

What About Fees?

What did Albert Einstein know about Mutual Fund Fees? Probably not much; but he is quoted as saying "Compound interest is the eighth wonder of the world". Just as time can work in your favor to compound your investment return, fees can also compound over time to reduce your return.

Fees are the related costs of managing a mutual fund, marketing it to consumers, and sales fees which may occur when you buy or sell a fund. All funds will have some of these fees. Some of the fees are fairly obvious, but others you may never know about unless you dig into the prospectus. No fund can operate without some of these fees, but some funds charge much steeper fees. To paraphrase Albert Einstein, "Compound fees are the eighth wonder of mutual fund management."

Here are three major expense categories that can damage your investment return:

1. Expense Ratio – This represents the fund's total operating expenses to manage your investment, which is usually expressed as a percent of assets. A typical index fund has an expense ratio of .2%; managed funds range from 1 to 2 %. This comes directly out of your annual return, and you never see that money. This difference over a period of years can make a dramatic difference in your portfolio value.
2. Load (Sales Charge) – This is the fee that you pay to buy or sell some mutual funds. A "Front" load typically charges you 5.75% to buy into the fund. What happens is you give the broker \$100 to invest, and he puts \$5.75 into his pocket, and the remaining \$94.25 goes into your investment. Not so bad you say, after your investment grows by 6% you will be back to even. More damaging is the "Deferred" load, typically 5%, which is your charge to exit the fund. As this fee is assessed as you exit a fund, its dollar cost will grow right along with the value of your fund.
3. 12b-1 Fee – This is an annual fee, expressed as a percentage of assets, specifically designated for marketing expenses for the fund. Typically you see a .25% charge, but they can range from zero to 1%. Some funds not only charge you a sales load, but also have a 12b-1 fee as well.

So just how much difference does it make? Assume that your financial advisor recommended you invest in Vanguard S&P 500 Fund, a large capitalization fund. Your annual expense would be a total of .2%. If you held this fund for the last five years a \$10,000 investment would be worth \$20,833 and you would have paid fees of \$143.03. On the other hand assume your "financial advisor" suggests a Large Cap Fund his company represents. This is a front end load, only \$9,425 of your \$10,000 investment actually goes into stocks, \$575 goes to pay the sales load. If you had invested in this fund over the last 5 years, your portfolio would now be worth \$17,463.52 and you will have paid \$1,317 in expenses. But, you don't like a front load; you can get the deferred load. The same fund is available, with a 5% back end load and higher operating expenses. If you once again exit this investment after five years, you will have paid \$2,168 in expenses, and your portfolio would be worth \$16,293; a full 20% less than the Vanguard S&P 500 fund.

Fees are important! Just a 1% difference in annual expenses can make a difference of \$10,000 on a \$10,000 investment after 20 years. Remember the only thing that is guaranteed about investing is that fees reduce your return.

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"I have learned that, if one advances confidently in the direction of his dreams, and endeavors to live the life he has imagined, he will meet with a success unexpected in common hours." Henry David Thoreau (1817 - 1862)

Defining one's own success brings piece of mind, sets one on the path to a meaningful existence, and ensures freedom from making the mistake of following the crowd.