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Do Direct Stock Market Investments Outperform Mutual Funds? A Study of Finnish Retail Investors and Mutual Funds¹

ABSTRACT

Earlier studies of mutual fund performance have not been able to exclusively show that it is profitable to invest in the stock market through mutual funds. Most studies are concerned with how mutual funds perform in relation to a benchmark index. We take a different approach and compare actual investment performance of retail investors (individual private investors) when they invest directly in the stock market, to the investment performance of mutual funds. The relative costs and efforts of constructing a well diversified portfolio are expected to be inversely related to portfolio size. To investigate if direct investments in the stock market are more suitable to larger portfolios, we categorize retail investors according to their portfolio size. Using randomly drawn samples of smallest, medium and largest investors of the active largest third of investors in Finnish shareholdings data for the period January 1995 to May 2000 we find the following: The smallest active investors underperform mutual

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funds. Medium size active investors perform similarly to mutual funds before transaction costs and taxes, but net of transaction costs and taxes medium size investors underperform mutual funds. The largest investors outperform the mutual funds both before and after transaction costs and taxes. We also find that investment strategies of large investors stand out as different while the other two groups of investors apply similar strategies that produce close to the average market return.

Keywords: retail investors, mutual funds, transaction costs, taxation

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