Find What Your Mutual Fund Fees Really Are

by Lynn O'Shaughnessy

Can you remember the last time you received a bill for your mutual funds? Think hard. Maybe you paid it when you wrote the check to the cable company and for your credit cards. Or perhaps the invoice is still stashed in your stack of bills.

Actually, don't bother looking for it, because you never received one. The fund companies automatically pull their fees out of your accounts. In fact, you pay the mutual fund managers about as frequently as you reimburse Visa or MasterCard.

The frequency isn't what should gnaw at you. It's the enormity of the price tag that should grab your attention. Many investors are blithely sitting on a portfolio of expensive funds because they don't know they're being gouged.

Surely, shoppers who are patient enough to stand in line at Costco to save a few bucks on toilet paper would be furious if they realized they were ponying up hundreds or even thousands of extra dollars for their mutual funds.

Unfortunately, the mutual fund industry long ago mastered the art of stealth fees. Consumer advocates, over the years, have clamored for account statements that pinpoint what each of us pay for the privilege of being fund investors. The fund industry, however, has routinely squashed the idea. Obviously, if we don't know what we're paying, we lose the motivation to find better deals.

The closest thing to a fee disclosure can be found is each fund's yearly prospectus. In this document, you'll find a chart that projects what the costs would be for a hypothetical investor.

Hardly anybody reads this ponderous handout and even if they did, it only provides an example. I wouldn't be alarmed at Donald Trump's credit card bill because I don't have to pay it. I'm only interested in what my bill is.

If you don't know whether your fund company has shaken you down, make this the day you find out. It isn't hard to do.

What you want to obtain for each of your funds is something called the expense ratio. You can locate this number in the prospectus, or you can call the fund company or the adviser who persuaded you to buy shares. Perhaps the easiest way to get this expense ratio is to visit www.Morningstar.com. Type in the name of your fund in its search engine and once it appears on the screen, click on the "Fees & Expenses" link.

This ratio tells you what percentage of your account is being siphoned out for expenses each year. For example, if you have $50,000 in a fund that maintains a 2 percent expense ratio, your tab for the year would be $1,000.

The cost for a $500,000 retirement nest egg that's invested in the same fund would be $10,000. It's these sorts of numbers that will make the time you spend chasing toilet paper discounts look pretty inconsequential.

So what's expensive? The average fund expense ratio, according to Morningstar, is 1.35 percent. Admittedly, that percentage standing by its lonesome isn't going to look Draconian. That's especially true for those of us paying sales tax of 7.75 percent every time we pull out our wallets. But over time, your returns will erode dramatically even if you stick with average-priced funds, much less the expensive ones.

Suppose, for example, that you invested $25,000 in a fund for retirement that charges the average rate and you hang on for 30 years. Assuming an 8 percent return, you'd end up with $167,326. The total cost of holding this average-priced fund would be $31,720 in fees and $52,519 in forgone earnings.

In contrast, if you put the money in an index fund that charges 0.2 percent, you'd walk away three decades later with $236,902. You'd pay $5,880 in fees and $8,784 in lost earnings. Which one would you rather own?

When examining a fund's costs, you should also check for a fee that I find particularly galling that's embedded in the expense ratio. It's called the 12b-1. The Securities and Exchange Commission signed off on this fee more than a quarter-century ago to help struggling mutual funds attract investors through marketing.

In theory, funds with all this extra cash could publicize their great track records and bring more investors into the fold. As they grew, these funds could become more efficient, cut their costs to investors and ditch their 12b-1 training wheels.

Unfortunately, that didn't happen.

Instead, an increasing number of mutual funds began tacking on 12b-1 fees. In fact, today a stunning 12,366 mutual funds out of 18,914 have embraced these fees.

Much of this money is no longer going to buy glossy brochures or other marketing materials. Instead, the fund companies use their windfalls to compensate brokers and investment advisers for recommending them to their clients.

Because these fees technically aren't a sale charge, a broker can tell his client that he's recommending a fund that doesn't charge a sales commission. The investor mistakenly thinks he's gotten a fund for free, and the broker gets to pocket a chunk of the 12b-1 cash. Now suppose a broker recommends a fund with a 12b-1 fee, you buy it and then never see the guy again. The broker will continue to be reimbursed for his advice -- whether or not it was any good -- for as long as you own the fund.

Even if you don't rely on a stockbroker, you could still get entangled with 12b-1 fees. Plenty of funds that are offered through discount brokerage supermarkets, such as Charles Schwab and Fidelity Investments, contain 12b-1 fees. The fund companies use their 12b-1 cash to compensate the brokerage firms for giving them shelf space.

What's the lesson in all this? Finding out what your funds cost is not only critical, it can also be an empowering exercise. That's because costs are the one thing that you can control as an investor. While you may devote many hours to picking the right mutual funds for your portfolio, they could turn out to be turkeys. If instead more people paid attention to costs, fund prices would surely drop and that would benefit everybody.

"The industry," says Roy Weitz, the publisher of Fund-Alarm, an online mutual fund newsletter, "takes advantage of the fact that people don't pay attention to their pennies."Lynn O'Shaughnessy is the author of "The Retirement Bible" and "The Investing Bible." She can be reached at lynnoshaughnessy@cox.net. Copley News Service

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