

# The Case Against Mutual Funds

## March 2019 Client Letter

For over 30 years, investors subscribed to Richard C. Young's monthly investment strategy report, The Intelligence Report (IR), for advice on how to become more comfortable and consistent long-term investors. When paging through earlier issues of IR, it's not difficult to find examples of the newsletter's consistency. Text from early issues of IR



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Matthew A. Young, President & Chief Executive Officer | 

RICHARD C. YOUNG & CO., LTD.  
NAPLES, FLORIDA NEWPORT, RI  
3100 Tamiami Trail, Suite 200 600 Middle Street  
Naples, FL 34103 Newport, RI 02840

(800) 843-7273

could easily be inserted into the last report in 2017 and still have relevance. By example, here is text from February 1986: “My basic financial armadillo concept is built around safety of principal value, and the merits of compound interest. Trading is not a part of this program. If your investment portfolio does not include gold insurance, now’s a good time to add some gold.”

While the overriding strategies of IR remained consistent, the advice evolved over the years to reflect the ever-changing and cyclical nature of markets and the economy. U.S. Treasury zero-coupon bonds were emphasized in the early 90s as interest rates declined, but once



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Matthew A. Young, President & Chief Executive Officer | 

**RICHARD C. YOUNG & CO., LTD.**  
NAFLEX, FLORIDA NEWPORT, RI  
3100 Tanager Trail, Suite 200 60 Wall Street  
Naples, FL 34103 Newport, RI 02840  
**(800) 843-7273**

rates bottomed out, the zeros strategy had less appeal and was gradually replaced, in part, with preferred stocks.

Actively managed, no-load, equity mutual funds formed the foundation of both the IR strategy and our equity component in the early days. However, as time passed, funds became less of a focus and were replaced by individual equity shares.

## Why Our Focus Has Shifted to Individual Stocks

Our focus shifted toward individual stocks for several reasons. First, some of our favored mutual funds became so



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Matthew A. Young, President & Chief Executive Officer | 

RICHARD C. YOUNG & CO., LTD.  
NAPLES, FLORIDA NEWPORT, RI  
2100 Tamiami Trail, Suite 200 600 Middlesex Street  
Naples, FL 34102 Newport, RI 02840

(800) 843-7273

large as to limit the flexibility of their investment approach. Take the Vanguard Wellington Fund, for example. The fund was once a staple holding at our firm, but now has over \$100 billion in assets. Taking a position in a stock equal to 2% of the Wellington Fund's assets would require a \$2 billion investment. In order to stay under the U.S. Securities and Exchange Commission's 5% ownership rule requiring additional filings and disclosures, a fund of Wellington's size would be limited to investing in about 2% of all U.S. publicly traded companies. Large funds have many benefits for mutual fund companies, but almost none for mutual fund



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Matthew A. Young, President & Chief Executive Officer | 

RICHARD C. YOUNG & CO., LTD.  
NAPLES, FLORIDA NEWPORT, RI  
3100 Tamiami Trail, Suite 2000 600 Bellevue Avenue  
Naples, FL 34102 Newport, RI 02840

(800) 843-7273

investors.

## **Individual Stock Portfolios Are More Easily Customized Than Mutual Fund Portfolios**

Mutual funds also limit customization. We have clients who don't want to hold a specific security because they have a legacy holding outside of our management, or they want to avoid certain stocks that are out of line with their personal beliefs. With a mutual fund or ETF, such an approach is not possible. With a managed portfolio of individual stocks, portfolios can be easily customized.



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Matthew A. Young, President & Chief Executive Officer | [www.rcy.com](https://www.rcy.com)

**RICHARD C. YOUNG & CO., LTD.**  
NAPLES, FLORIDA NEWPORT, RI  
2100 Tamiami Trail, Suite 200 600 Washington Street  
Naples, FL 34102 Newport, RI 02840

(800) 843-7273

# Tax Efficiency of Individual Stocks vs. Mutual Funds

Tax efficiency is another big advantage of investing in individual stocks as opposed to mutual funds. Mutual fund investors must pay taxes annually on distributed capital gains and again at the time of sale. The former is true even if your mutual fund has lost money. Consider, for example, the Vanguard Explorer Fund. Investors who purchased the Explorer Fund in the fourth quarter of last year got a nasty capital gains surprise. Those who bought the fund on September 28 of last year were down 19.5% on



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Matthew A. Young, President & Chief Executive Officer | [www.rcy.com](https://www.rcy.com)

**RICHARD C. YOUNG & CO., LTD.**  
NAPLES, FLORIDA NEWPORT, RI  
3100 Tamiami Trail, Suite 200 60 Walling Street  
Naples, FL 34103 Newport, RI 02840

**(800) 843-7273**

December 31. But even though the fund lost 20%, investors who held for the entire quarter would have received taxable capital gains distributions of \$8.87 for each share owned, or about \$4,400 on a 500-share position.

Mutual funds also limit the ability to harvest tax losses. While it is true the fund manager can harvest losses within the fund, mutual fund owners can only harvest a loss when the overall fund position is down. That opportunity tends to fade soon after purchasing a mutual fund or ETF when the broader stock market is rising.

Alternatively, in a portfolio of, say, 40 individual stocks, at least a couple of positions are likely to be



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Matthew A. Young, President & Chief Executive Officer | [www.rcy.com](http://www.rcy.com)

RICHARD C. YOUNG & CO., LTD.  
NAPLES, FLORIDA NEWPORT, RI  
2100 Tamiami Trail, Suite 200 600 Bellevue Avenue  
Naples, FL 34102 Newport, RI 02840

(800) 843-7273

held at a loss, even when the overall portfolio is at a gain. And capital gains distributions aren't a problem with individual stocks. Capital gains taxes are only due when a position is sold at a gain. With individual stocks, investors have more control over when to recognize their gains.

It is also important to remember the tax liabilities generated by mutual funds depend partly on your fellow shareholders. Let's say you own a mutual fund with a tax-sensitive portfolio manager who has held onto positions with big unrealized capital gains. If investors in the fund panic during a period of elevated market volatility, the fund



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Matthew A. Young, President & Chief Executive Officer

**RICHARD C. YOUNG & CO., LTD.**  
NAPLES, FLORIDA NEWPORT, RI  
2100 Tamiami Trail, Suite 200 60 Wall Street  
Naples, FL 34102 Newport, RI 02840

(800) 843-7273



manager may have no other choice but to liquidate positions held at a big gain in order to satisfy redemptions. The sentiments of other investors never create a tax problem when investing in individual stocks.

## **Funds Are Less Liquid and More Expensive Than Stocks**

We favor individual shares instead of mutual funds because open-end mutual funds can only be purchased and sold once per day. ETFs can be purchased throughout the day, but, during periods of heightened volatility, there is no guarantee your



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Matthew A. Young, President & Chief Executive Officer |  Fidelity Investments

**RICHARD C. YOUNG & CO., LTD.**  
NAPLES, FLORIDA NEWPORT, RI  
3100 Tamiami Trail, Suite 200 60 Melville Street  
Naples, FL 34103 Newport, RI 02840

(800) 843-7273



shares will be redeemed at net asset value. Mutual funds can also be expensive, adding an unnecessary second level of fees. An advisory firm charging a 1% management fee and investing in a portfolio of mutual funds with an average expense ratio of 1%, costs the end investor 2% per year.

## Expanded Research Capabilities

Finally, our preference for individual stock portfolios has increased over the years as we have added research staff and invested in technology, allowing us to craft globally diversified and customized dividend-stock portfolios more



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Matthew A. Young, President & Chief Executive Officer |  

**RICHARD C. YOUNG & CO., LTD.**  
NAPLES, FLORIDA NEWPORT, RI  
3100 Tamiami Trail, Suite 200 600 Middle Street  
Naples, FL 34103 Newport, RI 02840

(800) 843-7273

efficiently.

Our dividend-stock portfolios are focused not only on yield, but also on dividend growth. Yield is important when investing in dividend stocks, but it isn't the only variable to consider. Historically, investing solely on the basis of yield has been a losing strategy. Investing in companies with steadily rising payouts tends to be a more reliable method for finding quality dividend-payers that can withstand the economy's ups and downs.

Our equity component today is primarily comprised of individual dividend-paying stocks of companies that look to raise their dividend yearly. Many of the companies we



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Matthew A. Young, President & Chief Executive Officer | [www.rcy.com](https://www.rcy.com)

**RICHARD C. YOUNG & CO., LTD.**  
NAPLES, FLORIDA      NEWPORT, RI  
2100 Tamiami Trail, Suite 2000      600 Bellevue Avenue  
Naples, FL 34103      Newport, RI 02840

(800) 843-7273

buy are familiar stodgy types, including Kimberly-Clark and Johnson & Johnson, or those from the widow-and-orphan sector, such as Wisconsin regulated utility WEC. Others, however, may not be as familiar.

## **The Business Strategy That Delivered 54 Years of Dividend Growth**

You may never mention Illinois Tool Works around your kitchen table, but its products power your car, build your home, keep your food safe, and affect your life in hundreds more ways. ITW is a holding company that



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Matthew A. Young, President & Chief Executive Officer | [www.rcy.com](http://www.rcy.com)

**RICHARD C. YOUNG & CO., LTD.**  
NAPLES, FLORIDA NEWPORT, RI  
2100 Tamiami Trail, Suite 200 600 Bellevue Avenue  
Naples, FL 34102 Newport, RI 02840

(800) 843-7273

manufactures parts for cars, construction materials, food equipment, polymers and fluids, welding tools and supplies, electronic testing and measurement equipment, and more. ITW's brands include Miller and Hobart welding products, RainX, Vulcan Equipment, Paslode, and Deltar.

ITW was founded in 1912 and has grown to include 85 divisions in 56 countries. To manage the many pieces of its diverse business, ITW has developed and refined what has become known as the 80/20 front-to-back process. This is a proprietary set of business practices structured to satisfy the needs of ITW's largest and most profitable



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**RICHARD C. YOUNG & CO., LTD.**  
NAPLES, FLORIDA NEWPORT, RI  
2100 Tamiami Trail, Suite 200 60 Westview Street  
Naples, FL 34103 Newport, RI 02840  
**(800) 843-7273**

customers. The process seeks to minimize the cost, complexity, and distraction associated with serving small customers while giving the 20% of customers who generate 80% of the revenue the most attention.

In addition to its 80/20 process, ITW has a renowned innovation program, which has fueled over 17,000 granted and pending patents. The company's decentralized management style empowers teams closest to products and end markets to innovate without moving every decision through layers of bureaucratic overhead.

The 80/20 process has helped ITW become a dividend powerhouse. The



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Matthew A. Young, President & Chief Executive Officer | 

**RICHARD C. YOUNG & CO., LTD.**  
NAPLES, FLORIDA NEWPORT, RI  
2100 Tamiami Trail, Suite 2000 60 Wall Street  
Naples, FL 34103 Newport, RI 02840

(800) 843-7273

company has paid a dividend every year since 1933. And, without fail, ITW has increased its dividend in each of the last 54 years—that's more than half a century of annual dividend growth. ITW's long record of dividend success has earned it a place in the coveted Dividend Aristocrats Index, an elite group of companies with at least 25 consecutive years of dividend growth.

## A New Powerhouse in Streaming

Among the more familiar names, we are buying is Disney. Disney is a global media conglomerate and owner of what is likely the world's most valuable



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Matthew A. Young, President & Chief Executive Officer | 

RICHARD C. YOUNG & CO., LTD.  
NAPLES, FLORIDA NEWPORT, RI  
2100 Tamiami Trail, Suite 200 600 Middle Street  
Naples, FL 34103 Newport, RI 02840

(800) 843-7273

media library. Disney not only owns rights to Mickey Mouse and Donald Duck, but they also own rights to everything Marvel (X-Men and Captain America), LucasFilms (StarWars), and Pixar (Cars and Toy Story) have created.

Disney also owns a portfolio of media networks including ESPN, ABC, the Disney Channel, and Fox's cable networks. The recent acquisition of 21st Century Fox will provide Disney with a majority stake in the Hulu streaming service.

In addition to Disney and Fox's offerings on Hulu, Disney is set to launch a new streaming service called Disney+ later this year. With an unrivaled portfolio of content, Disney



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**RICHARD C. YOUNG & CO., LTD.**  
NAPLES, FLORIDA NEWPORT, RI  
2100 Tamiami Trail, Suite 2000 600 Bellevue Avenue  
Naples, FL 34102 Newport, RI 02840

**(800) 843-7273**



is well positioned to compete with existing streaming services, including Netflix and Amazon Prime.

While Netflix may have pioneered the direct-to-consumer model for media consumption, the firm relied heavily on licensed content and is now scrambling to catch up to Disney and others in original programming. As any long-time observer of the media industry will likely tell you, creating content consumers desire is easier said than done. Netflix is doing its best to catch up, but they are spending billions creating new content that may prove worthless.

And to make Netflix's challenge more daunting,



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NAPLES, FLORIDA NEWPORT, RI  
3100 Tenthredin Drive, Suite 200  
Naples, FL 34103 Newport, RI 02840

(800) 843-7273

before the Disney+ service launches later this year, Disney will pull all its existing movies and shows from Netflix and other streaming services.


## What Exactly is Disney+?

Disney+ will include all Disney, Pixar, Marvel, and Star Wars video, including existing movies and shows, along with four to five exclusive movies and TV shows at launch. Disney plans to make Disney+ the sole outlet for the company's family-friendly content. The edgier, adult-oriented content, including programming from the Fox acquisition, will be delivered via Hulu.

We view Disney's value as



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Matthew A. Young, President & Chief Executive Officer | 

RICHARD C. YOUNG & CO., LTD.  
NAPLES, FLORIDA NEWPORT, RI  
3100 Tamiami Trail, Suite 200 60 Wall Street, Suite 400  
Naples, FL 34103 Newport, RI 02840

(800) 843-7273

attractive, and the upside opportunity across the business as compelling. Disney's dividend yield is a modest 1.55%, but it is well covered and likely to increase at a mid-to-high single-digit rate over the medium term. Disney is also a regular buyer of its own shares. Buybacks have exceeded dividends by a wide margin for eight consecutive years. We would prefer to see the firm pay bigger dividends as opposed to buying back shares, but buybacks are a net benefit to shareholders nonetheless.

## Not Your Father's AT&T

Like Disney, AT&T is a familiar name and one that often comes to mind when



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NAPLES, FLORIDA NEWPORT, RI  
3100 Tenthredin Drive, Suite 200  
Naples, FL 34103 Newport, RI 02840

(800) 843-7273

thinking about consistent dividend payouts. Like electric utilities, telecom companies have historically been dividend champions. Commonly viewed by investors as a provider of cellphone and related services, AT&T is a massive multinational conglomerate whose businesses include technology, mass media, and entertainment.

AT&T's business segments include wireless, consumer fixed-line and DirecTV, the recently acquired WarnerMedia, fixed-line business, and Latin America. The wireless-business and WarnerMedia assets are where we see AT&T's opportunity. The emergence of 5G wireless technology has the



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NAPLES, FLORIDA NEWPORT, RI  
3100 Tamiami Trail, Suite 2000 600 Middleway Street  
Naples, FL 34103 Newport, RI 02840

(800) 843-7273

potential to be a game changer. 5G speeds are competitive with fixed-line high-speed Internet, and they will be needed for the emerging Internet of Things.

The eyesore in AT&T's business lineup is the consumer fixed-line and DirecTV business. DirecTV was purchased in 2015 and increasingly looks like a mistake. While the business generates cash for AT&T, company management overpaid for what is now a declining business. Our preference would be a sale of DirecTV with the proceeds used to reduce debt.

## AT&T's Beefy



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2100 Tamiami Trail, Suite 200 500 Middle Street  
Naples, FL 34102 Newport, RI 02840

(800) 843-7273

## Dividend

While we aren't fans of AT&T's DirecTV business, we do favor the company's attractive dividend. AT&T shares yield 6.5% today. AT&T has increased its dividend for 34 consecutive years. We anticipate continued modest increases over coming years. With a yield of more than 3X that on the S&P 500, some investors are concerned AT&T's dividend may not be rock-solid given the increased debt load used to purchase DirecTV and Time-Warner. We wouldn't necessarily disagree that AT&T went heavy on the debt, but the dividend appears secure at current levels. We expect AT&T's free cash flow to be \$26



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NAPLES, FLORIDA NEWPORT, RI  
3100 Tamiami Trail, Suite 200 60 Wall Street  
Naples, FL 34103 Newport, RI 02840

(800) 843-7273

billion this year. The dividend should come in at about \$13.5 billion, which leaves a more than ample \$12.5-billion cushion that can be used to pay down debt. There is, of course, no guarantee the dividend won't be reduced, but the risk-reward is appealing in our view.

## **Disney and AT&T in New Communication s Services Sector**

You will note on your quarterly holdings report that both Disney and AT&T are listed in the communications services sector. Standard & Poor's and MSCI (the creators of the GICS sector hierarchy)



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NAPLES, FLORIDA NEWPORT, RI  
2100 Tenthredin Road, Suite 200  
Naples, FL 34102 Newport, RI 02840

(800) 843-7273

decided to replace telecommunications with the expanded communications services sector last September. This sector includes telecom companies as well as media, entertainment, and interactive media firms. The largest companies in the sector are Facebook and Google, neither of which pay a dividend.

Have a good month. As always, please call us at (888) 456-5444 if your financial situation has changed or if you have questions about your investment portfolio.

Warm regards,



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NAPLES, FLORIDA NEWPORT, RI  
2100 Tamiami Trail, Suite 200 60 Wall Street, Suite 200  
Naples, FL 34102 Newport, RI 02840

(888) 843-7273



## President and Chief Executive Officer

**P.S.** The retail business has been tough lately, with many storied businesses, including Sears, Toys R Us, and others going bankrupt. Walmart, though, seems to be showing brick-and-mortar retailers the pathway toward competing in today's e-commerce focused world. In the fourth quarter of 2018, Walmart had its best holiday season in at least a decade. Comparable sales rose 4.2% in the quarter. Part of what made the season such a success was Walmart's drive to soak up as much of Toys R Us's market share as possible. The company pushed hard, using in-store experiences online retailers couldn't



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**RICHARD C. YOUNG & CO., LTD.**  
NAPLES, FLORIDA NEWPORT, RI  
2100 Tamiami Trail, Suite 200 600 Bellevue Street  
Naples, FL 34102 Newport, RI 02840

**(800) 843-7273**

replicate to get children and their parents through the doors. While e-commerce will surely continue to grow, Walmart's adaptation is a survival blueprint for other retailers.

**P.P.S.** While it appears that no one in Washington, D.C., is worried about growing deficits, we are. Deficits are blowing out, and the U.S. will likely spend about \$900 billion it doesn't have this year. America's accumulated debt is over \$22 trillion. Republicans don't want to talk about the debt because they're afraid it will encourage talk of raising taxes, and Democrats don't want to talk about the debt because they're afraid it



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Matthew A. Young, President & Chief Executive Officer

**RICHARD C. YOUNG & CO., LTD.**  
NAPLES, FLORIDA NEWPORT, RI  
2100 Tenthredin Drive, Suite 100  
Naples, FL 34102 Newport, RI 02840

(800) 843-7273

will encourage talk about cutting spending. The problem is soon the cost of the debt service itself will increase to a size that will hurt America's economy. By next year America will spend more on interest than on Medicaid. And by 2024, America will spend more on interest than on the military. While politicians like former Treasury secretary Larry Summers are suggesting America doesn't need to worry about the debt, it is hard to ignore the possible effects all that debt could have on the economy.

**P.P.P.S.** In January, America's economy enjoyed its 100<sup>th</sup> straight month of higher employment, with the number of payrolls rising



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NAPLES, FLORIDA NEWPORT, RI  
2100 Tamiami Trail, Suite 200 600 Washington Street  
Naples, FL 34102 Newport, RI 02840  
(800) 843-7273

by 304,000. Wages also rose by 3%, and the unemployment rate remained low at 4%. Even Americans who have been out of the workforce are returning to look for jobs. Participation of women in the workforce aged 25 to 54 is at its all-time high of 76%.



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**RICHARD C. YOUNG & CO., LTD.**  
NAPLES, FLORIDA NEWPORT, RI  
3100 Tamiami Trail, Suite 200 600 Middlesex Street  
Naples, FL 34102 Newport, RI 02840  
(800) 843-7273