Pulling Back The Curtain On Mutual Fund Fees:

Exposing The Real Costs Of Mutual Funds & What It Means To You

Over the past twelve years since I began my career in the investment industry, on countless occasions I've heard individuals complain about the poor performance of their investment portfolios. Not only have I heard people express their concern with their lackluster performance but also their fear that they won't have enough to retire when the time comes. And, while there are likely many reasons leading to this feeling, I've always thought it primarily related to the lack of having a well-diversified portfolio. Simply put, my thinking was that most people took far too much risk in investing their wealth. And as a result, their risky behavior hurt their returns. But, while I think this is indeed a major factor leading to their less than stellar performance, as I've recently learned it goes much further than that. Rather, I've come to the conclusion that most individuals invest most of their wealth in mutual funds and therein lies the problem. Now, if your decision is one of should I invest in a bank account earning 0.20%, should I bury my money in my backyard and pray I remember where I need to dig when the time comes, or should I invest in mutual funds, the answer is pretty straightforward. Unfortunately, in today's low interest rate environment, mutual fund investing is the only logical choice. However, the problem is that the mutual fund industry isn't nearly transparent enough for the majority of investors to make well-informed decisions. In fact, I'd argue that many of the investment firms are actually asset-gathering machines and are less skilled at actually managing the assets on their clients' behalf.

The problem is that investors hear all about their "green line" or they see someone jogging on the beach showing how they too can outpace their peers, but the truth of the matter is that no one has a real vested interest in explaining to small investors that there is a rather considerable cost to investing in mutual funds. I recently read a well-written article in the April 4, 2011 edition of *Forbes* Magazine, which did a great job of detailing what these costs really are. Typically, the only people that write about these kinds of topics are university professors who do extensive research dissecting information. Unfortunately, while many times these professors' white papers are written with the goal of providing information, they are not written in such a way as to be easily understood by the investing public.

That said, for those who truly desire to be informed and make the best decisions possible for their financial future, I would highly recommend reading "The Real Cost of Owning A Mutual Fund" in *Forbes*. In this article, the author, Ty A. Bernicke, does a good job of detailing all of these costs in a way that is not only easily understood by the small investor but provides useful content to aid in their decision-making process.

Assuming that someone works with a fee-based financial planner/advisor who charges somewhere around 1% of their portfolio's balance annually (the author notes that these advisor fees vary anywhere from .25% to 2.5%), the article highlights that the average all in cost of an actively managed stock mutual fund is approximately 5.17%. And, likely a little more than that, considering that soft dollar arrangements are so hard to quantify, even for those who have the understanding to attempt to do so. Note that this is for a taxable account. For a non-taxable account, the costs falls about 1% to 4.17%. Mr. Bernicke explains the different fees that make up the total costs that small investor's pay. For the purposes of this discussion, they are the expense ratio, transaction costs, taxes, cash drag, soft dollar costs, and advisory fees. While I will not go into greater depth in this forum, I strongly suggest that you read Mr. Bernicke's article. I'm providing a link for you to make finding the article easier.

(http://www.forbes.com/2011/04/04/real-cost-mutual-fund-taxes-fees-retirement-bernicke.html)

The point that I really want to make is that mutual funds charge considerable fees that I would suspect the great majority of the investing public has no idea about. Having a solid understanding of these fees will only help you as a starting place as you begin to question your performance.

As someone who takes his role as a fiduciary seriously, I feel compelled to share the following exercise with you. Let me share with you what generating an extra 1% or 2% does to an investment portfolio over time. I would imagine for most people, if one of your friends said that his/her return was 7.2% while yours was 6.5% and another friends was 7.7%, most would think that they all had about the same return. And for a short period of time, they'd be essentially right. However, when one considers the compounding effect that happens over a longer period of time, they couldn't be further from the truth. The thing is…..time matters. It not only heals all wounds, but it can really make a meaningful impact on your wealth. As an illustration, I'm assuming someone invests $500,000 at a 6% annual interest rate for 25 years. In 25 years, you'd have $2.15 million. Note that for these purposes, we aren't factoring in inflation. While no one knows what $2.15 million will buy in 25 years, the undeniable fact is that you'd be better off financially with the $2.15 million than without it. However, a funny thing happens when you earn just a 1% higher return. One percent may not sound like a lot, but over a 25-year period of time, the returns can be quite meaningful. So, investing the same $500,000 today, but generating 7% (instead of 6%), yields $2.71 million. That's a difference of almost $568,000. In fact, that differential is more than the amount you began with in the first place. Now, to further demonstrate how meaningful earning another 1% or 2% can be to your financial well-being, let's continue our exercise. Investing the same $500,000 but at 8% (instead of either 6% or 7%) for the same 25-year period yields an impressive $3.42 million, or nearly $1.3 million more than our 6% baseline. In fact, that extra 2% yielded an amazing 60% better return than our 6% target. (Note this is summarized in the chart below.) Still think that 1% or 2% don't make that much of a difference? The bottom line with these examples is that fees matter. And, when an individual invests in high-cost mutual funds, the returns and, ultimately their wealth, are negatively impacted. In some cases, quite significantly as our example demonstrated.

For most investors, mutual fund investing is their only option. However, when someone is looking for a financial planner/advisor to help him or her "manage" their financial well-being, my suggestion is to find someone who actually knows how to invest assets. Someone who not only has a good understanding of the capital markets, but also has experience valuing different asset types. That right individual or team is then able to manage the great majority of your wealth internally (and cost effectively) without having to "farm" the money out to mutual fund managers who, as the research shows, charge rather sizable fees. Perhaps in the era of 15%-20% annual returns, investors may have overlooked these considerable fees, but what was once overlooked is no longer acceptable in today's environment where return expectations are much more muted. Think about it….if before fees your portfolio grows 8-10%, that means that after fees roughly half of your gains go to someone other than you. This is an end result that most people, if they only were aware of the situation, would not stand for. Rather, consider yourself financially enlightened. Demand something better. The mutual fund industry is enormous in scale. But, there is no reason you need to continue to contribute to its well-being. Focus on what's in ***your*** best interest. The industry will be just fine without you (at least, until it isn't).