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SMART INSIGHTS FROM PROFESSIONAL ADVISERS

Beware the Hidden Costs of Mutual Funds

By ANDREW M. COSTA | Global Wealth Management

Kiplinger

The fees you may not even know you're paying can be hazardous to your investment health.

Your financial portfolio probably looks like alphabet soup, chock-full of investments you probably know little about. Some of those investments—I'm thinking mutual funds here—may not even be beneficial to you.

Yes, you read that right. This financial guy is about to drop a bomb on you about your mutual funds and how they aren't the great deal for your bottom line that you thought.

The reason: They are filled with hidden fees that eat away at your profits. But once you're aware of them, you can more carefully choose the right funds for you and know to work only with professionals who will help you avoid those unnecessary costs.

Do any of these sound familiar: share-holder servicing fee, account manager fee, revenue-sharing fee? The answer is probably "no" for the average investor. Yet those kinds of undisclosed fees are so detrimental to investors that the Securities and Exchange Commission has tried (unsuccessfully) to get Congress to approve more stringent reporting requirements.

The SEC's concern was that the vast majority of investors don't have a clue about what kind of fees they are paying to have someone manage their mutual funds. In some cases, investors don't know the fees exist at all.

Certainly, as even the SEC points out, some transactional fees are fairly transparent, such as front- and back-end sales loads. But other costs, such as management fees and distribution fees, aren't so easy to come across without some digging. They are just reflected in account balances, so investors don't know that these recurring costs have been subtracted and just assume that their balance is showing how well the investment performed.

And that's not what the account balance is showing—at all.

So if you're not making that money, who is?

1. The companies that create the funds watch their bottom line expand from the fees they charge to manage and administer them.
2. The brokers who sell shares of mutual funds to clients generate commissions and fees for themselves.

A river of money flows through the mutual-fund industry, supporting hundreds of thousands of jobs and creating substantial profits for the companies involved. When any industry becomes well entrenched in an economy and the profits are as large as they are, it invites greater efficiencies, but also potentially disastrous competition in the long run.

Add to this "soft-dollar" payments, in which mutual companies direct trading activity to certain brokerage houses, generating commissions for themselves, and "shelf-space" payments, which are revenue-sharing arrangements for a brokerage recommending a specific fund to clients.

Exactly how much could all these fees cost you? The SEC points out that even small differences in fees can be significant and gives this example: If you invested $10,000 in a fund that produced a 10% annual return before expenses and had annual operating expenses of 1.5%, then after 20 years you would have roughly $49,725. But if the fund had expenses of only 0.5%, then you would end up with $60,858.

The examples provided for illustrative purposes only; it does not represent a real life scenario, and should not be construed as advice designed to meet the particular needs of an individuals situation.

So what can you do about it?

- You need to take a hard look at your investments and look at your selling and buying activity. If you're buying and selling high-equity funds in a volatile market, you are likely to come out on the losing end. Investors who hold less volatile, more diversified funds fare better at weathering the ups and downs of the market. Consider index funds that have lower expenses and better tax advantages.
- Work with a financial adviser who is compensated on an agreed-upon annual advisory fee, no matter which investments they recommend.
- Don't fall for advertisements and commercials pushing investments with a catchy name or celebrity endorsement. Check the quarterly reports and make reasoned choices.
- After accumulating significant assets, consider moving them to separately managed accounts (SMAs) handled by a reputable custodian. SMAs provide access to professional money management and diversification. They also have potentially lower overall expenses, tax efficiency, customization and control and a tested and effective investment strategy.

If you do your homework, make reasoned choices about which funds you pick or the wealth adviser you choose, and show patience in your investments, the bottom line is more likely to provide you with the life of your dreams.