

The Short Answer

Are There Hidden Fees in Your Mutual Fund?

A fund's expense ratio is only a portion of your total costs.

By Christine Benz | 10-27-09 | 06:00 AM

I'm often surprised that many investors--even those who are quite savvy--aren't aware that a mutual fund's expense ratio doesn't encompass all of the costs associated with owning a fund. A host of other charges, ranging from a fund's brokerage charges to tax costs, can reduce your bottom line just as surely as your expense ratio will.

Take brokerage commissions. Your manager has to pay these costs when he or she buys or sells stocks and bonds for the portfolio, but fund companies don't have to include these costs when calculating fund expense ratios. You'd expect funds' trading costs to be lower than what you or I would pay to execute a trade; after all, funds are typically trading large numbers of shares, so they should be able to negotiate volume discounts, right? Well, yes and no. Unfortunately for fund shareholders, some fund shops have paid more than they've needed to for trades because they received research and other goodies in exchange for paying higher commissions. And under a practice called "directed brokerage," which regulators banned in 2004, some fund shops paid inflated trading commissions in exchange for having their funds placed on that brokerage firm's "preferred list."

Funds also face so-called market-impact costs. That means that if your manager is trying to buy or sell a big block of a given stock, there's a chance that the fund will have to accept a less advantageous price for that security than if he or she were buying or selling fewer shares. For example, say your manager is trying to buy 1 million shares of a certain small-company stock. If only 100,000 shares of that stock typically change hands each day, that means it will take your fund manager a minimum of 10 days to complete your fund's trade--and that's assuming your manager is gobbling up all of the shares that traded on those 10 days. In the meantime, the stock could get more and more expensive, reducing the amount of money that your manager can make in it.

So if these costs aren't included in a fund's expense ratio, how can you try to keep track of them and limit them? We have a couple of suggestions. To keep fund trading costs from dragging on your bottom line, we'd urge you to focus on those funds that simply don't trade much. Index mutual funds and exchange-traded funds, especially those that focus on large-company stocks, generally limit their trading costs, because they simply mirror the holdings in a given market benchmark. You could also look for those actively managed funds with low turnover rates, an indication that their managers like to buy their holdings and hang on. As a general rule of thumb, a fund with a turnover rate of 25% or less, indicating that the manager completely makes over the portfolio every four years, will have lower trading costs than one with a turnover rate of 100%.

What about limiting market-impact costs--the risk that your manager will obtain a less-than-advantageous price for your fund's securities? A couple of different characteristics tend to put a fund at a greater risk for racking up these hidden costs. First, because high-turnover funds trade frequently, it only stands to reason that they run a greater risk of affecting securities' prices when they buy and sell. And funds that traffic in small-company stocks, which invariably have fewer outstanding shares than large-company stocks, could also see market-impact costs erode their returns. Finally, market-impact costs will tend to be a bigger problem for funds with large asset bases than for tiny, nimble funds, simply because the manager of the big fund has to step up and buy or sell a greater number of the outstanding shares of a given security than does the manager of a tiny fund. We're not saying that you should automatically dismiss a fund simply because it has a large asset base, high turnover, or focuses on small-company stocks. But if you're considering a fund that has more than one of these risk factors, you would do well to consider whether market-impact costs could eventually drag on your own bottom line.

This week's column is an excerpt from the second edition of [The Morningstar Guide to Mutual Funds: 5-Star Strategies for Success](#).

About the Author

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