

Article location: <http://www.fastcompany.com/magazine/128/made-to-stick-the-myth-of-mutual-funds.html>

August 13, 2008

Tags: [Innovation](#), [Leadership](#), [Work/Life](#), [best mutual funds](#)

1 Readers Recommended this Article

Made to Stick: The Myth of Mutual Funds

By [Dan Heath & Chip Heath](#)

Let's pull off the Band-Aid quickly. You've come to believe that mutual funds are a smart place to put your money. They're not.

That's the assessment of the smartest minds in finance, supported by a mountain of historical data. If you own actively managed mutual funds, you will almost certainly retire with less money -- a lot less money -- than if you'd simply dumped your money into boring index funds. So two questions: How can this possibly be true? And why, in gleeful defiance of the data, do more people keep buying mutual funds every year?

First, the proof. A team of finance researchers conducted an exhaustive study of mutual-fund returns from 1979 to 1998. Mutual funds underperformed the Vanguard 500 Index Fund by an average of 2.8% per year (after taxes). From 1984 to 1998, the deficit was a stunning 5.1% per year.

It gets worse. Of all 203 mutual funds with at least \$100 million under management from 1984 to 1998, only 8 managed to beat the Vanguard 500. Your odds, then, of picking a "winning" mutual fund during that time were less than 4%. By way of comparison, if you get dealt two face cards in blackjack, and your inner idiot shouts, "Hit me!", you have about an 8% chance of winning.

"Overwhelming evidence proves the failure of the for-profit mutual-fund industry," says David F. Swensen in his revealing book *Unconventional Success*. Swensen knows a bit about investing. Since he began managing Yale's endowment in 1985, he has grown the fund from \$1.3 billion to \$14 billion (a 16.1% average annual return). And his opinion is clear: "Overwhelmingly, mutual funds extract enormous sums from investors in exchange for providing a shocking disservice."

None of this is breaking news. The data have been lying around for years. Yet we keep

buying mutual funds, just as people still buy bogus herbal remedies and corporate execs keep making statistically doomed mergers and acquisitions. Our behavior seems impervious to the truth. It's like waking up in a world where 91 million Americans drive Ford Pintos while wearing flammable pajamas.

Here's why this idea doesn't stick: It's true, but it violates common sense. Mutual funds are actively managed, which means that there's a team of Harvard and Wharton MBAs who come to work every day and hunt for good investments on your behalf. Whereas index funds (technically a kind of mutual fund) are passively managed; they simply track the market's performance. There's a robot behind the wheel.

We can't handle the truth that the robot beats the Ivy League MBAs. Even when the MBAs outperform the robot, you might still come out behind, because of the fees they charge. (Those fees ensure that, while you may lose, the MBAs never will.)

So why do mutual funds thrive? They take advantage of a mistake we all make. Two business-school professors -- Jay Koehler and Molly Mercer of Arizona State -- conducted studies on investors and documented the mistake. We treat cherry-picked data as typical. If a mutual-fund company advertises a 31% return on one fund, investors get more interested in others from the same company. But if the investors are reminded that the data were cherry-picked -- "the 31% return is from one fund of many managed by this company" -- then they are able to avoid this mistake (just as a bulleted highlight on someone's résumé doesn't convince you he's perpetually awesome). But mutual funds aren't inclined to provide helpful warnings like, "The returns we're hyping are anomalies!"

The consequences can be profound -- and invisible. Consider two 50-year-olds who each invested their life savings of about \$140,000 in 1984. Vanessa put all of her money in the Vanguard 500, and Muriel put hers in an average mutual fund. If they both retired in 1998, both would be happy, because their assets would have grown substantially.

But happiness comes in different sizes. If Vanessa's nest egg was \$1 million, Muriel's would've been about \$550,000. Now, remember, Muriel is happy, because she has no clue what she could have made. You know who else is happy? The mutual-fund managers. Muriel has padded their multimillion-dollar retirement accounts with roughly \$150,000 of her own foregone income. Forget sponsoring a child in Africa. You're sponsoring an MBA. And you don't even get a photo for your refrigerator.

The final irony is this: Every few years, one of Muriel's mutual funds would have a great return -- say, 22% in a single year! -- and the fund would then spend millions of dollars (including some of Muriel's own retirement money) touting its performance, like a movie trailer that showcases the one funny moment in a deeply unfunny movie. In the end, Muriel feels smart and Vanessa feels insecure.

It's possible, we suppose, that this feeling of superiority might be worth something. But not as much as it's costing you. Swensen's advice is to buy index funds from TIAA-CREF or Vanguard, where fees are minimal. Stop driving that Pinto. With your investments, boring is beautiful.

Dan Heath and Chip Heath are the best-selling authors of Made to Stick: Why Some Ideas Survive and Others Die.
