



ETF Portfolio Partners

“The Smarter Way to Invest”

The Compounding Effect of Mutual Fund Fees

By Richard D. Romey

Albert Einstein is credited with saying, “the most powerful force in the universe is compound interest.” I agree with his statement, however, if compound interest is one of the most powerful forces in the universe then the compounding effect of mutual fund fees is one of the most devastating forces in the universe.

Compound interest means that you earn interest on your interest. For example, if you invest \$1,000 and earn 8% compounded annually for five years you would have \$1,080 at the end of the first year ($(\$1,000 \times .08) + \$1,000$). In year two, you would earn 8% on \$1,080 which represents principal of \$1,000 and interest from year one of \$80. The cycle continues each year as you earn interest on both your initial investment and the interest earned in previous years.

The benefit of compound interest is clear: your money grows faster. To see the difference between compound interest and simple interest (interest is earned on the initial investment only) we will look at two investors. Both invest \$50,000 for twenty years. Investor A earns a compound annual rate of 8%. Investor B earns 8% per year simple interest (no compounding).

At the end of twenty years, Investor A has a balance of \$233,000 while Investor B has a balance of \$130,000. Albert Einstein was right! The power of compound interest means Investor A ends up with over \$100,000 more than Investor B.

It’s easy to see the benefits of compounding your earnings year after year. But, what happens when we lose out on the benefit of compounding because of investment-related fees. Every dollar spent in fees represents one less dollar you have to invest and compound over your lifetime. The devastating effect of investment-related fees is that they reduce what you have today and reduce what you have in the future.

Consider two mutual funds: Fund XYZ has annual fees of 1.5% while Fund ABC has annual fees of 0.5%. At first glance you might feel that an extra 1% per year is no big deal. After all, on a \$50,000 investment 1% is only \$500. But wait, don’t forget about compounding. When you pay \$500 today, it’s no longer in your investment ac-

count. You lose out on the benefits of compound interest.

Over time, paying an extra 1% in fees will cost you more than you realize. Based on a twenty year investment horizon and an 8% compounded rate of return, \$500 in fees represents a loss to you of \$2,330. That’s what \$500 will grow to over twenty years at an 8% compound rate of return. When we view investment fees in the light of lost future value, it’s easy to see how costly they really are. Remember, every mutual fund has ongoing fees, whether load or no load. You pay mutual fund fees every year that you own the fund.

Now let’s look at an example of the devastating effect of mutual fund fees. For this example, we will use a \$100,000 investment, twenty year time horizon, and annual mutual fund fees of 1.50% per year, which is pretty close to the industry average. Based on a return of 9%, before fees, you will pay \$69,760 in fees over twenty years. As we know, however, this is only part of what you will lose. The future value of the money you pay in fees must be considered. In this example, you will lose out on \$76,438 of potential earnings on the fees paid to the mutual fund company. In reality, the fund costs you \$146,242 over twenty years (fees of \$69,760 + lost potential earnings on the fees you paid of \$76,438).

What happens if you reduce your investment fees? To find out, let’s consider a mutual fund with operating fees of 0.5%. Based on the same \$100,000 investment, a 9% annualized return before fees and a twenty year time horizon the results are very different. In this example, the investor pays fees of \$26,233 over twenty years. They lose out on \$27,226 of potential earnings. The total cost of this fund is \$53,499 (fees + lost earnings).

Compare the two funds. The fund with higher fees (1.5%) costs you \$146,242 in fees and lost earnings. After twenty years with this fund your \$100,000 grows to \$414,242. The fund with lower fees (0.50%) costs you \$53,499 in fees and lost earnings. After twenty years with this fund your \$100,000 grows to \$506,980, a difference of almost \$100,000. Which fund would you rather own?

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Of course, Wall Street will tell you that you're paying for superior management that will produce superior returns. Unfortunately, the numbers say otherwise. Over the last 5 years approximately 75% of all actively managed mutual funds have failed to beat their comparison benchmark. There is no proof that higher investment-related fees mean better performance. In fact, most studies show the opposite. When you pay high investment fees you don't benefit. It's the people receiving the fees that come out ahead.

If you want to take advantage of what Albert Einstein described as a powerful force, then review all of your investments and get rid of those with high fees. If you're still using traditional actively managed mutual funds, you're probably paying too much in fees and getting very little in the way of better performance.

By switching to low cost investment tools, such as exchange-traded funds (ETFs), you can keep more of what you earn and compound your wealth. After all, why are you investing? My guess is that you want to grow your money. If so, stop transferring a large portion of your wealth to various mutual fund companies, in the form of fees and lost potential earnings, and keep more of what belongs to you.

About the Author

Richard D. Romey is the founder and chief investment strategist of ETF Portfolio Partners, a registered investment advisor (RIA) that specializes in ETF portfolio management. He is the author of *Strategic Index Investing—Unlocking the Power of Exchange-Traded Index Funds*, and he publishes a quarterly newsletter that focuses on the Exchange-Traded Funds industry. Send questions or comments about this article to rich@etfportfoliopartners.com or 913-851-1100.

ETF Portfolio Partners is a registered investment advisor (RIA) that builds and manages highly efficient portfolios using **exchange-traded funds** or **ETFs**. Each portfolio we manage is based on:

1. The Diversification Benefits of Asset Allocation.
2. The Efficiency of Exchange-Traded Funds.
3. Continuous and Ongoing Portfolio Monitoring

To find out more about our approach to portfolio management, or to schedule a meeting, call us at 913-851-1100 or email to rich@etfportfoliopartners.com

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