

Chapter 4

The High Cost of Low Returns

A billion dollars here, a billion dollars there, and pretty soon you're talking about real money.

Everett Dirksen

Our examination of the performance gap begins with the obvious, a discussion of fees and expenses. As a general rule, investment costs detract from performance on a one for one basis. There is no advantage to paying a high price for investment products or advice. The perception that superior returns can be achieved by paying a large fee to a mutual fund manager or an investment advisor is a marketing myth. There is no data to support this wishful thinking. If you spend a lot of money seeking superior returns, you will end up further behind.

The average investor faces a mountain of expenses, many of which they don't even know about. Some costs are easy to find, such as brokerage commissions, management fees, custodial costs, and sales loads. However, the most damaging costs are often hidden below the surface. These include trading spreads, market impact of trades, opportunity costs, "soft dollars", taxes, and other expenses that degrade returns. Taking all costs into consideration, except taxes, the average individual investor gives up about 3% per year on their stock funds and about 1.5% per year on their bond funds. If you hire a financial advisor to pick investments for you, subtract another 1% or so from returns. Except for the very fortunate, investment costs prohibit individual investors from ever achieving long-term results close to the markets they invest in.

The True Cost of Investing in Stocks and Bonds

The best way to understand investment costs is to analyze a basic stock and bond trade. Stocks and bonds are the building blocks of most investment portfolios, and the cost of trading these securities are inherent in mutual funds, unit trusts, and wrap fee accounts.

One important cost that is often overlooked is the cost of taxation. Paying unnecessary tax on investment gain can cause a large reduction in long-term wealth. Tax considerations are mentioned briefly in this chapter and in Chapter 15. Wise investors work hard to reduce the cost of investing. This is the first step toward reducing the performance gap.

The Cost of Executing a Stock Trade

Executing a stock trade is more expensive than most people think. All investors incur some form of commission cost, even large institutional investors. Besides the commission cost, there is a bid/ask trading spread, market impact of a trade, and the opportunity cost of trading.

Only SEC licensed brokers are allowed to trade securities on the major exchanges, and they charge a fee for their service. The commission paid on a stock trade varies depending on the broker and brokerage firm. If you sell 1000 shares of General Motors, the commission may cost \$800 using a full service brokerage firm, but only \$20 through an Internet broker. Does the \$800 full service brokerage firm do anything different than the \$20 broker? No. Both trades are routed through the same standard electronic trading system and clear through the same channels. Unless you are trading thousands of shares at a time, or trade obscure over-the-counter stocks, the difference between an expensive full service broker and a cheap discount broker is simply the cost of the commission.

The stock market is a live auction, and professional traders run the auction. They bid for stock when investors want to sell, and offer stock for sale when someone wants to buy. The difference between the bid and the offer price is known as the bid/ask spread. The spread varies widely from stock to stock, depending in part on the liquidity of that issue. Large companies, with many shares of stock outstanding, usually trade with a small spread, perhaps 6 cents per share. Small companies, with few shares outstanding, can trade with a much larger spread, perhaps \$1.00 per share. Novice stock investors are shocked to find the cost of the bid/ask spread is much more expensive than the commissions they pay.

Hidden Costs of Trading Stocks

The cost of stock trading is not limited to the commission and bid/ask spread. There are abstract expenses that are not readily apparent. One cost is market reaction to a buy or sell order. The markets are dynamic, and every order has an effect on supply and demand. It is a new experience for novice investors to learn that their buying and selling can change the market price of a stock. Consider this old Wall Street story:

One day an old wise investor passed a stock tip to an eager young man. The young man knew this was a good tip, so he called a broker and bought 1000 shares of the stock for \$2 per share. The next day the stock was quoted at \$3 per share. When the fellow heard the news, in his excitement he bought another 1000 shares. By the third day the stock was offered at \$5 and the young man was convinced he had found gold. He borrowed \$5,000 against his house to buy 1000 more shares. By the fourth day, the stock was offered at \$8. Sitting on a large profit, the young man decided to take the money and run. He told his broker to "SELL IT ALL", to which the broker replied, "Too whom would you like me to sell? Only 3000 shares have traded all week and you have been the only buyer!"

Most individual investors never consider the impact their trades have on the market, but large mutual fund managers are keenly aware of the problem. Consider the difficulty in selling hundreds of thousands of shares of a thinly traded, illiquid stock. It can take several days or even weeks to sell the position, and the price will likely drop along the way. John Bogle Jr. studied the market impact of trading small-cap stocks in a mutual fund. He found that small-cap funds holding \$350 million in assets or more suffered a significant deterioration in performance due to the market impact of trading. Small-cap mutual funds with over \$700 million in assets generally lose more money to market impact than the manager could possibly gain with superior stock selections¹. The market impact of trading can be costly to investors, but you will not find this expense listed in any mutual fund prospectus.

Opportunity cost is more abstract than market impact of trading. Generally, it takes time for money managers to convert an idea into a market trade, even if it is a very liquid stock. Opportunity cost is the price change that occurs between the time a manager

¹ John Bogle Jr, CFA, *Optimal Fund Size and Maximizing Returns*, Investing in Small-Cap and Microcap Securities, AIMR Seminar, September 25, 1996, Boston MA

decides to trade a stock and the time that trade is actually executed. If a fund manager has information on a stock that has not been widely disseminated, they must execute trades quickly. It will only be a matter of seconds before the information is widely known and fully reflected in the stock price. In a fast paced market, time is money. Slow execution means higher opportunity cost.

Take a trip on a cruise ship and you will understand hidden costs. An advertisement in the newspaper may read, “For only \$695 per person, you can enjoy an all-inclusive week on a beautiful luxury ocean liner”. Sounds like a bargain, but that’s not the end of the story. In order to get to the ship, you must fly to the port, which could cost \$300 round trip. Parking at the airport cost \$70 per week. Once you are on board, you discover all sightseeing trips ashore are an extra cost, and they are not cheap. Add \$150 for land tours. Like an occasional fruit drink while cruising? They cost \$5 each. At the end of the trip, you are expected to tip the waiters, busboys, and room service. Tipping runs another \$250. By the end of the week the \$695 vacation cost you \$1,500. The hidden costs of investing are no different than taking a cruise. It’s what you don’t see that gets you.

The Cost of Trading Bonds

Bond trading has the same costs as stock trading, only the brokerage commission is typically hidden in the price of the bond. Most bond trades are conducted over-the-counter, meaning the brokerage firm with whom you are dealing will sell you their bonds that they have in inventory. The difference between the price you pay for a bond and what you can sell it for is known as the sales spread. Each brokerage firm is independent and sale spreads vary from firm to firm. So it pays to shop around for the best price.

To give you an example of a bond trade, assume you want to sell a bond that has a current market value of \$10,000. You call your broker to request a bid price. The broker will show the bond to the firm’s bond trader, and then call you with the traders bid price, less a “mark down”. For this example, let’s assume the trader bids \$9,800. The broker will call you and offer \$9,700. If you accept this bid, the broker buys the bond from you for \$9,700, turns it over to the trader for \$9,800, and books a \$100 commission. Then the

trader puts the bond in the firm's inventory, where it is re-offered to other clients for \$10,000. The National Association of Securities Dealers (NASD) has rules that govern the spreads on bond trades, and excessive spreads are illegal. More information on trading bonds can be found in Part III, Chapter 13, Investing in the Bond Market.

Mutual Fund Fees and Expenses

Now that we understand the basics of stock and bond trading, it is time to add two more layers of expense. Mutual funds and private portfolio managers charge management fees to run portfolios. With a mutual fund, this fee is listed in the prospectus as part of the fund's expense ratio. If you work with a stockbroker or other financial adviser, an extra commission or fee is also included. This section explains the expense inherent in commission mutual funds and wrap fee accounts.

Mutual Fund Expenses

Open any mutual fund prospectus and you find a section titled "Portfolio Expenses" or similar wording. This is a list of the fees charged directly to the mutual fund on an annual basis. They include investment manager fees, marketing fees, legal costs, administrative fees, and miscellaneous expenses. Several funds charge a 12b-1 fee. This money is paid to brokers and other advisors each year who have placed investors in the fund. It is an incentive to brokers to sell more of the fund. A 12b-1 fee provides no benefit to current shareholders, and continues to be a topic of discussion between the SEC and the investment industry.

The "Operating Expense Ratio" is found by dividing all these fees by the total amount of money in the fund. A typical operating expense ratio runs about 1.5% for stock funds and 1.0% for bond funds. However, expense ratios can vary widely from fund to fund.

Recently there have been a number of highly publicized studies suggesting mutual fund fees are dropping. That is a misconception. If you eliminate low cost producers Vanguard and Fidelity from the universe of fund companies, fees have actually crept

higher over the years². Studies show that high fees are not good for investors. Table 4-1 compares the returns of high expense Growth and Income funds to low expense funds over a ten and fifteen year period. The evidence makes a strong case for investing in low fee funds.

Table 4-1
Growth and Income Funds
Expense Ratio Verses Performance
1984 - 1998

Category	Expense Ratio	10 Year Return	15 Year Return
All 65 Funds	1.27%	15.6%	14.6%
Low Fee	0.69%	16.5%	15.7%
High Fee	1.83%	14.8%	13.8%

Source: *Morningstar Principia*

The Trading Costs within Funds

The cost of trading stocks and bonds within a fund are not included in the expense ratio, but they do add to the expense of managing a fund. As explained earlier, mutual fund managers must pay commissions and bid/ask spreads when they trade securities. The more trades a manager makes during the year, the more it reduces the value of the fund.

Table 4-2 compares the returns of high turnover Growth and Income funds to low turnover funds. The data clearly suggests that portfolio turnover is one of the factors driving returns.

Table 4-2
Growth and Income Funds
Portfolio Turnover Verses Performance
1984 - 1998

Category	1998 Turnover Rate	10 Year Return	15 Year
All 65 Funds	68%	15.6%	14.6%
Low Turnover	24%	16.5%	15.5%
High Turnover	109%	14.8%	13.8%

Source: *Morningstar Principia*

² Scott Cooley, *Revising Fund Costs: Up or Down*, Morningstar Mutual Funds, February 21, 1999

According to Morningstar, the average turnover rate of a US equity fund is about 80% per year, meaning about 4 out of 5 stocks are held less than 12 months. This turnover generates a brokerage commission cost of about 0.3% per year³. Some funds have higher turnover, which increases the commission cost of those funds. On average, small-cap portfolios have about twice the turnover of large-cap funds.

In addition to the commission expense, mutual funds sometimes incur a profound market impact cost. Plexas Group is a research and consulting firm that tracks trading costs for investment companies. Plexas estimates the market impact of a large-cap US equity funds run about 0.4% per year and small-cap funds were significantly higher with a market impact about 1.5%⁴.

One final hidden expense faced by almost all mutual funds is the cost of holding cash in a portfolio. Cash includes Treasury bills and other short-term interest bearing investments. Most stock mutual funds hold between 5% and 10% in cash, depending on market conditions. Over time, the cash portion of a portfolio reduces the return of the fund. For example, if the stock market went up by 10%, and a stock mutual fund held 5% in cash paying 4%, the “cash drag” of the fund was 0.3% for that year. Said another way, if 5% of the portfolio under-performed the stock market by 6%, the cost of holding cash was 0.3%. The cash portion of a stock fund is charged the same management fee as the stock portion, making it a very expensive money market fund. Market impact and cash drag are not part of the Operating Expense Ratio, but they are an expense nonetheless.

In 1972, Charles Ellis explained that the reason professional managers cannot beat the market is that they have effectively become the market⁵. Commissions, fees, and hidden expenses have precluded most mutual funds from achieving market returns over the last 25 years. I do not anticipate a change over the next 25.

³ Miles Livingston and Edward S. O’Neal, *Mutual Fund Brokerage Commissions*, Journal of Financial Research, Vol. 19, no. 2 (Summer 1996): 273-92

⁴ Plexas Group, *Quality of Trade Execution in Comparative Perspective: AMEX vs. NYSE vs. NASDAQ*, August 1996, Plexas Group Inc., Los Angeles, CA

⁵ Charles D. Ellis, *Investment Policy; How to Win the Loser’s Game*, Business One Irwin, NY, Page 5

Sales Charges

The final cost is the cost of investment advice. Stockbrokers, insurance agents, and other financial advisors sell over 60% of all mutual funds. The funds they sell typically carry some sort of sales commission or load that pay the salesperson for their time. Until a few years ago, most investors paid an upfront sales commission to buy a mutual fund. Times have changed. The fund industry now offers all kinds of ways to pay your advisor. There are “A” share front-end loads, “B” share back-end loads, “C” share level loads, “L” share combined loads, and “Z” shares for use in wrap fee programs.

A large bulk of fund sales is through brokerage firms, but this method of distribution does not come cheap for mutual fund companies. Fund companies are required to pay access charges to get in the door of a brokerage firm. This charge simply allows access to the firm’s salespeople. A fund company may spend \$100,000 or more per year for the right to talk to brokers, but then they must spend a lot more money wining and dining the brokers to get them to listen. That will include the cost of lunches, golf outings, trips, and an assortment of goodies.

In many cases, the level of access a fund company has within a brokerage firm depends on the size of the check they initially write. At some brokerage firms, the highest paying fund companies earn special privileges, such as the right to be on the firms “recommended fund list”. Is this an ethical way for brokers to select mutual funds for their recommended list? Of course not. But that is Wall Street. “Pay to play” is a big revenue source for brokerage firms, and it is a necessary evil for most mutual fund companies. Performance is secondary to payoffs. As David J. Evens of Glencoe Investments once said, “Performance is nice; but marketing is better”.⁶

Wrap-Fee Services

In the 1970s, E.F. Hutton developed a private managed account program for individual investors who had an account worth \$100,000 or more. The program allowed small investors to hire institutional money managers that normally invest only for large clients.

⁶ Article by Jim McTague, *Dropouts*, Barron’s, April 7, 1997

Clients pay for this service under an all-inclusive “wrap fee”. The fee includes commission costs, manager fees, custody, performance monitoring, and other miscellaneous charges. The wrap fee can run as high as 3% per year, although the going rate seems closer to 2%.

Hutton’s wrap fee program was an instant hit and was quickly copied by other brokerage firms. Over time, the wrap concept spilled over into the mutual fund industry. Financial advisors began charging annual fees to build and manage mutual fund portfolios. The popularity of all wrap fee programs has mushroomed. Large brokerage houses are the biggest sellers of wrap fee products, although banks, insurance companies, independent advisors, and even accountants are now offering wrap account products. According to a 1998 study by Charles Schwab, more than one trillion dollars are managed under a wrap fee program, and the trend is not slowing.

The Hidden Costs in Wrap Fee Accounts

The wrap fee is supposed to cover all trading costs and management fees. But it doesn’t. The fee does not include the bid/ask spread, market impact, or opportunity cost of trading. These unreported expenses can add an additional 1% per year to the cost, depending on the style of the account. In addition, a wrap fee is charged on the non-invested cash portion sitting in your portfolio, not just the stocks and bonds. This creates the most expensive money market fund on the planet. Assume you pay 2% for a wrap account and 90% of your money is placed in stocks while 10% stays in the money market fund. You are charged the same 2% fee on the money sitting in the money fund as you are on the stock portion. Assume the money market fund has its own internal cost of about 0.6% and your total expense on the cash adds up to 2.6%!

Asset growth can be a major drag on performance for investment companies in large wrap programs, and that adds to your cost. Most money management firms are invited to participate in wrap fee programs *after* they finished a period of superior performance. Unfortunately, in the investment industry, success often breeds failure. As the brokers and other advisors throw millions, and sometimes billions of dollars of new money at these management firms, many develop operational problems. It is impossible

to invest this flood of new money the same way the old money was invested in the past. This reality usually causes a significant deterioration in returns, and the eventual downfall of the investment style. I have watched this boom-bust cycle occur dozens of times shortly after a manager is invited to participate in a wrap fee programs at a large brokerage firm.

Mutual Fund Wrap Programs

In the late 1980's, discount broker Charles Schwab introduced the concept of a mutual fund supermarket called Schwab OneSource®. Clients could buy and sell no-load mutual funds from hundreds of different fund families all under one roof. As an offshoot of the mutual fund concept, financial advisors began to offer trading strategies through the program. Advisors charge their clients a separate fee to pick mutual funds. The wrap-a-fund concept was so popular at Schwab that every major brokerage house and insurance company has a similar program.

Mutual fund wrap programs are actually fees on top of fees on top of fees. First, there are stock and bond trading costs internal to the mutual funds. Second, each mutual fund charges management fees and operating expenses. Third, the financial advisor charges an extra fee to pick the funds for you. After accounting for all fees, hidden or otherwise, investors in some mutual fund wrap program can pay upwards of 5% per year to have their account managed. There is no chance that a high cost investment advisor will overcome all of these expenses and achieve market results, let alone beat the market.

Other Packaged Products

It is always thus, impelled by a state of mind which is destined not to last, that we make our most irrevocable decisions.

Marcel Proust

Investment products are packaged and repackaged in a variety of ways. The marketing of those products has changed over the years, but the products themselves have remained

fairly consistent. The list of package products is long, and it grows each day. There are unit investment trusts, limited partnerships, commodity funds, variable annuities, variable life, and on and on an on. If there is a common thread among all these packaged products, it is that they typically charge a high commission and have high annual fees.

It is common knowledge in the industry that high commissions drive the sale of packaged products. Some advisors will find something good to say about any product if the yield to broker is large enough. Many insurance related annuity products pay brokers 6% in commission, followed by annual trailers. Many commodity and hedge funds charge investors 2% in annual fees plus 15% of the profits. At the 1996 annual meeting of Berkshire Hathaway, Warren Buffett labeled a unit investment trust as a “high commission product with substantial annual fees”. Clearly, commissions drive the recommendation of most investments, not the needs of investors.

Summary

The more you pay for investment products and advice, the less you make on your investment portfolio. About 3% of the performance gap is a direct result of annual investment costs, before accounting for sales commissions. The best place to begin to reduce the performance gap is to seek out investments that you do not have to pay a commission to buy. The next phase is to buy only funds with the lowest fees. There are several funds that fit this criterion in Part III of this book.