fees can also be charged, which further erode returns.

While many fund managers justify these fees by claiming that mutual funds significantly reduce the risks and complexities associated with investing in stocks while boosting returns, this could not be further from the truth.

If the stock market is extremely complicated, how did a janitor amass an US$8 million fortune, or an IRS auditor build a US$21 million nest egg from investing in stocks? Aside from common-sense considerations, such as budgeting, both were focused on long-term investing in companies that had wide economic moats, steadily growing earnings, and growing sustainable dividends. That can be achieved without paying the fees levied by fund managers.

More damning is data from S&P Dow Jones Indices that shows that in 2018, three quarters of active

Canadian fund managers failed to beat equity benchmarks. Such a lacklustre performance fails to inspire confidence in mutual funds or justify the tremendous wealth-destroying fees charged.

A powerful tool to boost returns and accelerates the pace at which wealth is created is compounding, whereby dividends are reinvested to purchase additional stock. Over the last decade, a range of top Canadian stocks with regularly growing dividends have delivered considerable value for investors.

An example is Canada's largest lender, **Royal Bank of Canada** (TSX:RY)(NYSE:RY), where a $10,000 investment 10 years ago would now be worth $23,739 if dividends were reinvested, representing a compound annual growth rate (CAGR) of 9%. While past performance is no guarantee of future returns, the bank will continue to deliver value.

Royal Bank is growing its wealth management business, including U.S. operations, reporting a 13% year-over-year increase in 2019 net income. Expanding its U.S. business reduces Royal Bank's dependence on Canada, and it can profit from a stronger U.S. economy. The bank is focused on unlocking greater efficiencies to boost profitability by expanding the number of digital users and reducing operating costs.

The improved outlook for Canada's housing market over the next two years will also give Royal Bank's earnings a lift. Royal Bank has a high-quality loan portfolio, as evidenced by its gross impaired loans ratio of just under 0.46%, meaning it would take a substantial decline in credit quality to impact its balance sheet.

Royal Bank, which has a beta of 0.99, meaning it is less volatile than the overall market, has delivered solid returns beating one of Canada's largest mutual funds, the IG Mackenzie Dividend Fund Series A. The fund, which has $12.5 billion under management and some of Canada's largest companies among its top 10 holdings, charges a 2.4% management fee, yet it only delivered a CAGR of 6% over the last decade, well below the returns of many Canadian stocks.

Foolish takeaway

Direct stocks are a less costly and more effective strategy for building wealth than mutual funds. They provide greater flexibility as well as control over investments, and, contrary to the claims of investment managers, can be done with as little as $500. With only brokerage fees, there is no need to pay entry, exit, or ongoing management fees, which can be as low as $6.99 per trade, payable when buying or selling stocks.

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1. Bank Stocks
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