

Expense ratio tells just part of story

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While the average U.S. stock fund has an expense ratio of 1.47%, most funds cost more than you realize. Understanding all such expenses is crucial, for lowering expenses is among the easiest ways to enhance returns.

Most funds pay recurring operating expenses out of fund assets, meaning investors indirectly pay the costs. The most widely known cost is the management fee, paid to a fund's investment adviser as compensation for managing the portfolio. Some funds also tack on a 12b-1 fee, which helps cover the costs of marketing, shareholder services, and broker compensation. Finally, a third category called "other expenses" includes legal, accounting, and administrative costs.

A fund's expense ratio, found in the prospectus, totals all three fees and is expressed as a percentage of net assets. For example, Forecasts' recommendation **Baron Asset** (\$60; *BARAX*) charges a management fee of 1.0%, a 12b-1 of 0.25%, and other expenses of 0.08%, putting the total expense ratio at 1.33%, below the average of 1.55% for midcap growth funds.

But the cost of owning a fund can be much higher than the expense ratio indicates. Expense ratios do not reflect trading costs, which include brokerage commissions and the indirect costs of trading — two potentially huge drags on performance. Like individual investors, portfolio managers pay commissions to buy or sell stocks. Commissions on institutional trades usually range from \$0.01 to \$0.05 per share, with the largest funds generally paying the lowest fees. Even small commissions add up. A recent study of nearly 4,300 U.S. equity funds found that the average fund incurred an annual commission expense of 0.36% of assets. Large-cap funds had the lowest commission costs, with midcap and small-cap funds roughly equal.

The study also found that the average equity fund had an indirect trading cost of 0.58% per year. The cost partly reflects the "slippage" that occurs when trading stocks with bid-ask spreads. The bid-ask spread is the difference between what buyers pay for a stock (the higher ask price) and what the seller receives (the lower bid price).

Trading expense also includes the market impact of very large trades. When a fund unloads a large stake, the selling pressure may reduce the price of the stock being sold. Conversely, heavy buying may drive up share prices. Summing brokerage commissions and indirect costs, the typical U.S. stock fund incurs 0.94% in trading expenses each year — an amount larger than the reported expense ratio for many funds.

Conclusion

Just to stay even, a fund with a high expense ratio run by a manager who trades frequently will have to perform better than a low-cost fund with a buy-and-hold strategy. While expense ratios are easy to

compare across funds, investors can only roughly gauge the effect of trading practices.

One important tool for assessing trading expenses is the turnover ratio. Funds that limit trading tend to have low turnover ratios and lower trading costs, and are typically more tax-efficient. Moreover, a Morningstar study found that low-turnover funds typically outperform high-turnover funds. The average U.S. stock fund has an annual turnover ratio of 88%, indicating that nearly 90% of the securities in the portfolio are bought and sold over the course of a year. At 96%, midcap funds have the highest average turnover ratio, followed by small-cap funds at 91% and large-cap funds at 78%.