ETF Portfolio Partners
"The Smarter Way to Invest"

A Simple Way to Improve Investment Performance

By Richard D. Romey

Do you know how much you pay each month for utilities? How much does a gallon of gas cost? What about the cost of your health insurance? It's safe to say that most Americans can easily answer these questions without much trouble. But, ask a group of mutual fund investors how much they are paying each month for their mutual funds and they will probably have no idea.

To understand the costs associated with owning a mutual fund it's important to understand how mutual fund fees work. Mutual fund fees can be divided into two groups: sales charges, or loads, and ongoing operating expenses. A sales charge or load (either front end or deferred) is a charge you pay when purchasing or selling shares of a mutual fund. It's compensation for the financial salesperson who sold you the fund. Mutual fund sales charges are typically 3% to 5% of your total investment. A no-load mutual fund does not charge the investor a fee when they purchase or sell shares.

In contrast to a one-time sales charge, a mutual fund's ongoing operating expenses represent the single largest cost associated with mutual fund ownership. All mutual funds, both load and no-load, have operating expenses. Operating expenses represent the day-to-day costs of running the fund and include items such as administrative expenses, advisor or management fees, marketing fees, legal fees, director fees, and other expenses.

Operating expenses are deducted from the fund's portfolio on a daily basis. The net result is that the price per share of the mutual fund is reduced by the amount of the expenses, which lowers the fund's performance. Mutual fund expenses continually work against you as you try to accumulate wealth and grow your portfolio. You don't receive a monthly bill or see the expenses on your statement, but over time excessive mutual fund expenses are a portfolio killer.

While operating expenses vary most studies suggest that the average actively managed mutual fund charges about 1.50% per year. To understand what this equates to in dollars and cents, consider the following scenario: $100,000 invested in a mutual fund that has a 1.5% expense ratio, a 20 year holding period, and a 7% annualized rate of return before expenses. Based on these assumptions, the investor will pay $55,341 in operating expenses over the next 20 years. If we divide the total expenses by 240 months (20 years x 12 months per year) we see that the investor will pay $230 per month over the 20 year holding period. Wow, and you thought gas prices were high!

Using an investment advisor to manage a portfolio of mutual funds, a trend that has been growing in popularity over the last few years, dramatically increases investment related expenses. Not only does the investor have to pay the advisor's annual fee, they still have to pay the ongoing expenses associated with the mutual funds they purchase. It's not unusual to see total expenses under such an arrangement reach 2.5% to 3.5% per year. For example, if an advisor charges 1% per year and the mutual funds they recommend have an average expense ratio of 1.5%, the investor pays a total of 2.5% per year (1% advisor fee + 1.5% mutual fund expense ratio). Based on a $100,000 portfolio, a 7% annualized rate of return before expenses, and a 20 year holding period, the investor ends up paying $82,396 or $343 per month. That's not only outrageous, it should be illegal!

This brings us to the simple way every investor can improve investment performance: *cut expenses.* In this respect, investing is no different than other services you pay for; the less you spend the more you save. Using the second example above, an investor

Continued on back….

could save $41,198 over the next 20 years if they cut investment-related expenses by half. Cutting investment-related expenses by 70% would save the investor over $57,000. That means an extra $57,000 in their portfolio instead of in the pockets of some investment advisor or mutual fund company executive.

With a better understanding of how damaging investment-related expenses can be over time, the question for us is how to minimize them. There are three simple ways to lower fees and expenses. First, you can switch to low cost index-based investments. Indexing is a very cost effective way to access the equity market and typically offers the investor a cost savings of 60% to 80% per year compared to most actively managed mutual funds. In addition to the cost savings, indexing has proven very hard for most actively managed mutual funds to beat.

A relatively new type of index-based investment that offers investors even lower expenses than most traditional index mutual funds are exchange-traded funds (ETFs). ETFs combine the most attractive characteristics of traditional index mutual funds and common stocks. As a result, they offer extremely low operating expenses and a high level of liquidity.

Second, stop paying two people to manage your money. Mutual funds were created so investors would have easy access to professional money management. When you pay an advisor to manage a portfolio of mutual funds you're paying two people to manage your money and both have their hands in your pocket. Instead of paying a mutual fund advisor to pick funds, use a mutual fund rating service such as Morningstar or Lipper Analytical. These companies rate mutual funds based on a number of factors. The reports are easy to understand and available at most libraries or on the internet. Best of all, you don't have to pay them a fee year after year.

Finally, become a more informed investor. Ask tough questions and demand to know how much you're paying, in total, for the investment services you're receiving. That way you can evaluate whether or not you're getting the service you deserve based on the dollars you're spending. Remember, you must be concerned about the expenses you see and the ones you don't. The bottom line is that it's your money, spend it wisely. The less you pay in fees the faster your portfolio will grow. Be a low cost investor and keep more of what's yours.

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