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Rick Ferri (http://www.forbes.com/sites/rickferri/) Contributor

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PERSONAL FINANCE (/FINANCE) 5/27/2013 @ 10:00AM | 52,296 views

The Heavy Toll Of Investment Fees

The thought of giving up 40% per year in investment return to pay for portfolio management and advice would cause most people to walk away. Yet, this is the price many people pay when they hire an investment adviser to manage a mutual fund portfolio or exchange-traded fund (ETF) portfolio. Cutting this cost by as much as two-thirds is easily done and highly recommended.

The 40% annual cost is simple math. Take the average expense ratio charged by mutual funds and add it to the average advisor fee, then divide this number by the expected portfolio return before fees. The result is your investment cost. I'll walk you through an example.

Let's start with a hypothetical example of an expected portfolio return before fees. A portfolio allocation that's invested 60% in global stocks and 40% in US investment grade bonds should earn about 5.3% before costs, according to my best estimate. Investment grade bonds are yielding 2.0% based on the Barclays Aggregate Bond Market Index, and this is what you can reasonably expect to earn from intermediate-term bonds going forward. On the equity side, the FTSE Global All Cap Index should earn about 7.5% annualized based on global economic growth and dividend reinvestment.

A 60% stock and 40% bond mix comes to 5.3% before fees; what you earn after fees depends on how much you pay. There are two investment costs in my calculation: mutual fund expenses and an adviser fee. There may be trading costs and taxes to pay as well, but I've excluded them in this exercise.

The average expense ratio for actively-managed equity mutual funds is 1.2% and investment grade bond funds have an expense ratio of 0.9%, according to Morningstar (http://www.morningstar.com). Taken together, a 60% global stock and 40% bond fund portfolio has an average combined expense ratio of 1.1% per year.

The second expense is an adviser fee. The typical investment adviser charges about 1.0% per year on the first $1 million dollars of assets under management. This cost may be higher or lower depending on the amount being managed. Adding mutual fund expenses and adviser fees comes to 2.1% annually.

Dividing 2.1% in fees by the 5.3% expected market return before fees provided a true picture of investor cost. A 5.3% expected (before cost) return divided into 2.1% per year in total costs comes to 40% of expected return lost to expenses.

Giving up 40% per year to access the markets should cause every investor's head to turn. That's much too high. You can do better. Granted, no mutual fund is free and professional advice isn't free either, but you can get the cost down substantially with a few changes. I believe paying no more that 15% per year in total cost, including the adviser fee, is a good goal.

Let's start with mutual funds. Actively-managed funds attempt to beat the markets. The managers spend a lot of time and money on analysis and research to find securities that they hope will outperform. Unfortunately, there's no evidence to support the idea that active managers have beaten the market over the years. In fact, most do not come close. See Index Fund Portfolios Reign Superior (http://www.portfoliosolutions.com/index-fund-portfolios-reign-superior/).

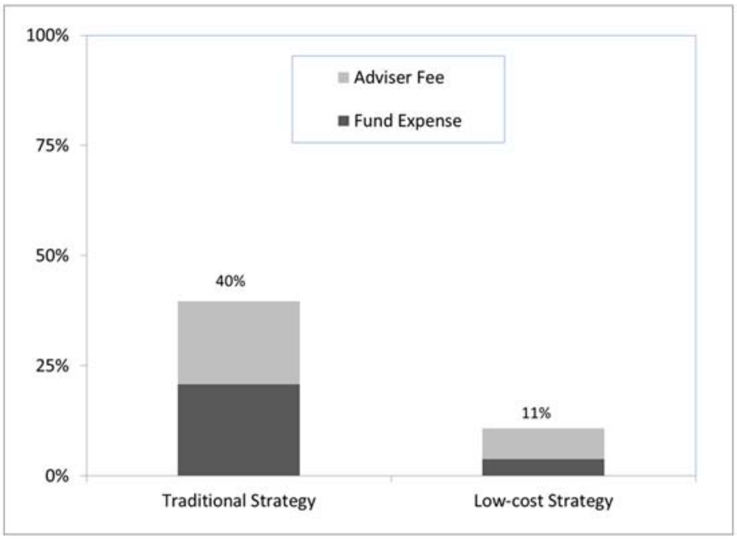
Why pay 1.1% per year to active fund managers when you can buy index funds that track the markets for a fraction of that cost? A typical all index fund portfolio that's globally diversified and balanced to 60% in stocks and 40% in bonds costs only 0.2% per year. That's a huge cost savings right off the top.

The second part of the equation is the adviser fee. The traditional 1.0% annual adviser fee for managing a mutual fund portfolio is as outdated as 8-track tapes. You can find advisers that provide quality one-on-one advice at a fraction of the traditional cost. Adviser fees ranging from one-quarter% to one-half% can be found in the marketplace today.

You're getting in the ballpark with reasonable fees when the combined mutual fund expense and adviser fee is below 0.7% annually. You can even get total cost close to 0.5% if you shop around, and this includes personal advice. It tallies up to a total expense that's below 15% of the expected gross return for a global balanced portfolio.

Figure 1 highlights the difference fees make as a percentage of a 5.3% expected portfolio return. The traditional approach assumes mutual fund expenses of 1.1% and a 1.0% adviser fee. It consumes about 40% of the expected return. The low fee approach assumes index fund fees of 0.20% and an adviser fee of 0.37%. This approach consumes only 11% of the expected return.

Figure 1: Total Portfolio Cost as a Percentage of 5.3 Percent Expected Gross Return



(http://b-i.forbesimg.com/rickferri/files/2013/05/Fees1.png)

Source: Morningstar (http://www.morningstar.com/), Portfolio Solutions, LLC (http://www.portfoliosolutions.com/)

Investing isn't free, but you can drive expenses down to a reasonable level, including personalized one-on-one advice. Paying two-thirds less than the traditional model puts a lot more wealth in your pocket over the years.

In the spirit of full disclosure, the firm I founded, Portfolio Solutions® (http://www.portfoliosolutions.com/), manages index fund portfolios for a low fee. We were an early pioneer in the low-fee adviser industry. Competition has since entered the marketplace.