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Will Deener: Hidden costs in mutual funds can add up

12:00 AM CDT on Monday, September 7, 2009

On the boredom scale I put this topic just slightly ahead of watching cows chew, but stick with me here and you'll thank me later – perhaps in 25 or 30 years.

I want to chat about the fees that mutual fund companies subtract annually from your portfolio before they report results. Your eyes are already starting to glaze over – that's impolite by the way – because you think those small charges don't matter.

But those fees – otherwise known as a fund's expense ratio – are the main reason your mutual fund manager cannot consistently outperform the overall stock market. Savvy investors already know that the average expense ratio for a U.S. stock fund is between 1 percent and 1.5 percent annually.

These costs include things like fees paid to the fund's investment adviser, marketing, legal expenses and accounting and auditing fees. Investors should at least make sure the expense ratio of their funds is no more than that.

Given enough time, high expense ratio funds will dramatically underperform low expense funds, according to Morningstar. But I called this meeting to discuss something more than just expense ratios.

There are other hidden costs that are not captured in the expense ratio that investors need to be aware of. Academics refer to these invisible and sometimes damaging charges as trading costs.

They include the brokerage commissions paid when fund managers buy and sell stocks for their fund, but there is more to it than simply commissions.

Let's say, for example, a large mutual fund places an order to buy 100,000 shares of a stock at $20 a share. It's likely that the share price will rise before the order is completed because the extra demand will push the stock higher.

That's an additional expense to the fund to buy those shares. Similarly, if the fund manager decides to sell 10,000 shares, the price will probably drop before the order is completely filled – another expense. And it is not insignificant.

"In some cases, the trading costs are as great as the expense ratio," said Russ Kinnel, director of mutual fund research at Morningstar.

In one academic study referred to in *Ignites*, a mutual fund industry magazine, trading costs for one group of funds averaged 1.44 percent, while the average expense ratio was a much lower 1.19 percent. This study and others have prompted Morningstar to develop a method to measure trading costs. The goal is to help investors

make better decisions on which funds they buy.

Morningstar has teamed up with a company called ReFlow Management, based in San Francisco. Paul Schaeffer, president of ReFlow, said he is hopeful Morningstar will roll out the new measure later this year.

"Everyday money is flowing into and out of funds, and sometimes it causes mangers to buy and sell stocks when they really don't want to," Schaeffer said. "These are extra expenses and another hurdle the fund must get over to beat the market."

Kinnel is reluctant to announce the exact date for the rollout, saying, "We have a team working on it, and it's obviously important to us." Whenever it is rolled out, a fund's trading costs information would be reflected as "high, medium or low," he said. Lower is better.

Kinnel and many others, including Jack Bogel, founder of the Vanguard Group, have consistently warned investors about how all these costs erode fund performance. For example, a fund with an average annual return of 10 percent and no expense ratio would turn a $10,000 investment into $67,275 over 20 years.

Add on a relatively low 0.5 percent expense ratio and this investor would have about $6,000 less, or an 8.7 percent hit, at the end of 20 years. Add 2 percent, and this investor would have $20,665 less money – $46,665 – for a 31 percent hit.

That's why expense ratios are one of the best predictors of future fund performance.