Are There Too Many Mutual Funds?

How fund proliferation can hurt investors.

By Rob Silverblatt, Contributor June 10, 2013, at 1:15 p.m.

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TOCKS, MUTUAL FUNDS, 6C-7C
DOW 30
8,870.54
-73.27
S&P 500
919.21
-11.78
NASDAQ
1,616.74
-30.66
3.76
-.03
63.41
+1.37

(iStockPhoto)

Jack Bogle, founder of The Vanguard Group, recently called attention to one of the investing industry's most uncomfortable truths: Each and every year, a huge number of mutual funds fail.

Of course, there are dozens of ways in which a mutual fund can fail. Perhaps the most basic is that it can underperform its peer group in a particular year. But Bogle was talking about failure in a different sense – a more permanent sense. The problem that he was highlighting wasn't the mutual funds that don't sufficiently reward investors, but rather mutual funds that are dropping off the map entirely, whether by liquidating or merging away into other products.

According to Bogle, around 7 percent of mutual funds "died" each year between 2001 and 2012. That's up from about 1 percent per year during the 1960s. "Assuming (as I do) that such a failure rate will persist over the coming decade, some 2,500 of today's 4,600 equity funds will no longer exist – the death of about one fund on every other business day," Bogle said last month at a presentation to the Boston Security Analysts Society. *Forbes's* Robert Lenzner called that figure "shock[ing]" and "sickening."

Just based on that statistic, it would be reasonable to infer that the number of mutual funds available to investors is on a dramatic decline. However, quite the opposite is true. Although funds are dying at a rapid rate, they are being born at an even quicker clip.

At the end of 2012, there were 7,238 mutual funds available to investors. That includes the equity funds Bogle was referring to, as well as all other types of open-end mutual funds (except for money market funds). At the end of 2000, that number was 6,876. That means that even as funds were dying at a rate of 7 percent per year, the net number of funds increased. These statistics, as well as all others from this point forward, come from an analysis Morningstar conducted for U.S. News.

To get a sense of how much the fund industry has grown, it helps to go back a little further. At the end of 1990, for instance, there were just 2,395 mutual funds. That means that since then, the number of funds has more than tripled. In the year 2000 alone, 786 new funds were created. Although that number has fallen off, the number of new funds is still substantial. Notably, in each of the past two calendar years, we've seen the birth of more than 500 funds.

With so many new funds opening their doors, it is little surprise that so many are dying. Many new funds are highly specialized products that come with esoteric risks. Others are funds created to chase a fad. It's no coincidence, for instance, that so many funds were created in 2000 at the height of the tech bubble.

Innovation, of course, is what keeps the mutual fund industry – and all other industries, for that matter – going. But at a certain point, the costs of proliferation begin to outweigh the benefits. If the annual rate of fund deaths has increased from 1 percent to 7 percent, that suggests a large number of newly created funds should never have existed in the first place.

These costs, of course, are more than just the abstract notion of mutual funds disappearing into nothingness. When a mutual fund liquidates or merges away, it's generally because it wasn't performing well. The most obvious victims are the people who were invested in the failed products.

But even investors who have never heard of a particular failed fund suffer when that fund dies. Notably, calculations of how well the fund industry is doing tend to focus on the group of funds that currently exist, ignoring those that have ceased to exist. The result is called "survivorship bias," meaning people get false impressions about what types of returns an average mutual fund investor can expect. And it's precisely those false impressions that contribute to a willingness on the part of investors to overlook the risk that a fund can fail.

In other words, while proliferation can be good, what we've been experiencing looks more like excess proliferation. "It remains to be seen whether this quantum increase in investment options – ranging from the simple and prudent to the complex and absurd – will serve the interest of fund investors," Bogle said during his presentation. "I have my doubts, and so far the facts seem to back me up."