Understanding and Minimizing Fund Fees

by Donna Fuscaldo | Apr 3, 2015 | Advice |

Do you know how much you're paying for your investments? Fund fees are a necessary evil — one that investors cannot avoid altogether, but should do their best to minimize and understand. The industry has a poor track record of transparency in this regard.

The two major types of fund fees you need to evaluate when reviewing your investment options are expense ratios and commissions. Here is what you need to know about each:

1. Fund expense ratios

The most common fee investors hear about is the expense ratio, which typically includes all the costs associated with running the fund, including administration and back office functions. Fees covering distribution and shareholder service expenses, known as 12b-1 fees, are also typically included in the expense ratio.

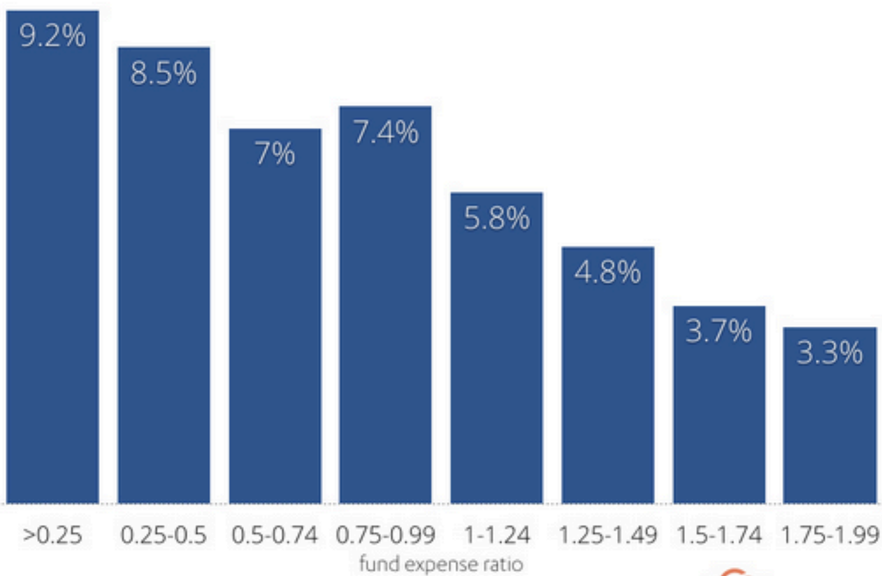
The simplest way to think of an expense ratio is what the fund charges annually per dollar of investment. Fund returns are stated net of this fee.

Expense ratios vary by an order of magnitude across funds. Passive index funds tend to be lower cost, while actively-managed funds charge significantly more. According to Morningstar, the average actively managed fund charged 1.25% in fees in 2013, compared to 0.44% for the average ETF. Across SigFig users, State Street's **SPDR S&P 500 Trust** (SPY) is the most popular index ETF, and charges 0.09%. **Vanguard's Total Stock Market Index** (VTI) charges 0.05% — that's *25 times less* than the average actively managed fund.

Expensive funds could be worthwhile if they delivered better returns, but research has shown that high-cost funds underperform low-cost ones over time (even during bear markets), and that fund performance is negatively correlated with cost. Simply put, the lower the fees, the greater the investor's net returns.

Analyzing fund returns for the 12 months ending March 8, 2015, SigFig found that funds with a 0.25% expense ratio earned nearly double the returns of those with a 1% expense ratio: 9% vs 4.8%.

Median 1-year total net return*



* Analysis includes funds with at least 500 investors in each fund, over the 12 months ending March 8, 2015.
Past performance is no guarantee of future return.

The New York Times recently summarized research finding that in the past six years no actively managed fund has ever consistently beaten the market:

> The truth is that very few professional investors have actually managed to outperform the rising market consistently over those years… In fact, based on the updated findings and definitions of a particular study, it appears that no mutual fund managers have…

And even if a small minority of fund managers do, it is very difficult to identify who they are in advance.

Takeaway:
Buy low-cost index funds. Avoid high-cost actively managed funds, even those that have performed well in the past. (How low is low? ETFs that passively track the major indices typically charge 0.15% or less.)

2. Fund commissions, or loads

Mutual fund companies are in the business of making money. They want investors to buy their funds and, to that end, some funds pay broker dealers a commission for hawking the product. A front-end load is a fee, typically up to 5% of invested assets, charged upfront. A back-end load is charged when you sell the fund and tends to get lower with each year you hold the fund. A no-load fund, on the other hand, has no commission associated with buying or selling.

How do you know what type of fund you are investing in? Brad Jenkins, chief executive and chief investment Strategist at Jenkins Wealth, says to look at the letters in the fund's name. If it includes mention of Class A, B, or C, you are paying a commission.

Takeaway:
Don't invest in load funds altogether. Instead, go with a no-load fund, or buy an ETF.