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Mutual Funds

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"Don't try to find the needle in the haystack. Just buy the haystack."
— John Bogle

Executive Summary

This article explores the evolution, structure, and current landscape of mutual funds, examining how these investment vehicles continue to serve individual investors despite the growing competition from ETFs. Through examining historical context, performance data through 2024, and recent regulatory developments, we provide individual investors with the insights needed to navigate today's complex mutual fund marketplace.

The Revolutionary Beginning: How Mutual Funds Democratized Investing

Before mutual funds existed, investing was an exclusive privilege reserved for the wealthy elite. At the turn of the 20th century, an estimated 1% of Americans owned stocks[1]. The barrier to entry was enormous—individual investors needed substantial capital to achieve any meaningful diversification, and transaction costs were prohibitively high for smaller investors. Most Americans had no systematic way to save for retirement, with no 401(k)s, IRAs, or even Social Security[1].

The concept of pooling investments for collective benefit actually traces back centuries. Many historians credit Dutch merchant Adriaan van Ketwich with creating the first investment fund in 1774, named "Eendragt Maakt Magt" (Unity Creates Strength) [2]. Van Ketwich's innovation allowed small investors to purchase shares in a diversified portfolio, spreading risk across multiple investments—a revolutionary concept that would eventually transform global finance.

The idea gradually spread across Europe throughout the late 1700s and 1800s, with investment trusts appearing in Switzerland in 1849 and

Scotland in the 1880s[1]. These early funds were closed-end structures, meaning investors could only buy and sell shares on the open market rather than redeeming directly with the fund company.

The American Innovation: Open-End Mutual Funds

The United States saw its first closed-end fund with the Boston Personal Property Trust in 1893, primarily focused on real estate investments[2]. However, the true breakthrough came on March 21, 1924, when Massachusetts Financial Services (MFS) launched the Massachusetts Investors Trust—the first open-end mutual fund with redeemable shares[3]. This fund allowed investors to buy and sell shares directly with the fund company at net asset value, creating the flexible structure we recognize today.

The Massachusetts Investors Trust demonstrated immediate success, growing from $50,000 to more than $390,000 in assets within just one year[2]. By 1928, it became the first mutual fund to go public, validating the concept for a broader audience.

The 1929 stock market crash temporarily dampened enthusiasm for mutual funds, but ultimately led to crucial regulatory protections. The Securities and Exchange Commission (SEC) was established in 1934, followed by the Investment Company Act of 1940, which created the modern regulatory framework for mutual funds, hedge funds, and eventually ETFs[2].

The Modern Mutual Fund Landscape: Three Distinct Approaches

Today's mutual fund industry offers investors three primary management philosophies, each with distinct characteristics, benefits, and drawbacks. Understanding these differences is crucial for making informed investment decisions.

Passive Mutual Funds: Matching the Market

Passive mutual funds seek to replicate the performance of specific market indices, such as the S&P 500 or Bloomberg U.S. Aggregate Bond Index. The first retail index fund was offered to the public in 1976 by Vanguard, though institutional index funds had existed since the early 1970s[4].

The Case for Passive Investing

Passive funds offer compelling advantages that have made them increasingly popular among individual investors. Their expense ratios typically range from 0.02% to 0.10% annually, leaving more money working for investors rather than paying management fees. This cost efficiency compounds significantly over time—a difference of just 0.50% in annual fees can reduce portfolio value by more than 10% over 20 years.

The simplicity of passive investing cannot be overstated. Investors know exactly what they own, as these funds transparently track well-defined indices. There's no risk of style drift or manager changes affecting the investment approach. The diversification is immediate and broad—a single S&P 500 index fund provides exposure to 500 of America's largest companies across all sectors.

The Limitations of Pure Indexing

However, passive investing comes with inherent constraints. When markets decline, passive funds decline in lockstep—there's no defensive positioning or tactical adjustments. During the dot-com bubble of 1999-2000, index funds faithfully held overvalued technology stocks as their index weightings increased, participating fully in both the bubble and subsequent crash.

Passive funds also cannot capitalize on market inefficiencies or temporary mispricings. If a company faces temporary challenges that may not affect long-term prospects, active managers might view this as a buying opportunity, while index funds will mechanically adjust holdings based solely on market capitalization changes.

Rules-Based Mutual Funds: The Academic Advantage

Rules-based or factor-based mutual funds represent a sophisticated middle ground between passive indexing and active management. These funds, exemplified by companies like Dimensional Fund Advisors (DFA) and Avantis, base their strategies on decades of academic research in financial economics.

The Factor Advantage

The foundation of rules-based investing lies in the work of Nobel laureates Eugene Fama and Kenneth French, who identified persistent factors that have historically driven higher returns[5]. The most established factors include:

- **Value**: Stocks trading at low prices relative to fundamentals (book value, earnings, sales)
- **Size**: Smaller companies that tend to outperform larger ones over long periods
- **Profitability**: Companies with strong and consistent earnings
- **Investment**: Companies that invest conservatively in assets tend to outperform those that invest aggressively

Avantis, founded by former DFA executives, has added additional refinements to factor investing, including their emphasis on profitability defined as ongoing cash flow from operations[5]. This approach excludes one-time events and focuses on sustainable business fundamentals.

Research has shown the effectiveness of factor-based approaches. A study of U.S. equity mutual funds from 1990-2010 found that while only 20% of funds with no factor exposure achieved long-term outperformance, success rates increased dramatically for factor-exposed funds—ranging from 51% for single-factor funds to 78% for three-factor funds[6].

The Reality of Factor Investing

Rules-based funds typically charge expense ratios between 0.20% and 0.40%—higher than pure index funds but significantly lower than most active funds[5]. However, investors must understand that factor premiums can disappear for extended periods. Small-cap value stocks, for instance, significantly underperformed large-cap growth stocks throughout much of the 2010s, testing the patience of factor investors.

The systematic nature of rules-based investing eliminates the risks associated with star managers leaving or changing investment approaches. The strategies are repeatable and based on systematic rebalancing rather than subjective judgment calls.

Active Mutual Funds: The Human Element

Active mutual funds rely on professional managers to select securities they believe will outperform relevant benchmarks. These managers employ various strategies, from detailed fundamental analysis to macroeconomic positioning to quantitative models.

When Active Management Works

Active management has historically shown the most promise in less efficient market segments. According to the 2024 SPIVA scorecard, small-cap active managers achieved their best performance in over two decades, with only 30% underperforming their benchmark—their lowest underperformance rate in the 24-year history of SPIVA tracking[7]. This suggests that in markets where information is less efficiently priced, skilled managers can add value.

International markets, emerging markets, and certain fixed-income sectors also provide opportunities for active managers to exploit inefficiencies. In 2024, real estate funds demonstrated strong active management success, with 66% of actively managed U.S. and global real estate funds outperforming passive strategies[7].

The Active Management Challenge

Despite these bright spots, active management faces significant headwinds in efficient markets. The 2024 SPIVA data shows that 65% of large-cap active funds underperformed the S&P 500[7]. Over longer periods, the challenge becomes even more pronounced—over 15 years, more than 89% of large-cap funds failed to beat their benchmarks[7].

The mathematics work against active managers: they collectively represent the market, but after fees, taxes, and transaction costs, their average performance must lag passive alternatives. This doesn't mean individual managers cannot succeed, but identifying them in advance and maintaining conviction during inevitable periods of underperformance requires significant skill and discipline.

Active funds also tend to be less tax-efficient due to higher portfolio turnover, which can generate taxable capital gains distributions even when the fund's overall performance is poor.

Proponents of active management would point out that, even if only 10 or 20% of actively managed mutual funds had the potential to outperform over the long term, there are 7,000 mutual funds available in the United States. That would suggest that hundreds of mutual funds have the potential to outperform their respective benchmarks. In addition, outperforming the benchmark by just 1% annually could lead to substantially more wealth over the long term.

The ETF Challenge: Why Mutual Funds Are Losing Ground

The rise of exchange-traded funds (ETFs) represents the most significant challenge to traditional mutual funds since their inception. ETF flows in 2024 reached a record-breaking $1.1 trillion, while mutual funds experienced net outflows[8]. This shift reflects several structural advantages that ETFs offer over traditional mutual funds.

The Flow Migration

The data tells a stark story of changing investor preferences. In the first half of 2024, while combined mutual fund and ETF inflows totaled $272 billion, ETFs captured $423 billion in inflows while mutual funds experienced $151 billion in outflows[9]. This trend has been particularly pronounced in North America since 2021, with ETFs becoming the sole driver of growth for the overall fund industry[9].

Weekly flow data from 2025 shows this trend continuing, with ETFs capturing $31.29 billion in net issuance while mutual funds experienced $2.69 billion in outflows for the week ended May 14, 2025[9]. The organic growth rate for active ETFs topped 55% in 2024—nearly five times the growth rate of passive ETFs[9].

Why ETFs Are Winning

Tax Efficiency: ETFs' unique structure allows for in-kind redemptions, which help avoid triggering taxable capital gains distributions to shareholders. This advantage is particularly valuable in taxable accounts, where mutual fund distributions can create unwanted tax consequences.

Trading Flexibility: Unlike mutual funds that price once daily at market close, ETFs trade throughout market hours like individual stocks. This provides investors with real-time pricing and the ability to use limit orders, stop losses, and other trading strategies.

Transparency: Most ETFs publish their holdings daily, giving investors complete visibility into what they own. Many mutual funds only disclose holdings quarterly.

Lower Costs: The competitive ETF marketplace has driven expense ratios to extremely low levels, with many broad-market ETFs charging less than 0.10% annually.

Areas Where Mutual Funds Maintain Advantages

Despite ETF growth, mutual funds retain certain structural advantages. For retirement plans, mutual funds often provide simpler administration and better integration with automatic investment plans. Many investors prefer the discipline of automatic monthly investing that mutual funds facilitate, rather than the manual purchase decisions required for ETFs.

Mutual funds also continue to dominate in certain active strategies where the daily portfolio transparency of ETFs might compromise a manager's strategy. Some sophisticated fixed-income and alternative strategies work better within the mutual fund structure.

Regulatory Revolution: The Coming Dual Share Class Era

The regulatory landscape for mutual funds is poised for its most significant change in decades. The Securities and Exchange Commission is prioritizing review of applications that would allow fund companies to offer both mutual fund and ETF share classes of the same underlying portfolio—a structure currently available only to Vanguard under a patent that expired in 2023[10].

The Current Application Landscape

Over fifty applications for dual share class relief have been waiting SEC approval for up to two years[10]. Major asset managers including Charles Schwab, Fidelity, Dimensional Fund Advisors, and BlackRock have all filed for similar exemptive relief[10]. According to Cerulli research, 93% of standing applicants have requested exemptive relief for dual-share-class structures in their filings through December 2024[10].

The applications cite several advantages of dual share class structures, including "lower portfolio transaction costs," "greater tax efficiency," and "additional distribution channels for asset growth and economies of scale"[10]. These structures could provide the benefits of both investment vehicles while addressing some of the current limitations of each format.

Implications for Investors

If approved, dual share class structures could fundamentally change how investors think about mutual funds versus ETFs. Instead of choosing between two different products, investors could select the share class that best fits their specific needs while accessing the same underlying investment strategy and management.

This development could potentially slow the migration from mutual funds to ETFs by allowing fund companies to offer ETF benefits within existing mutual fund structures. It could also increase competition and potentially reduce costs across both structures.

Dimensional Fund Advisors co-CEO Gerard O'Reilly notes that this change could "revolutionize the ETF and mutual fund landscape" by providing "lower transaction costs, tax efficiencies, and benefits of scale to all shareholders"[10].

Performance Through 2024: What the Data Reveals

The 2024 performance data provides crucial insights into how different mutual fund strategies performed in a year characterized by strong market returns and continued concentration in large-cap growth stocks.

Market Context for 2024

U.S. equity markets experienced an impressive year in 2024, with the S&P 500 recording 57 all-time closing highs and finishing up 25%[7]. This marked the best two-year run for the index since 1998[7]. However, performance varied significantly across market segments, with the S&P 500 Growth outperforming the broader S&P 500 by 11 percentage points[7].

Active Management Performance

The performance dispersion across different market segments highlighted both the challenges and opportunities for active management. Large-cap active managers continued to struggle, with 65% underperforming the S&P 500 in 2024[7]. However, this represents only a modest deterioration from 2023's 60% underperformance rate[8].

Small-cap managers experienced their best year in over two decades, with only 30% underperforming the S&P SmallCap 600[7]. This marked the lowest underperformance rate in the 24-year history of SPIVA tracking, suggesting that market inefficiencies in smaller companies continue to provide opportunities for skilled active managers.

Mid-cap funds faced mixed results, with 62% of all mid-cap funds lagging the S&P MidCap 400[7]. International small-cap managers also performed well, with only 43% underperforming at the one-year horizon[7].

Fixed Income Active Management

Fixed income markets provided a more favorable environment for active managers in 2024, despite inflation concerns and volatility in Treasury yields. Active managers benefited from higher-yielding, lower-quality bonds, with leveraged loans and high-yield strategies leading performance[7].

The changing interest rate environment created both headwinds and tailwinds for different fixed income strategies, with active managers able to navigate these complexities more effectively than in previous years.

Choosing the Right Approach: A Framework for Individual Investors

Given the complexity of today's mutual fund landscape, individual investors need a framework for making informed decisions that align with their specific circumstances, goals, and beliefs about markets.

Core Portfolio Construction

For most individual investors, a core portfolio built around low-cost passive funds provides the foundation for long-term wealth building. These funds offer broad diversification, minimal costs, and the assurance of capturing market returns. A simple three-fund portfolio—U.S. total market, international developed markets, and bonds—can provide comprehensive global exposure at minimal cost.

Strategic Enhancements

Investors who believe in factor-based investing might consider allocating a portion of their portfolio to rules-based funds from providers like Dimensional or Avantis. These strategies work best when held for extended periods, as factor premiums can underperform for years before reasserting themselves.

The key is treating factor investing as a long-term strategic allocation rather than a tactical trade. Research suggests that investors who maintain consistent exposure to multiple factors tend to achieve better outcomes than those who chase individual factor performance[6].

Active Management Opportunities

Active management may make sense in specific circumstances:

- **Market Inefficiencies**: Small-cap, emerging markets, and certain fixed-income sectors where information is less efficiently priced
- **Specialized Strategies**: Real estate, commodities, or alternative investments where passive options are limited
- **Tax-Advantaged Accounts**: Where the tax inefficiency of active management is less problematic

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Fee Sensitivity Analysis

Fees remain one of the most predictable aspects of investment performance. The 2024 research confirms that lower-cost active funds consistently outperform higher-cost ones, with 28% of the cheapest active funds outperforming passive peers over 10 years, compared to just 17% of the most expensive funds[8].

This fee sensitivity extends beyond just expense ratios to include transaction costs, tax efficiency, and the hidden costs of cash management and trading.

The Behavioral Dimension: Psychology Meets Strategy

Understanding the behavioral aspects of mutual fund investing is crucial for long-term success. The structure of mutual funds can either help or hinder good investment behavior, depending on how they're used.

The Discipline Advantage

Mutual funds excel at promoting disciplined investing behavior through features like automatic investment plans and systematic rebalancing. The inability to trade intraday—often seen as a disadvantage compared to ETFs—can actually benefit investors by reducing the temptation to make emotional trading decisions during market volatility.

Research consistently shows that investor returns lag fund returns due to poor timing decisions. Mutual funds' structure naturally encourages a long-term perspective that can improve investor outcomes.

Managing Expectations

Each mutual fund approach requires different behavioral preparation:

- **Passive investors** must accept that they will never beat the market, but also never dramatically underperform due to poor manager selection
- **Factor investors** need patience to endure extended periods when their chosen factors underperform
- **Active fund investors** must maintain conviction through inevitable periods of underperformance while being prepared to change managers if evidence suggests persistent skill degradation

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Points to Remember: Key Takeaways for Individual Investors

Historical Perspective Matters: Mutual funds have democratized investing over 100 years, transforming from an exclusive privilege to a mainstream tool. Today, more than 54% of U.S. households use mutual funds for long-term savings[1].

Structure Follows Strategy: The mutual fund wrapper is simply a vehicle—what matters is the investment approach inside. Passive, rules-based, and active strategies each serve different investor needs and market beliefs.

Costs Compound: Fee differences that seem small annually become significant over decades. A 0.50% annual fee difference can reduce portfolio value by more than 10% over 20 years.

Market Efficiency Varies: Active management shows the most promise in less efficient markets like small-cap stocks, emerging markets, and specialized sectors. Large-cap U.S. equity markets remain the most challenging for active managers.

ETF Competition Is Real: The migration from mutual funds to ETFs reflects genuine structural advantages in taxation, trading flexibility, and costs. However, mutual funds retain advantages in retirement plans and automated investing.

Regulatory Change Coming: Dual share class structures could reshape the mutual fund versus ETF decision, allowing investors to choose the most appropriate share class for the same underlying strategy.

Performance Is Cyclical: 2024 data shows that active management success varies dramatically by market segment and time period. Small-cap active managers achieved their best performance in over 20 years, while large-cap managers continued to struggle.

Behavior Drives Outcomes: The structure that best supports disciplined, long-term investing behavior is often more important than minor differences in expense ratios or tax efficiency.

Diversification Across Approaches: Many successful investors combine multiple approaches—using passive funds for core exposure, factor-based funds for strategic tilts, and selective active management in inefficient markets.

Time Horizon Is Critical: All mutual fund strategies work best with extended time horizons. Short-term performance comparisons are often misleading and can lead to poor investment decisions.

The mutual fund industry continues to evolve 100 years after its creation, adapting to changing investor needs, technological advances, and competitive pressures. While ETFs have captured significant market share, mutual funds remain essential tools for building long-term wealth, particularly when matched appropriately to investor circumstances and goals. The key is understanding that success comes not from finding the "perfect" fund, but from choosing an approach that aligns with your beliefs, maintaining reasonable costs, and staying disciplined through market cycles.

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