

What do your investments cost and why should you care?

Virtually all investments come with some level of ongoing annual expense. These expenses may not be well advertised but they do exist. In the case of mutual funds and exchange traded funds, those expenses are referred to as the **expense ratio** and are the ratio of the fund's operating expense divided by the amount of assets managed. These expenses include fees paid to the fund's managers, record keeping, accounting and auditing fees, etc. These fees are subtracted from the fund's asset base and since we invest in that asset base we ultimately end up paying these fees.

The level of the fund expense can vary widely. On the high end a fund may charge 1.5%. On the low end an index fund or an exchange traded fund might cost 0.10% to 0.20%. According to the Investment Company Institute the average expense ratio for a stock fund in 2011 was 0.79%.

The level of expense can have a profound impact on a financial plan. In investing you don't get what you pay for. Rather you get what you *don't* pay for. In other words, an investor is going to get the return of that segment of the market he or she is invested, in minus the cost of investing.

The table below shows the impact fees will have on \$10,000 invested for 30 years with an assumed market return of 7%.

Expense level	Market return	Their expense fee	Your Return	Value in 30 years	Total fees paid
Market return	7%	0%	7%	\$76,123	\$0
Low cost	7%	0.1%	6.9%	\$74,017	\$2,105
Avg. cost	7%	0.79%	6.21%	\$60,948	\$15,174
High cost	7%	1.5%	5.5%	\$49,840	\$26,283

In our simplified analysis the low cost investor has 49% more wealth than our high cost investor. For our high cost investor, fees consumed a whopping 35% of the market return (\$26,283/\$76,123). By the way, the argument that the higher cost fund with its implied superior management will pay for itself by consistently beating the market by at least 1.5% year after year doesn't hold up to scrutiny. There's a tremendous amount of research proving that this is has not been the case, but we'll save that for another post.

As expected, these fees also have a profound impact on portfolio longevity during retirement. Assume a retiree has a \$1 million portfolio that she hopes will support \$61,000 in annual spending for 30 years. The portfolio is assumed to return 5% annually. The table below shows the impact of fees on portfolio longevity.

Expense level	Portfolio longevity in years
Low cost	30
Avg. cost	26
High cost	23.3

In this case our high cost investor ran out of money almost seven years before our low cost investor. Note: a million dollar portfolio cannot support \$61,000 in annual spending due to expected variations in market return that must be accounted for when creating a distribution plan. This is a simplified example to demonstrate the impact of expenses.

There are several ways you can find out what you're paying in fees. The expense ratio can be found in the fund's prospectus or you can check the Morningstar website. Better still; the Financial Industry Regulatory Authority (FINRA) has a free online tool that shows a fund's expense ratio as well as cumulative fees paid over time: <http://apps.finra.org/fundalyzer/1/fa.aspx>

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