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# The Real Cost Of Owning A Mutual Fund

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In over 25 years of business, our firm has never had an initial meeting with an investor who completely understood the total costs of the mutual funds they owned. The following article seeks to simplify the many complexities of mutual fund expenses so investors are able to discover the true costs associated with mutual fund ownership. To simplify this topic, six different costs will be evaluated: expense ratio, transaction costs (brokerage commissions, market impact cost, and spread cost), tax costs, cash drag, soft dollar cost and advisory fees.

***Expense Ratio***

The expense ratio is frequently the only cost that many investors believe they pay when owning a mutual fund. The expense ratio is frequently used to pay marketing costs, distribution costs and management fees. This ongoing cost can be identified by reading a mutual fund's prospectus. The average U.S. Stock fund now costs .90% per year according to a recent Morningstar article.

***Transaction Costs***

A study by Edelen, Evans and Kadlec found U.S. Stock Mutual Funds average 1.44% in transaction costs per year. These costs can be difficult to determine, are not found in most prospectuses, and are not included in the aforementioned expense ratio. A group of cost conscious investors called the Bogleheads breaks down transaction costs into three categories: brokerage commissions, market impact, and spread cost.

1. The first type of transaction cost is brokerage commissions. Brokerage commissions result from mutual fund managers buying and selling stocks for mutual fund investors inside of the fund company's brokerage account (s). Discovering the additional expenses due to turnover can be a difficult endeavor. This task can be accomplished by making estimates based on information found in the Statement of Additional Information, a document mutual fund companies must make available upon request, but don't generally distribute to investors.

2. The second transaction cost even more difficult to estimate is market impact cost. The Bogleheads define market impact cost this way: "A mutual fund making a large transaction in a stock will likely move the stock price before the order is completely filled." This negatively affects mutual fund owners in three distinct ways. First, individuals receive less favorable prices on certain stocks being bought and sold. This occurs when an investor's mutual fund manager is buying or selling large quantities of stock that drives the price artificially higher or lower. Second, a fund manager may alter its investment management strategy to avoid excessive market impact costs. This can happen if a manager chooses to enter and exit stock positions over long time horizons in an effort to mitigate sudden short term movements in the securities it is trying to sell or acquire. Last, a mutual fund manager may be forced to include less favorable stocks in its portfolios to alleviate the market impact pressure on its favorite stocks. Market impact cost can be a lose-lose situation for mutual fund investors because they may get unfair pricing on both the buy and sell side of stock transactions in addition to having their mutual fund managers compromising their stock picking prowess to avoid excessive costs.

3. The final transaction cost is called spread cost. This cost also occurs when a mutual fund manager buys and sells stocks for mutual fund owners. Spread cost reflects the difference between the best quoted ask price and the best quoted bid price. This cost is also difficult to quantify. Generally, it is more excessive when a mutual fund is trading international or smaller, less liquid stocks.

As illustrated on the next page, transaction costs can add substantially to the overall expense of an investor's mutual fund. In addition to being substantial, these costs are nearly impossible to accurately quantify.

***Tax Costs***

Many investors pay more than their fair share in taxes when owning mutual funds. This problem is most transparent when mutual funds are owned outside of an IRA, Roth IRA, 401(k), or other tax-deferred accounts. An investor who buys into a mutual fund that is holding stocks that have appreciated prior to the purchase of the fund runs the

risk of paying for these stocks' capital gains taxes. Essentially, even if the investor did not benefit from stocks' gains, this investor will share proportionately in taxes due from the sale of these appreciated stocks when the mutual fund manager makes a change. Ultimately, one can end up paying taxes on investments that other investors profited from.

Before purchasing an actively managed mutual fund in a taxable account, an investor should consider contacting the company to determine the level of embedded gains within the mutual fund. According to Morningstar, the average tax cost ratio for stock funds is 1% to 1.2% per year.

***Cash Drag***

Another cost of owning a mutual fund is cash drag. Cash is frequently held by mutual fund managers to maintain liquidity for potential transactions and potential redemptions by mutual fund owners. This may stifle the performance of a mutual fund if stocks increase in value greater than the cash held. According to a study by William O'Rielly, CFA, and Michael Preisano, CFA, the average cost from cash drag on large cap stock mutual funds over a 10-year time horizon was .83% per year. This cost results from investors paying the mutual fund's expense ratio on 100% of the money invested despite the fact that not all of the assets are invested into stocks or other securities. Someone who holds cash in a bank savings or money market account on an individual basis generally does not have to pay these extra costs. Essentially, buy and hold investors are subsidizing other investors' liquidity needs. It should be noted that cash held within a mutual fund could be beneficial during a time when stocks do poorly and incrementally more expensive when stocks perform well relative to cash.

***Soft Dollar Cost***

One of the most difficult mutual fund expenses to estimate is called soft dollar cost. This cost comes into play when mutual fund managers are buying and selling stocks within the mutual fund's brokerage account(s). Frequently, mutual fund managers may direct the money being managed to brokerage companies providing them with research and/or other services, even if the brokerage companies are not providing the most cost efficient brokerage commissions involved with buying and selling stocks. Essentially, this is a quid pro quo arrangement. The mutual fund manager gets special services and/or research, and the brokerage company gets the brokerage business at a premium rate. This effectively keeps this cost out of the public's eye, giving a fund the artificial appearance of lower than actual expenses. A research study by Stephen M. Horan suggested that U.S. soft dollar brokerage commissions may total $1 billion annually, or up to 40% of all equity trading costs.

***Advisory Fees***

The final cost is only relevant to individuals working with fee-based financial and/or investment advisors who select mutual funds for their clients. Many fee-based advisors will manage an investor's portfolio for an annual fee commonly ranging from .25% to 2.50% of the portfolio's balance. This fee is required to be disclosed on investors' statements, and is charged in addition to the other mutual fund costs discussed.

***Cost Summary***

The following summarizes the average quantifiable costs described. Advisor and soft dollar costs are excluded due to the large range in advisory fees and the difficulty of quantifying soft dollar costs. When working with a financial advisor, it is important to add the advisory fee to the mutual fund costs listed below for an accurate depiction of total potential costs.

| Non-Taxable Account | Taxable Account |
|---|---|
| Expense Ratio .90% | Expense Ratio .90% |
| Transaction Costs 1.44% | Transaction Costs 1.44% |
| Cash Drag .83% | Cash Drag .83% |
| -- | Tax Cost 1.00% |
| Total Costs **3.17%** | Total Costs **4.17%** |

As illustrated, hidden costs have infiltrated the mutual fund industry and are being paid by many unsuspecting investors. Despite potential drawbacks, investors can acquire broad tax efficient diversification at a fair price by utilizing mutual funds properly. In addition to potentially utilizing mutual funds, high net worth investors can obtain broad tax efficient diversification through direct ownership of securities or through privately managed accounts. These possibilities can increase transparency and eliminate many of the costs directly linked to mutual fund ownership. Cost considerations are one of many factors to analyze when allocating your portfolio and making investment decisions.

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