# Reflections on the Past and Future for the Individual Investor

## by James B. Cloonan


As I approach retirement, I cannot help but reflect on the changes in the financial services industry during the half century that I have been a part of it.

I feel almost all the changes have benefited the individual investor. The major changes have been:

**The addition of money market funds.** These funds have provided a secure and easily accessible place for short-term assets with low risk. Their use by brokers for sweep accounts enabled investors to receive some income on idle funds even for very short periods of time.

**The development of exchange-traded funds (ETFs).** From an investment theory point of view, ETFs are not significantly different from traditional mutual funds, but they have advantages in tax planning and ease of transaction. In areas where they compete with mutual funds, they are forcing expense ratios down. As ETFs move from index orientation into more active management, they will force more traditional mutual funds to reduce expense ratios. A significant advantage of ETFs is that they get rid of the administrative and financial burden of the useless, captive-but-called-independent boards required of traditional mutual funds.

**The end of fixed commissions.** Fifty years ago, commissions ran from 1% to 2% of the transaction value. If you turned over your portfolio once a year, you lost that percentage on the sell and then on the buy. Whatever your strategy, its success was reduced by 2% to 4% a year. Now commissions are almost negligible for online brokerage accounts.

**The reduction in bid/ask spreads.** Spreads are way down, partially based on the switch from fraction to decimal pricing. This further reduces transaction costs.

**The introduction of no-load funds.** If you reflect on mutual fund operations 50 years ago, they almost seem criminal. Front-end loads ran up to 8%, and you paid that not just on the initial investment, but on any distributions reinvested. There were the indicated expense ratios, but also the commissions at the rates indicated above because all sales went through the exchanges. If the overall market was gaining 10% a year, mutual funds were gaining 6% to 7% if their strategy matched the market. Between commissions and fees, the typical individual investor would have been lucky to see a return of 6% to 7% rather than the 10% the market indexes have returned over the last century. Investors who bought and held would have done better than those who traded frequently, but most investors probably would have been better off in investment-grade bonds prior to the 1970s.

**The beginning of index funds.** While there may be problems with index funds, which I will touch on later in this article, for many investors they provide an acceptable return—certainly better than the return of the average mutual fund, ETF, adviser-managed portfolio or hedge fund.

Investing costs have gone down dramatically, but only for those investors who take advantage of the changes. There are still load funds and funds with expense ratios of over 1%. There are still high-commission brokers. But even in these cases, commissions and loads are less than they had been.

But what about the future? The long-term future with technological changes is really unpredictable, but I can see current trends continuing into the near-term future. The one unknown that can change everything is the impact of legislation and regulation. Many aspects of investing are among the issues that politicians feel are critical for electioneering. If I could force one procedure on legislators, it would be that no piece of legislation impacting taxes or investment regulation could be changed for eight years without a super-majority vote. Give us a chance to adjust to a change before it changes again.

# Predictions

Based on current trends, the following are my predictions for the future.

Online brokerage commissions can't really go much lower. This is also true of bid/ask spreads. In fact spreads on less-traded equities may have to come up in order to encourage market makers to bother with these stocks.

Expense ratios for ETFs and traditional funds that are above 50 basis points will continue to come down.

With or without legislation on requiring fiduciary responsibility for brokers, there will be more movement toward wrap accounts for full-service brokers. Brokers have discovered more potential profit if wrap fees can be kept high. Hopefully these fees will settle below 1%, but it will take some time.

ETFs will continue to replace traditional funds, though at a very slow rate. Also, there are investment areas that will not lend themselves to ETFs.

More and more money will head into index funds; I discuss this further below.

While most of the trends are positive, there are a few that concern me. As is and should be the case, enterprises are always looking for new sources of income and profit. The financial services industry is no exception and will continue to develop and promote products that lead to increased profits. These profits come not just from the particular product but also from additional fees that can accrue when changing from product to product. Individual investors must be very critical of new or newly promoted products to see if they have value. An example of this is stock options, which maintain extremely high commissions and ridiculous bid/ask spreads except in the most active underlying stocks and indexes. Most of the theoretically good option strategies fail because of transaction costs. Probably no more than 1% of investors should be using options, and then only rarely.

Another concern is with index funds and the impact they can have, and already are having, on the market. To understand this impact, visualize the extreme case. What if all assets went into index funds? The status quo would become fixed. All relative prices would then be frozen. All equity prices could go up or down together, but if Stock A was double the price of Stock B, it would forever maintain that ratio regardless of the earnings changes of the two stocks.

The only change in relative prices would come if a stock was dropped from an index. It has been argued that indexing would never get so large that it would have that impact. I believe it is already having a small impact. The constant growth of indexing could lead to a disastrous stickiness of stock prices—they would stop reflecting earnings and other fundamental characteristics of a company. This would be true only for capitalization-weighted indexes. But if equally weighted indexes were dominant, it would have an equally devastating impact in that all companies from Apple to Sam's Grocery would have the same market value.

We would be buying and selling based on the likelihood of the index listing or delisting a stock. Companies would continually be considering mergers and acquisitions to get on the dominant indexes. Since the S&P does not put stocks on the index based on price alone, it would be in a position to require specific corporate behavior to be listed on the 500 (i.e., all stock must be voting, all board seats elected annually, potentially meet social criteria, etc.).

## Regrets

I have several regrets.

I wish AAII could reach a wider range of investors. We are serving mostly fairly affluent investors who already have a basic or advanced knowledge of investing. Even though our membership fees are low and we have tried programs aimed at beginners, we have simply not been able to serve those who really need us the most. The same is true of age. Because of the power of compound returns, the young have the most to gain from effective investing but our membership age continues to average in the low 60s.

Perhaps my greatest regret is not being able to convince as many investors as possible of what I feel is the most important lesson I have learned over the years: *Real risk* is the likelihood of not having the assets saved when you need them. *Phantom risk* is volatility that has little impact on the long-term investor. In fact, the long-term investor should love short-term volatility because the fear of it by most investors is what leads to the 10% annual returns that cannot be justified by risk alone.

On the other hand, money that is needed in the short term (less than three to five years) should be concerned with volatility and should not be in the stock market. Concerns with phantom risk lead to long-term portfolios with bond and cash allocations of 30% to 50%. This is a sure way to reduce your retirement nest egg from X to ½X. That is real risk.

While I have often written about this mistake in defining risk and much of my book, "Investing at Level3," concentrates on it, the feedback I get indicates I have not convinced enough people that this aspect of portfolio allocation can be more important than stock selection in the long run.

## Appreciation

Last but not least, as I head for retirement I am, as always, a long-term bull on the stock market. I am also positive on the future of individual investors and their ability to outperform the institutions and the market averages. I feel certain that AAII will continue to provide the support that will make that possible.

Finally, I want to thank the AAII staff, without whose support the development and expansion of AAII would not have been possible. Special thanks to John Markese and John Bajkowski, who have shared the leadership of AAII with me. And, as I reflect on what I have learned about investing over the years, I realize that AAII and its members have been my teachers as well as my students.

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