

How Fund Expenses Eat Into Returns*

Whether a mutual fund invests in stocks, bonds, or money market securities, the evidence indicates that expenses, rather than a manager's investment prowess, provide the strongest influence on returns.

During the 1990s, when an ebullient stock market provided a tailwind, most equity mutual funds delivered double-digit returns and few investors paid much attention to fund expenses.

After a long bear market, and with the prospect of a more subdued investment environment, mutual funds can no longer depend on phenomenal market returns to mask high expenses. Not surprisingly, fund expenses are receiving attention from both regulatory agencies and industry observers as a major factor in overall fund performance.

In testimony in March 2003 before the U.S. House of Representatives, John Bogle, founder and retired Chief Executive of The Vanguard Group, noted a clear and dramatic link between fund costs and investment returns. Among other things his testimony noted that:

- During the decade ended June 30, 2001, the lowest-cost quartile of funds earned an average net return of 14.5 percent a year, while the average high-cost fund earned an average 12.3 percent a year. The low-cost advantage prevailed regardless of the fund's investment strategy or focus.
- The average equity mutual fund's performance lagged the returns of the Standard & Poor's 500 Stock Index by an average of 3.1 percent a year between 1982 and 2002. This lag corresponds almost exactly to the actual total costs fund investors incur annually.
- The impact of expenses on capital accumulation is enormous. An investment of \$10,000 in the Standard & Poor's 500 Stock Index would have produced \$105,250 over the decade

studied, compared to \$56,765 if it were invested in the average equity fund. This means the average stock fund captured just 54 percent of cumulative market profits over the period, largely because of the impact of fees.

Statistics from the Investment Company Institute (ICI) a trade organization for the mutual fund industry, suggest that investors have obtained some relief in the form of lower expenses in recent years. The organization found that between 1980 and 2001, the average annual cost of purchasing and holding equity mutual funds decreased 43 percent, from 2.26 percent to 1.28 percent. The cost of owning bond and money-market funds decreased by 41 percent and 35 percent, respectively.

But ICI's figures provide only a partial and somewhat misleading picture of trends in fund expenses. Costs have decreased mainly because more people are buying lower-cost funds, either on their own or through 401(k) and other retirement plans, not because the majority of funds have lowered their fees. The ICI study also excluded many costs of fund ownership, such as redemption fees, and it amortized up-front sales charges over a ten-year period, which is several times longer than the average holding period for fund investors today.

Other evidence suggests that while front-end sales charges have fallen, mutual fund fees that are more difficult to detect have gone up. In March, the General Accounting Office reported that, "since 1998, the majority of stock and bond funds we analyzed had higher expense ratios in 2001 that they did in 1998." This finding was confirmed by data from Lipper Inc., indicating that the median expense ratio for equity funds increased from 0.91 percent in 1984 to 1.36 percent in 2002.

Avoiding the Fee Trap

While the average mutual fund fee

may seem high, some mutual fund sponsors keep their fees relatively low. The best way to avoid getting socked by excessive fund fees, and to find reasonably-priced funds, is to understand how fees work and determine as precisely as possible how much they cost. Much of this information can be gleaned from the *fee table* in the prospectus, a document that is often available both in hard copy form and on the Internet.

The fee table separates "shareholder fees," or fees borne directly by shareholders for buying, selling, or exchanging a fund, from "annual fund operating expenses," which cover the ongoing expenses of running the fund and servicing shareholders. It also includes an illustration of the dollar amount an investor would pay in expenses on a \$10,000 investment over one, three, five, and ten years, assuming a five percent return each year.

Shareholder fees may be charged in the form of an up-front sales charge, or front-end load. A 4.5 percent sales charge on a \$10,000 investment, for example, would cut the value of the initial investment to \$9,550. Fund shares may also have a back-end load, or deferred sales charge, which applies if you sell fund shares before a specified period of time.

While no-load funds do not have either front- or back-end sales charges, all funds have annual operating expenses. Annual fund operating expenses may include a management fee, an ongoing fee the investment advisor charges to manage the fund. They may also include a distribution (12b-1) fee, an ongoing fee that fund companies use to compensate the financial professionals who sell their funds. This fee may not exceed one percent of assets, and may include a service fee of up to 0.25 percent a year. The fact that a fund does not have a front- or back-end sales charge does not make it a true no-load, as some brokers may imply. The sales commission just comes from the assets of the fund in the form of a 12b-1 charge, rather than directly from the shareholder.

The share class will usually indicate which form the sales charge takes. Class A shares usually have a front-end sales charge, and no, or a low, 12b-1 fee. Class

* This article was written by Marla Brill, the author of *Windfall—How To Manage Sudden Money Before It Manages You* and publisher of *Brill's Mutual Funds Interactive* (brill.com).

B shares usually have no up-front charges, but instead have a back-end load if the shares are sold before a certain number of years. They may also have a 12b-1 fee. Class C shares typically have the highest 12b-1 fee of any share class, but no initial or deferred sales charges. Class I shares, available only to financial advisors and institutional investors, usually have no sales charges or 12b-1 fees, and very low annual expenses. These lower costs are offset by the fact that individuals who purchase these shares on behalf of clients usually charge

their own, separate management fees.

The total amount of annual fund operating expenses is listed in the prospectus as the expense ratio. It includes investment management fees, 12b-1 fees if applicable, administrative expenses, and the cost of shareholder mailings. This standardized figure allows investors to compare annual expenses among different funds.

According to data from Lipper Inc., funds that invest in U.S. stocks have an average annual expense ratio of 1.54 percent of assets, while the average investment-grade bond fund has an expense ra-

tio of 0.97 percent. But expense ratios among mutual funds, even those with similar investment strategies, can vary enormously. Some stock funds charge less than 0.20 percent of assets a year, while others sport double-digit expense ratios.

Look for Low-Cost Funds

To help compare fund costs, the U.S. Securities and Exchange Commission has a Mutual Fund Cost Calculator, located at www.sec.gov/investor/tools/mfcc/get-started.htm. The SEC's calculator does not take into account brokerage commissions

Portfolio Turnover and Other Potential Abuses

The mutual-fund industry is highly regulated. Instances of outright deceit, embezzlement, "Ponzi" schemes, etc., are virtually unknown. Nevertheless, the discretion that investors grant to portfolio managers creates a variety of temptations that could compromise a manager's duty to act as a fiduciary on the investor's behalf. Most of these involve the purchase and sale of securities. Managers choose the brokers they use and determine the method and timing of trades. It is extraordinarily difficult to monitor the extent to which they make these decisions purely in their shareholders' interests.

Expense ratios do not include transaction costs. When a fund buys securities for its portfolio, the commission on those securities is added to their cost, and is not counted as an expense. Because the commission absorbs a portion of the assets used to purchase the securities, it reduces the fund's net assets. In contrast, ordinary expenses reduce a fund's net income. The commission on a sale of securities absorbs a portion of the proceeds from that sale, thus reducing net realized gains.

Even if mutual funds reported the total of commissions paid, it almost certainly would not provide an accurate measure of the amount by which a fund's trading activities reduce net assets and net gains. There often is no explicitly stated commission as institutional trades are often conducted on a "net" basis, whereby securities dealers make their money on the difference between the prices at which they buy securities for their inventories and the prices at which they sell such securities. This markup is known as the "bid-asked spread." The spread on a particular security depends on the volume of trading in that security. An institutional trade can produce a significant increase in volume, therefore it can widen or narrow the spread. Because a changing spread is indistinguishable from a change in the price of a security, it is impossible for a fund to measure the cost of such a trade, let alone disclose that cost.

Absent a direct measurement of a fund's trading costs, investors can only make educated guesses about such costs based on a fund's trading activity. This is measured by the *turnover ratio*, which is the total dollar value of either purchases or sales of securities, whichever is lower in a given period, expressed as a percentage of average assets for the period. The calculation uses the lesser of purchases or sales so as to exclude trades made to accommodate changes in a fund's assets from shareholder purchases and redemptions. The calculation also excludes certain short-term debt securities, because they turn over

so frequently that their inclusion would render the ratio meaningless.

A broker that a fund favors with its business may pay some of the expenses of the fund (research costs, for example). The broker then may recover such costs with a higher commission, or a larger spread on block trades. At best, this can lead to an understatement of the expenses of the fund. Another possibility is that the fund's return may be reduced, because these "soft dollars" (payments for research not disclosed as such) may not be the most cost-effective way to pay expenses. Also, using soft dollars to pay for expenses can lead to the execution of trades mainly because they generate revenue for brokers, a practice known as "churning." Investors have few means of monitoring or examining such practices, other than comparing a fund's portfolio turnover to the turnover of similar funds.

More sinister possibilities include direct kickbacks from brokers to managers, and trading by managers for their personal accounts on the basis of their knowledge and control of their funds' activities. For example, a manager may place an order for his own account shortly before placing a large order for his fund, and then sell out after the fund's order has pushed up the price of the security in question. Presumably this practice, known as "front-running," causes the fund to pay more than it otherwise might.

Similar abuses arise from the possibility of placing orders with brokers and then allocating securities to various accounts some time after the orders are executed, when profits and losses already are evident. When a manager has responsibility for more than one fund, winning trades might be allocated to a small fund to boost its returns, in hopes of attracting additional assets. The losing trades would go to other, larger funds under the manager's control where they would have little impact on returns. (An unscrupulous manager could even assign winning trades to a personal account.) For the same reason, managers may attempt to "paint the tape" (push up the prices of their holdings) by executing wasteful and inefficient purchase orders during the last trading day of a month or quarter.

Such abuses, while difficult to detect, are subject to disciplinary actions, lawsuits, and even criminal charges. There is little that the average investor can do to avoid them, aside from avoiding funds and managers with such proceedings on their records. Prospectuses and certain other fund documents must disclose such blemishes on the records of their officers and directors.

or other trading costs that the fund incurs when its managers buy or sell securities (see the box on p. 62). According to the General Accounting Office, estimates of the size of brokerage commissions mutual funds pay range from 0.15 percent of assets to as much as 0.50 percent.

Also, be sure to check whether a fund that has a low expense ratio will continue to do so. Some fund managers agree to absorb a portion of a fund's costs until its total assets reach a certain size. These temporary fee-waivers have the most visible impact in bond and money-market funds because they provide an immediate and visible boost to yields, but can also appear in equity funds as well. The prospectus will indicate whether the fund is waiving fees, and how long the fee waiver is in effect.

Claim Your Volume Discounts

Many mutual funds sold with sales charges offer volume discounts to investors. The amount of these discounts, which can be found in the prospectuses of mutual funds offering them, depends on the size of the investment. The investment amounts at which investors qualify for these discounts are called breakpoints. Typical breakpoint discounts apply to purchases at \$50,000, \$100,000, \$250,000, \$500,000 and \$1 million, although some funds provide a breakpoint at \$25,000.

DEFICIT MYTHS

The return to budget deficits has revived the debate over how they affect the economy. Deficits are not invariably bad. The challenge is to avoid chronic, large deficits that are driven by unrestrained spending.

When the Federal government closes the books on fiscal year 2003 on September 30, we are likely to see something remarkable. Tax revenues probably will decrease for the third year in a row. If so, it will be only the second time this has happened in the past 100 years. The first was 80 years ago, when the economic boom that followed World War I gave way to recession and price deflation and the government's revenues fell from 1921 through 1923.

The Bush Administration's Office of Management and Budget predicted back in February that revenues would decrease, but the drop will probably be larger than they anticipated. They expected revenues to fall by \$17 billion but, with the first seven months of the fiscal year now complete (including April, the biggest month for tax payments), revenues already are running \$60 billion below their level for the same period a year ago.

This unusual drop in receipts is largely

Last March, the Securities and Exchange Commission reported that many investors who were eligible for breakpoint discounts did not receive them. They reported that of 5,515 transactions that appeared eligible for such a discount, 1,757 did not receive it. In many instances, investors forfeited the discount because their broker did not link fund shares held by all family members, or did not consider their ownership in related funds within the same fund "family."

Cost is certainly not the only consideration when buying a mutual fund, but it is an important one. As a general rule, certain types of mutual funds have lower costs than others. Larger funds tend to have lower expense ratios than small ones because they can spread costs over a larger asset base. Funds with low portfolio turnover typically incur lower commission costs. While the typical equity fund has a 100 percent turnover rate, implying a complete turnover of securities in the portfolio each year, the turnover rate can fall well above or below that figure. Index funds, which mirror the performance of a particular stock index, usually cost less to own than actively-managed funds because of their low turnover and low management fees. Funds with higher expense ratios, on average, include those that invest in small-company or foreign stocks, and smaller or newer funds. □

due to another historic development, the bursting of the stock market bubble. Tax revenues soared in the late 1990s to unprecedented peacetime heights, mainly due to a sharp increase in the income taxes paid by individuals. This revenue bubble was the product of the booming economy and especially the stock market, which generated record taxes tied to capital gains and stock options. As a result, the share of Gross Domestic Product (GDP) paid to the Federal government in 2000 was the highest since World War II.

That flood of revenue has now dried up and is not likely to return any time soon. Tax receipts are expected to equal about 17 percent of GDP this year, down from almost 21 percent a few years ago. However, this reduced ratio is not unusually low by historical standards, as shown in Chart 1 on the next page.

The bursting of the revenue bubble is one reason that the Federal budget is once again in deficit. The other is that govern-

ment spending lately has increased at a faster pace. In the late 1990s, spending increased by just three percent a year, but it began to accelerate in 2000, and last year outlays grew by eight percent.

This acceleration is partly due to increased spending on defense, homeland security, and other outlays triggered by September 11. But outlays for social programs such as unemployment insurance and Medicaid also have increased more rapidly, primarily as a result of the weak economy.

The deficit for fiscal 2003 is projected to be well over \$300 billion, in dollar terms, the largest ever. However, the more relevant measure is its size in relation to the economy. The annual GDP of the United States is approaching \$11 trillion. Thus, this year's deficit will be about three percent of GDP. As shown in Chart 2, the deficits of the 1980s and 1990s were higher.

Deficits, it should be remembered, are nothing new. The government has run them in 58 of the past 70 years. Most of these were years of economic growth, when productivity and national income increased, which suggests that deficits are not invariably bad for the economy.

Still, the swing from four years of budget surpluses to projected deficits "as far as the eye can see" has revived the debate over how deficits affect the economy. Deficit critics most often cite two arguments. One is that deficits cause interest rates to increase. The other is that Americans should not burden the taxpayers of tomorrow with the bill for what their government spends today.

"Crowding Out"

The first assertion is based on the theory that when the Federal government borrows to cover a deficit, it competes with private borrowers for a fixed pool of savings. As the government absorbs more and more funds, private borrowing is "crowded out." This crowding-out effect allegedly pushes up interest rates, which in turn reduces private investment, and over time this reduces economic growth.

The problem with this theory is that there is no evidence to support it. The historical record shows that interest rates have not increased in tandem with budget deficits. Indeed, in recent years just the opposite has been observed: when the deficit shrank and turned into surplus, interest rates did not fall but actually increased. And as the surplus has turned back into deficit, interest rates have decreased.

What About Our Grandchildren?

As to the burden of debt on future generations, the size of that burden will depend on how wealthy future generations

become—and they are likely to be much wealthier than we are today.

Consider that Americans today are much richer than they were just a few generations ago. They have higher real incomes, due to continued increases in productivity. Per-capita disposable personal income, which measures how much people have available to spend and save after paying taxes, was \$9,200 in 1960, \$16,100 in 1980, and \$23,500 in 2000. That's in constant 1996 dollars—that is, after adjusting for price inflation. In other words, real income per person has more than doubled in the past 40 years.

Forty years from now, real per capita income may well have doubled again—the actual increase will depend on how fast productivity increases—and the standard of living of Americans likely will be much higher than ours. Thus, as economist Steven Landsburg has noted, shifting the debt burden to future generations may well be less of a problem than is often suggested, because they will be richer than we are.

The argument that deficits place an undue burden on future generations is often made by the same people who say we should pay for government by increasing taxes on “the rich.” But if taxing today’s rich is okay—well, why not tax tomorrow’s rich? In the meantime, keeping today’s taxes lower by relying on deficit financing frees resources that potentially can be used to increase productivity—the very basis for increases in incomes and in the standard of living.

This is not to suggest that deficits are never a problem, or that we should simply reduce taxes to zero, borrow whatever we need to pay for government, and let the wealthy Americans of tomorrow pay for it all. If the government runs large deficits for a *prolonged* period, the Federal debt will eventually become so large that future generations will indeed find it to be an intolerable burden.

For most of the postwar era the Federal debt (the sum of all the annual budget deficits the government has run) was higher in relation to GDP than it is now. Following World War II it was over 100 percent of GDP. This ratio decreased until the 1970s, when it reversed trend, and by the early 1990s the debt was approaching 50 percent of GDP and climbing. Over the past decade, however, the ratio of debt to GDP fell to 35 percent.

The debt could remain relatively low in relation to GDP even if the government continues to run deficits. The debt increases each year by roughly the amount of the deficit. But if the debt increases at a slower rate than GDP, the ratio of debt to GDP will not change. For example, if the

deficit equaled three percent of GDP, and GDP increased by three percent, the ratio of debt to GDP would not increase.

Of course, if deficits are large, the debt ratio would increase. This is another way of saying that prolonged large deficits would create a debt burden for future taxpayers that would be large even by their richer standards.

Spending Is Key

Government spending is the most important factor in any discussion of the deficit. Spending must be paid for by taxing or borrowing. Tax cuts do not shrink the cost of government; they only shift it from today’s taxpayers to future taxpayers. Only spending cuts reduce the cost of government.

The Bush Administration has yet to address the issue of how to slow the growth

of government spending. As noted above, spending has increased more rapidly under President Bush than under President Clinton. Of course, outlays for Social Security, Medicare, and other age-related entitlement programs are expected to increase sharply when the baby boomers retire—beginning just five years from now.

Policies that foster increases in productivity and thereby contribute to growth in the national income will make it easier to pay for future obligations. Well-designed tax cuts could help achieve this. But there is no free lunch. Cutting taxes without curtailing spending clearly has the potential to lead to chronic large deficits and a rapid increase in the Federal debt. Eventually this would increase the pressure on government officials to raise taxes or to reduce the burden of that debt by inflating away its real value. □

Chart 1

Federal Receipts and Outlays
(Percent of GDP)

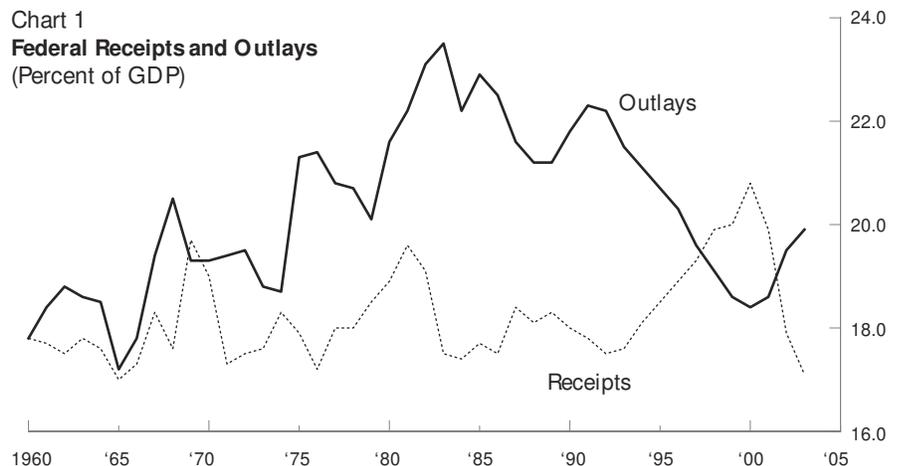
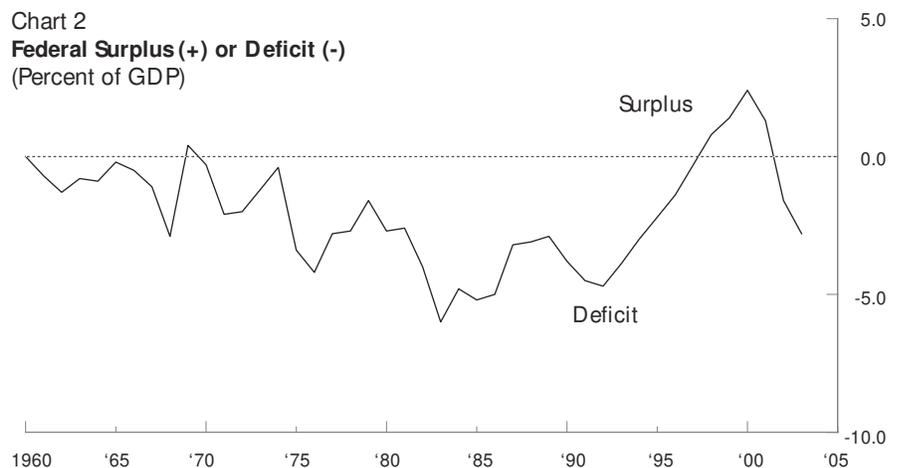


Chart 2

Federal Surplus (+) or Deficit (-)
(Percent of GDP)



PRICE OF GOLD

	2001 Jun. 7	2002 Jun. 6	2003	
			May 29	Jun. 5
Final fixing in London	\$266.10	\$324.10	\$363.10	\$366.75

Research Reports (ISSN 0034-5407) (USPS 311-190) is published twice a month at Great Barrington, Massachusetts 01230 by American Institute for Economic Research, a nonprofit, scientific, educational, and charitable organization. Periodical postage paid at Great Barrington, Massachusetts 01230. Sustaining memberships: \$16 per quarter or \$59 per year. POSTMASTER: Send address changes to **Research Reports**, American Institute for Economic Research, Great Barrington, Massachusetts 01230.