Investors Lose When They Choose Mutual Funds Based On Ads

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Investors put more money into mutual funds that advertise, but in the end these customers pay a high price.

A new study in Sweden found that mutual funds that advertise don't perform any better than their competitors. But, maybe as a result of their advertising costs, these firms do tend to charge higher fees, meaning that their customers may actually earn less income over time.

"Mutual fund investors who pay attention to ads could end up with less money available for retirement," said Henrik Cronqvist, author of the study and assistant professor of finance at Ohio State University's Fisher College of Business.

The results are available as a working paper at the *Social Science Research Network*.

The mutual fund industry spends about $6 billion each year on advertising in the United States, Cronqvist said. But little attention has been paid on how this advertising affects consumers.

The study was done in Sweden to take advantage of a unique circumstance in 2000 that allowed Cronqvist to see exactly how advertising influence investor choices.

In 2000, Sweden launched a partial privatization of its public pension system – much like what has been proposed for the Social Security system in the United States .

Under the new system, Swedish workers contributed 2.5 percent of their annual earnings to individual savings accounts. The workers were allowed to form

their own portfolios by selecting from an approved list of Swedish and international mutual funds. One fund was designated as a default fund for anyone who did not make an active choice of mutual funds. All the funds, expect for the default, were allowed to advertise.

Cronqvist looked at the mutual fund choices of 4.4 million workers who allocated a total of $5.6 billion in 2000.

He examined how their decisions were related to advertising done by the mutual funds. The study examined advertisements in more than 250 newspapers, outdoor ads on billboards and buses, and commercials that appeared on all the major television and radio networks.

The advertising was effective in attracting attention: three out of four investors recalled seeing some fund advertising in newspapers or magazines and 86 percent recalled seeing some television commercial for a fund.

But did these investors learn anything from these ads? A content analysis suggests they did not.

“If you look at most of these ads, they do not provide a lot of information that would be helpful to investors,” Cronqvist said.

For example, only about 8 percent of the ads made some mention of the fees charged investors. And even of those ads, fewer than one in ten actually enabled an investor to compare fees to those of some other fund.

The most common type of advertising message focused on the past performance of the fund. But as all investors are taught, past performance is not a good predictor of future results. And indeed, Cronqvist found that firms that advertised prior to 2000 had no higher returns after 2000 than the average for funds in their category.

While advertising does not seem to provide investors with better information or better returns, it does seem to attract the attention and the money of consumers. Findings showed that advertised funds received more allocations from workers than did other funds, even after taking into account a variety of other factors that may affect choices, such as the size of the firms, media attention to the firms, and the bias toward favoring local companies.

The next step was to see how investors fared when they put their money in these more heavily advertised funds. The answer is not very well.

The results showed that firms that advertised generally charged higher fees than did other firms. Moreover, these firms did not seem to provide more services that would have made these higher fees worthwhile, Cronqvist said.

"Investors didn't get more value by paying higher fees," he said.

The bottom line is that choosing mutual funds based on advertising -- and as a result paying higher fees -- can be a costly mistake, he said.

For example, take a 20-year-old investor with 45 years until retirement, who will get an annual raise of 2 percent and who pays 1 percent higher fees per year because he based his portfolio choice on advertising.

"My calculations suggest that this investor will accumulate 15 to 20 percent less wealth in his retirement account," Cronqvist said. "That's bad news.”

While this study was done in Sweden, Cronqvist said he believes that findings are applicable to the United States. For example, it seems that many mutual fund advertisements in the United States focus on past performance, just as they do in Sweden.

“But just because a fund has been successful in the past doesn't mean it will continue to be successful,” Cronqvist said.

“Mutual funds that would be good choices based on my study would be those that are not heavily advertised and which do not spend a lot of money on branding. If they spend a lot of money on branding, they probably will have to pay for that with higher fees.”

Source: Ohio State University