

Hidden Mutual Fund Expenses

Ray J. Shreder, RFC, CRC, AIF

Mutual fund investors are normally aware if any sales charges accessed when they purchase shares of a mutual fund. However, many mutual fund investors are unaware of the additional fees they pay annually on both load and no-load mutual funds. Mutual funds have two separate ongoing internal expenses, fixed and variable. Fixed expenses include the fund's operating costs, such as employee salaries, phones, marketing, etc. and are included in the mutual funds Annual Expense Ratio. According to Morningstar, the average equity mutual fund's Annual Expense Ratio is 1.20%ⁱ.

Many investors, as-well-as investment advisors, are not aware of the many variable costs of operating a mutual fund, which are excluded from the expense ratio.

Variable costs include brokerage commissions and trading expenses. Whenever the fund manager buys or sells a security, a brokerage commission is paid. These expenses are disclosed in a document called the Statement of Additional Information (SAI). However, unlike the prospectus, this statement is not automatically provided to investors. It is provided upon request. As a result, few investors are aware of its existence, and of the additional fees.

These fees can be substantial and even exceed the Annual Expense Ratio. Research reveals that the average SAI charge is 1.40% per yearⁱⁱ. This is in addition to the average Annual Expense Ratio of 1.20%. Therefore, to determine a mutual fund's true annual fees, both the fixed and variable fees must be added together. Thus, the average mutual fund total fees are 3.00% per year.

Also, if a financial advisor provides an investor with a portfolio of mutual funds, another fee called the Asset Management Fee, may be accessed annually. This is the fee that an advisor charges for their services. This fee is generally expressed as a percentage of assets and averages 1.41% per yearⁱⁱⁱ.

To determine the true cost of owning a mutual fund, all of these fees must be added together, which would make the industry average 4.01% per year.

In addition, mutual fund's internal fees are normally not based on a sliding scale. Based on industry averages, a \$10,000 mutual fund investment would incur \$300 of internal fees per year, and a \$500,000 investment would incur \$15,000 in internal fees per year. Add an advisor's average fee and the total annual costs increase to \$401 for the \$10,000 investment and \$20,050 for the \$500,000 investment.

Mutual funds also expose investors to taxes on profits that they never received. Embedded Capital Gains Taxes are taxes that must be paid on individual securities sold by the mutual fund for a profit. Unfortunately for many mutual fund investors, the gain is based on the original price paid for the security by the mutual fund, not the price when the investor bought the mutual fund shares.

If you are looking to invest new money in a mutual fund, you would do best to check its distribution schedule by calling the company or checking their web site. You don't want to invest right before a payout, since you will end up paying taxes on gains you did not receive. According to the SEC, mutual fund investors lose an average of 2.5% of their returns to taxes on embedded capital gains each year^{iv}.

Mutual funds do have many benefits. However, for many investors the disadvantages of high costs and increased tax liability potential probably outweigh the benefits by a wide margin. Especially when considering the alternatives available to large investors, such as Separately Managed Accounts.

ⁱ Morningstar, "Fund Spy", 2006

ⁱⁱ Registered Rep Magazine, Morningstar, Roger Edelen of Boston College, Richard Evans of University of Virginia and Gregory Kadlec of Virginia Polytechnic Institute, "Scale Effects in Mutual Fund Performance".2007.

ⁱⁱⁱ Tiburon Strategic Advisors, 5/03 Fee-Only Financial Advisor Best Practices Survey; Tiburon Research & Analysis

ⁱⁱⁱ Securities and Exchange Commission, 2006