The Hidden Costs of Mutual Funds

At this time of year mutual fund investors are gathering tax slips and evaluating their annual statements to assess how their investments fared in 2003. Unfortunately, most do not consider the unseen costs embedded within their mutual fund portfolios - costs that are often punitive. This unhappy fact came up recently at an investment conference where the well-respected mutual fund commentator Duff Young reported total costs for mutual funds sometimes **approach 5% per year**. If this number seems surprising, a quick tally of the many charges associated with mutual funds reveals the problem for investors. The following table details, on average, how the costs can add up:

Average Mutual Fund Fees (MER)	2.35-2.75%
Brokerage Commissions	0.25
Trading Impact Costs	0.25
Sales Charges (front or deferred charges)	1.00
Total Costs	**3.0-4.0%**

To explain:

- Average Fees - Last year Morningstar released a study indicating that average equity fund MERs have risen to approximately 2.75%. Elsewhere, it has been recently reported in the financial press that, on an asset-weighted basis excluding segregated funds and labour sponsored funds, equity fees are closer to 2.35%. Either way, it's a punishing first hurdle. As a rule, smaller company funds and globally oriented funds have the highest management expenses and index funds have the lowest.

- Brokerage Commissions - Most investors do not realize brokerage commissions are not included in the MER of a mutual fund. Obviously, the higher the turnover rate in the fund, the higher the cost that needs to be factored in. Studies have shown the average turnover rate for a Canadian mutual fund is about 80% per year, meaning 80% of the assets in a fund will change annually. Large blue chip funds with low turnover rates may have commission charges as low as .05% while funds with higher turnover easily reach costs of 0.4% and above.

- Trading Impact Costs - The total cost to complete every trade equals the commission **plus** market impact costs. The more illiquid the security, the higher the bid/ask spread and therefore the higher the ultimate cost to the investor. According to a recent study in the U.S., these costs approximate 0.1% for large cap stocks, as much as 1% for small cap stocks and upwards of 4% for micro cap stocks. Again, higher turnover will translate into higher market impact costs.

- Sales Charges - If the above costs aren't depressing enough, there is more bad news for mutual fund investors. According to Investor Economics, approximately 75% of funds in Canada have sales charges, either front-end or deferred. Front-end charges or loads are incurred at the time of purchase while deferred charges are charged at time of sale and will decline to zero after a period of several years. Typically, deferred sales charges start at about 6% and decline by 0.5% per year over seven years to the point when no sales charges exist. Unfortunately, most investors do not hold their funds for seven years. According to Dalbar, a U.S. based mutual fund research firm, the average holding period for U.S. mutual fund investors is only three years. Although there is no comparable data available for Canada, we have little reason to believe the holding period here would be materially different.

  Assuming a fund is sold after three years, the deferred load is usually about 5%. This equates to approximately 1.5% in additional fees each year. We should note that the deferred sales charge is not triggered if an investor purchases another fund within the same mutual fund family. However, many times such a decision is less than optimal from an investment perspective.

In conclusion, if we add up all the above costs, it is easy to see how mutual fund fees might approach 5%. And that's before taxes are taken into account. On a high turnover fund taxes may reduce returns by another 1% or 2% per year due to realized capital gains distributions.

Historically, let's remember that equity markets have delivered long-term returns of about 10% per year on average. Some years will be better of course, but as recent experience has shown, some years will also be worse. This reality makes it highly unlikely that mutual fund investors can ever build wealth if their market returns are so hampered by the drag of costs and taxes. We believe, therefore, that once assets reach six figures and beyond, investors should look to restructure mutual fund portfolios into less expensive, superior alternatives.

In an upcoming article we will discuss an even greater cost to mutual fund investors: namely the cost of selling poorly performing mutual funds.