Hidden Mutual Fund Fees:

What You Don't Know Hurts Your Bottom Line

A Resource Provided by Carlson Capital Management and Zero Alpha Group

INTRODUCTION

When the time comes to buy a new home, you see a detailed breakdown of the closing costs—including points, title search, inspections and appraisal fee—that can add thousand of dollars to the purchase price. Imagine your reaction if it turned out that the closing costs on your home added up not to the $2,500 disclosed to you, but, instead, to $5,000. To make matters worse, imagine that you don't find out about the 100 percent higher hidden closing costs until long after you purchase your home.

If that sounds like an utterly implausible scenario in this era of vigorous protection of consumer interests, think again: It turns out that nearly half—44 percent—of the true costs of owning your mutual funds are hidden. Even the savviest investors who pride themselves on knowing all of the angles when it comes to controlling costs pay out more than they realize for mutual funds. The reason that the question of cost is important to mutual fund shareholders can be summed up in one sentence: **What you earn on a mutual fund is the return MINUS the cost of investing in the mutual fund.** That "minus" covers a lot of ground—including taxes—but one of the things that does the most damage to your return are undisclosed mutual fund costs.

The bottom line is that the hidden costs of mutual funds are cutting investor returns by no less than $17.3 billion. How can it possibly be the case that almost half of the full cost of owning mutual funds is hidden today? A November 2004 study commissioned by Carlson Capital Management and the other seven members of the Zero Alpha Group (ZAG) looked into the full costs involved in owning more than 5,000 funds. The ZAG researchers learned that 44 percent of the real costs of owning a typical mutual fund are not directly disclosed to shareholders—and that is over and above the fees and expenses to which mutual funds do own up! *(See the "Know Your Fees" sidebar in this article.)*

WHAT THE NEW MUTUAL FUND COST RESEARCH SHOWS

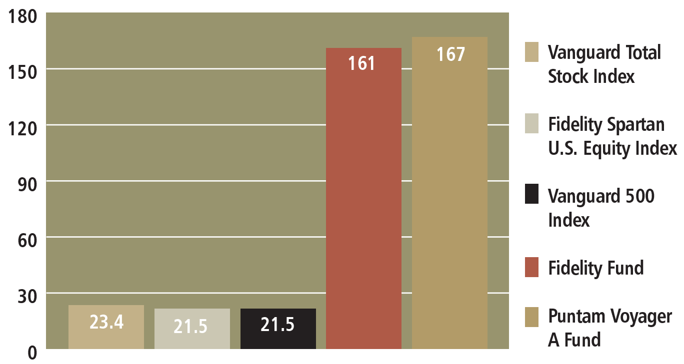
The groundbreaking Zero Alpha Group study on mutual fund costs was conducted by Edward O'Neal, assistant professor of finance at the Wake Forest University Babcock Graduate School of Management, and two University of Florida business researchers: Jason Karceski and Miles Livingston.

By teasing out the full cost of owning several thousand mutual funds, the three researchers uncovered $17.3 billion in hidden mutual fund fees. The biggest culprit not appearing on the radar screens of investors: trading costs that fail to show up in the stated expense ratios of mutual funds. These trading costs were found on average to be 43.4 percent as large as reported mutual fund expense ratios. For many mutual funds, these hidden costs of trading actually exceed the publicly disclosed expense ratios!

If this sounds complicated, there's a good reason. It is. Here's how to think about this problem: Mutual fund trading costs fall into two categories: the explicit (disclosed to investors) and the implicit (not disclosed). The explicit costs—including brokerage commissions, management fees, advertising costs, and charges for shareholder services—reflect the cost of doing business for the funds. The implicit trading costs include such arcane things as turn-over costs and bid-ask spreads—the difference between what a stock is priced at and what it actually

FIGURE 1

Basis Points of Hidden Cost for Select Mutual Funds



funds' expenses are omitted from their expense ratios and that the transaction costs of some funds exceed 400 percent of their expense ratios.

Consider how that translates to individual fund purchases: The earlier ZAG study found that the most inexpensive index funds were the Vanguard Total Stock Index Fund (23.4 basis points), Vanguard 500 Index Fund (21.5 basis points) and Fidelity Spartan U.S. Equity Index Fund (21.5 basis points). At the other end of the spectrum, the Fidelity Fund (161 basis points), Fidelity Contrafund (164 basis points) and Putnam Voyager A Fund (167 basis points) were found to have the highest total costs for investors.

costs to buy the shares so that they can be included in a mutual fund portfolio—that are difficult to quantify and even harder to understand. Unfortunately, it is almost necessary to be one of the ZAG study authors to ferret out these invisible trading costs!

One of the most eye-opening conclusions in the ZAG study is the huge gap in trading costs that separates index funds from actively managed funds. The researchers concluded that the total trading costs of actively managed funds averaged 0.48 percent per year. The trading costs of index funds averaged 0.064 percent per year. As Professor O'Neal points out: "The fact that investors in actively-managed funds incur portfolio trading costs that are over seven times that of index fund investors is another in the long line of reasons for investors to favor index funds."

To understand what that "seven times" cost difference means, imagine what things would be like if banks did not disclose the fees they charge when consumers use ATMs. You would go to one bank and be charged 50 cents for withdrawing your cash. But another bank branch down the street would charge you $3.50 for the same transaction—and then not disclose to you the additional $3.00 surcharge.

What does all of this mean to you in practical terms? An earlier ZAG study looked at the costs involved in owning the 30 largest domestic equity mutual funds in the United States, representing roughly $750 billion in investor assets through the end of calendar year 2001. That January 2004 study found that 43 percent of the

WHAT SHOULD INVESTORS DO?

Don't panic. The reality is that mutual funds are one of the only practical ways for most investors to achieve proper diversification and to manage risk. Justin Stets, Managing Director, Carlson Capital Management says the following to investors when they first learn about hidden mutual fund costs: "No one is suggesting that people should stop buying mutual funds. We completely recognize that these funds are the only practical way for most investors to achieve proper diversification and to manage risk. But better disclosure and education are clearly needed to ensure that investors understand the true costs of owning mutual funds. We are a long way away today from achieving genuine transparency in terms of revealing the real costs associated with these funds."

Do your research on all publicly disclosed mutual fees. Fortunately, mutual fund investors can easily find information on the fees that mutual funds openly charge.

KNOW YOUR FEES

According to the U.S. Securities and Exchange Commission (SEC), you should look for the following:

- **Sales Charge (load)**—the amount you pay when you buy shares in a mutual fund. Also known as a "front-end load," this fee typically goes to the brokers that sell the fund's shares. Front-end loads reduce the amount of your investment.

- **Purchase Fee**—another type of fee that some funds charge their shareholders when they buy shares. Unlike a front-end sales load, a purchase fee is paid to the fund (not to a broker) and is typically imposed to defray some of the fund's costs associated with the purchase.
- **Deferred Sales Charge (Load)**—a fee you pay when you sell your shares. Also known as a "back-end load," this fee typically goes to the brokers that sell the fund's shares. The most common type of back-end sales load is the "contingent deferred sales load" (also known as a "CDSC" or "CDSL"). The amount of this type of load will depend on how long the investor holds his or her shares and typically decreases to zero if the investor holds his or her shares long enough.
- **Redemption Fee**—another type of fee that some funds charge their shareholders when they sell or redeem shares. Unlike a deferred sales load, a redemption fee is paid to the fund (not to a broker) and is typically used to defray fund costs associated with a shareholder's redemption.
- **Exchange Fee**—a fee that some funds impose on shareholders if they exchange (transfer) to another fund within the same fund group or"family of funds."
- **Account Fee**—a fee that some funds separately impose on investors in connection with the maintenance of their accounts. For example, some funds impose an account maintenance fee on accounts whose value is less than a certain dollar amount.
- **Management Fees**—fees that are paid out of fund assets to the fund's investment adviser for investment portfolio management, any other management fees payable to the fund's investment adviser or its affiliates, and administrative fees payable to the investment adviser that are not included in the "Other Expenses" category (discussed below).
- **Distribution Fees ("12b-1" Fees)**—fees paid by the fund out of fund assets to cover the costs of marketing and selling fund shares and sometimes to cover the costs of providing shareholder services. "Distribution fees" include fees to compensate brokers and others who sell fund shares and to pay for advertising, the printing and mailing of prospectuses to new investors, and the printing and mailing of sales literature.

FUNDS WITH HIGHER HIDDEN COSTS DRAG DOWN PERFORMANCE AND TAKE MONEY OUT OF YOUR NEST EGG.

"Shareholder Service Fees" are fees paid to persons to respond to investor inquiries and provide investors with information about their investments.

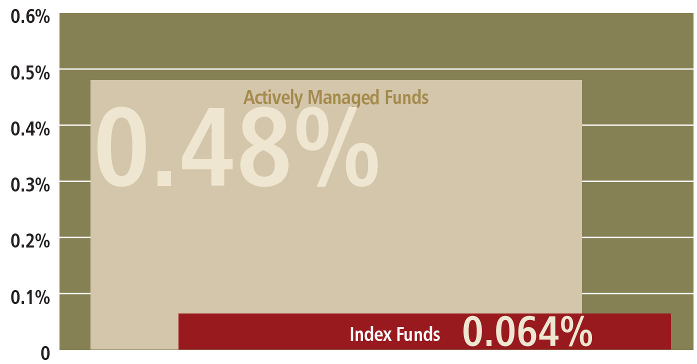
Examine the fund's expense ratio. This is the line of the fee table that represents the total of all of a mutual fund's annual fund operating expenses, expressed as a percentage of the fund's average net assets. Looking at the expense ratio can help you make comparisons among funds. But remember, the expense ratio will not show you hidden fund costs.

Work with your financial advisor to identify hidden mutual fund costs. Remember: Funds with higher costs drag down performance and take money out of your nest egg. If you are paying for professional financial help, make sure that you get all the information that you need to make informed decisions.

Don't obsess about mutual fund fees to the exclusion of other factors. Of course, hidden fees are not the only things to consider when buying a mutual fund. Other factors include: tax implications (distribution of short term and long term gains); style drift; sector concentration(s), and so on. Talk to your financial advisor about what these considerations mean for you in the context of your financial plan.

FIGURE 2

Hidden Mutual Fund Costs: Index Funds v. Actively Managed Funds



Want to know more?

For additional information on this or any other wealth management topic, please contact one of our principals at the locations below or visit our website at www.carlsoncap.com.

THE REALITY IS THAT MUTUAL FUNDS ARE ONE OF THE ONLY PRACTICAL WAYS FOR MOST INVESTORS TO ACHIEVE PROPER DIVERSIFICATION AND TO MANAGE RISK.

ABOUT CARLSON CAPITAL MANAGEMENT

Carlson Capital Management, Inc. is a comprehensive wealth management advisory firm with Minnesota offices in Northfield, Hastings and Rochester. Serving 450 clients in Minnesota and various other states, Carlson Capital Management brings together in one place all of the key disciplines of financial, investment, estate, tax, retirement and philanthropic planning for clients seeking an integrated wealth management experience.

For a complete background summary of the firm, please visit our website at www.carlsoncap.com.

ABOUT ZERO ALPHA GROUP

Carlson Capital Management is a member of the Zero Alpha Group. Founded in 1995, the Zero Alpha Group, which is not an investment advisory firm itself, was created to serve as a nationwide network for eight independent investment advisory firms that manage a total of more than $3.5 billion in assets.

Members of the Zero Alpha Group are committed to providing objective, long-term private wealth management solutions to investors, focusing on asset allocation and a structured, quantitative approach to investing. The eight firms in the Zero Alpha Group network share a common philosophy about investing and client service—a commitment to passive, tax-managed investment strategies while providing an independent financial planning solution for investors.

Visit ZAG online at www.zeroalphagroup.com.

SOURCES

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