HOW MUCH ARE YOU REALLY PAYING FOR YOUR MUTUAL FUNDS?

By John Markese

Mutual fund loads and expenses decrease your investment return dollar-for-dollar. Looking forward, the costs are predictable, while returns are not. It pays to pay attention to how much you pay.

Here's some advice: Drop a little sweat on the small stuff, because small stuff can accumulate into big stuff.

Which amount would you rather have on an investment of $100,000 after 10 years, $242,220 or $220,940? An easy question. The difference is big stuff, $21,280. But these ending account values would have been achieved by two funds that differed only by the expenses they charged, one 0.75% and the other 1.75%, assuming both returned 10% before expenses each year.

And we haven't gotten around to considering the impact of any loads, another word for sales charges, or account activity fees.

FUND OPERATING EXPENSES

Let's look closely at the components of annual fund expenses. A standard fee table is found in every mutual fund prospectus, detailing expenses, loads, and other charges (see Figure 1).

- *Management Fees*: The management fee is what you pay the fund adviser to manage your money and is charged as a percentage of assets under management. Some funds charge less when assets reach a certain level—a breakpoint. A typical statement on management fees might read as follows: "For its services (the management corporation) receives a monthly fee of $^1/_{24}$th of 1% (0.5% annually) of the average daily net assets of the fund up to $250 million, computed daily. The monthly fee is reduced to $^3/_{80}$ths of 1% (0.45% annually) of the average net assets in excess of $250 million." But fund advisers that charge a fund 1.50% a year with no asset size breakpoints are not hard to find.
- *12b-1 Fees*: The second category of fund expenses, 12b-1 fees, are distribution fees paid to promote the fund or compensate organizations or individuals for selling fund shares. Asset-based sales charges, 12b-1 fees, and service fees are limited to a maximum totaling 1.00%. Funds with 12b-1 charges are required to note that "the distribution expenses for long-term shareholders may total more than the maximum sales charge that would have been permissible if imposed entirely as an initial sales charge." More on this when we discuss loads.
- *Other expenses*: Other expenses include custodian fees for securities, legal, accounting, transfer agent fees, and administration fees.

These three expense categories sum up to *total operating expenses* and are expressed as an expense ratio—expenses as an annual percentage of fund assets, or what you pay as a fund investor to have your money managed by the fund. Table 1 gives averages and ranges of expense ratios for funds in various investment categories reported in AAII's Quarterly Low-Load Mutual Fund Update.

From the ranges of expense ratios for each category, it should be apparent that expense ratios can be extremely variable for funds performing the same services in the same investment arena. Variation in expenses can also be classified in other ways. On average, stock funds are more expensive than bond funds; international funds more than domestic funds; and funds with less assets under management are more expensive than larger funds due to the

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FIGURE 1. FEE TABLE EXAMPLE

The following table describes the fees and expenses that are incurred when you buy, hold or sell shares of the fund. The annual fund operating expenses provided below for the fund do not reflect the effect of any reduction of certain expenses during the period.

Shareholder Fees (paid by the investor directly)

Sales charge (load) on purchases and reinvested distributions	None
Deferred sales charge (load) on redemptions	None
Annual account maintenance fee (for accounts under $2,500)	$12.00

Annual Fund Operating Expenses (paid from fund assets)

Management fee	0.44%
Distribution and Service (12b-1) fee	None
Other Expenses	0.26%
Total annual fund operating expenses	**0.70%**

A portion of the brokerage commissions that the fund pays is used to reduce the fund's expenses. In addition, the fund has entered into arrangements with its custodian and transfer agent whereby credits realized as a result of uninvested cash balances are used to reduce custodian and transfer agent expenses. Including these reductions, the total fund operating expenses would have been 0.67% for Capital Appreciation.

This example helps you compare the cost of investing in the fund with the cost of investing in other mutual funds.

Let's say, hypothetically, that the fund's annual return is 5% and that your shareholder fees and the fund's annual operating expenses are exactly as described in the fee table. This example illustrates the effect of fees and expenses, but is not meant to suggest actual or expected fees and expenses or returns, all of which may vary. For every $10,000 you invested, here's how much you would pay in total expenses if you close your account after the number of years indicated.

1 year	$72
3 years	$224
5 years	$390
10 years	$871

Source: Fidelity Capital Appreciation Fund prospectus, December 30, 1998

fixed costs of running funds. Actively managed funds are usually far more expensive than passively managed index funds. Also, it pays to read the fee table carefully. Many fund advisers agree to cap expenses for a period of time. Without the cap—and cap periods do expire—fund expenses would rise substantially.

Here are some summary thoughts on fund expenses:

- Funds with significantly higher expense ratios than the average for their category are likely to suffer in performance. In the long run, few managers are heads above their peers or sufficiently better to consistently cover a high expense ratio differential.
- High expenses are even more of a drag for bond funds because returns are usually lower than for stock funds, and performance among funds within the category is more highly clustered.
- Because expense ratios are reflected in historical performance figures, it is easy to slip into the mind-set that as long as performance is strong, who cares about expenses. Well, looking forward, expense ratios are far more predictable than performance will ever be.

LOADS

The term "load" is self-descriptive. But sales commissions, when equal to the value of advice received, may be justifiable. While the value of that advice is uncertain, it is certain that any load paid will reduce returns dollar for dollar.

On average, load funds perform as well as no-load funds. But if load fund returns were adjusted for loads paid, they would have lower average performance compared to no-load funds by the amount of the load. Remember, loads go to sales personnel and not to the hiring of better fund managers or analysts. And just as with expense ratios, it is easy to fall into the trap of thinking, "I would have been happy to pay a load to get that performance." The fallacy: Looking forward, the only certainty is the amount of the load.

How are loads charged? In a variety of ways, as noted in the Shareholder Fees section of the sample Fee Table in Figure 1. A front-end load is levied on the amount invested when it is invested. A back-end load, or deferred sales

TABLE 1. EXPENSE RATIOS FOR VARIOUS INVESTMENT CATEGORIES

Stock Funds	**Average (%)**	**Range (%)**
Aggressive Growth	1.32	0.40 to 2.53
Growth	1.06	0.40 to 2.18
Growth & Income	0.91	0.17 to 2.45
International	1.39	0.31 to 2.49
Bond Funds	**Average (%)**	**Range (%)**
Corporate	0.69	0.26 to 1.03
Corporate High-Yield	0.77	0.03 to 1.30
Government	0.60	0.15 to 1.20
Mortgage-Backed	0.71	0.27 to 1.02
General	0.72	0.20 to 1.18
Tax Exempt	0.64	0.17 to 3.74
International	1.12	0.49 to 1.86

Source: AAII's Quarterly Low-Load Mutual Fund Update, October 1998.

TABLE 2. HOW LOADS MAY BE IMPOSED BY SHARE CLASS

Loads	Fund Classes A	B	C	D
Front-End	Yes	No	No	Yes
Back-End	No	Yes	Optional	Optional
Asset-Based Sales Charge and Service Fee*	Optional	Yes	Yes	Yes

**Asset-based sales charges and service fees are capped at a maximum combined total of 1.00% per year and are charged continuously (paid by the investor) based upon asset value of the fund; generally termed 12b-1 loads.*

Source: Investment Company Institute, Washington, D.C.

charge on redemptions, is levied on the amount invested when an investor exits a fund. And a 12b-1 load is levied continuously on the value of the investment. Some funds also charge loads on reinvested dividends.

The prospectus sorts all the loads out and details when and in what amount a fund imposes loads. The maximum loads a fund may impose are restricted to the following:

Maximum Loads

8.5%	Front-end or back-end load on initial investment if no 12b-1 load is imposed
7.25%	Front-end or back-end load on initial investment if a 12b-1 load is imposed
1.00%	12b-1 load (asset-based load plus service fee) on fund assets each year
0.25%	12b-1 load to be still classified as a no-load fund

While these are the maximum loads, front-end loads commonly are 5.75%, 4.25%, or 3%, and back-end loads decline, some disappearing if the fund is held long enough, years in most cases.

Many funds also charge combinations of loads—for instance, front-end and 12b-1, back-end and 12b-1. In fact, many mutual funds are offered in different classes of shares, so you can choose your load or load combination—same fund, just different ways to pay a load, as shown in the fund class table in Table 2.

When faced with no-load funds, funds with different loads, and the same fund with different classes, how can you make a reasoned choice?

- Unless you need advice and can judge with some certainty that the advice will be of value—a difficult judgement—favor no-load or low-load funds.
- If you do choose to pay a load, realize that your holding period for the fund, something you don't always know beforehand, will favor one load form over another. For example, investing in a fund with a 12b-1 charge may prove more expensive than paying an initial front-end load and no 12b-1 charge if you are invested over many years. Short-term investors should choose 12b-1 charge funds over a front-end or back-end load, and long-term investors should choose a low front- or back-end load over a high 12b-1 charge. But what is short-term versus long-term? Some tables will help.

Table 3 is a simple translation of front-end loads into 12b-1 equivalents. (Since front-end loads are charges on initial investments rather than the value of the final account, as is the case with 12b-1 charges, and front-end loads are paid at the time of investment rather than continuously over time, return and discount rate assumptions are made to create the table.) No surprise: High front-end loads translate into high annual 12b-1 changes. But the table also shows that high front-end loads and short-term holding periods, 6.00% front-end loads and five years for example, create alarmingly high 12b-1 equivalents—1.20% per year. A 3.00% front-end load over 10 years translates into an acceptable 0.30% annual 12b-1 equivalent, just a notch above the 0.25% maximum 12b-1 no-load designation level.

Table 4 reverses the translation, providing front-end equivalents of 12b-1 charges. For shock value, look at the maximum 1.00% 12b-1 charge and a 30-year holding period. No one knowingly would pay a 30% front-end load, but that's just what high annual 12b-1 charges and long holding periods translate into. Even the no-load 0.25% 12b-1

TABLE 3. FRONT-END LOADS AND THEIR 12B-1 EQUIVALENTS

Holding Period (Years)	Front-End Load 1.00%	2.00%	3.00%	4.00%	6.00%	8.50%
	12b-1 Equivalent:					
1	1.00	2.00	3.00	4.00	6.00	8.50
2	0.50	1.00	1.50	2.00	3.00	4.25
3	0.33	0.66	1.00	1.33	2.00	2.83
4	0.25	0.50	0.75	1.00	1.50	2.12
5	0.20	0.40	0.60	0.80	1.20	1.70
10	0.10	0.20	0.30	0.40	0.60	0.85
20	0.05	0.10	0.15	0.20	0.30	0.42
30	0.03	0.06	0.10	0.13	0.20	0.28

TABLE 4. 12B-1 CHARGES AND THEIR FRONT-END LOAD EQUIVALENTS

Holding Periods (Years)	12b-1 Charge (%) 0.10%	0.25%	0.50%	0.75%	1.00%
	Front-End Load Equivalent:				
1	0.10	0.25	0.50	0.75	1.00
2	0.20	0.50	1.00	1.50	2.00
3	0.30	0.75	1.50	2.25	3.00
4	0.40	1.00	2.00	3.00	4.00
5	0.50	1.25	2.50	3.75	5.00
10	1.00	2.50	5.00	7.50	10.00
20	2.00	5.00	10.00	15.00	20.00
30	3.00	7.50	15.00	22.50	30.00

charge starts pushing the maximum front-end load over a 30-year period.

Table 5 tackles the front-end load versus 12b-1 decision by focusing on breakeven holding periods in years. For example, a fund with a 0.75% 12b-1 charge compared to a fund with a 4.0% front-end load results in a 5.3-year breakeven. Holding periods longer than 5.3 years argue for the front-end load; holding periods shorter than 5.3 years argue for the 12b-1 alternative.

If you are contemplating a front-end load, estimate your most likely holding period, then take the 12b-1 equivalent of the front-end load and add it to the expense ratio for the fund; now stand back and take a look. If it seems high, it probably is. Don't forget that funds with 12b-1 charges already have the charge incorporated into the expense ratio, but some funds have both a front-end load and a 12b-1 charge.

THE BOTTOM LINE

Loads and expenses decrease your mutual fund return dollar-for-dollar. Looking forward—the best direction in which to look to make judgments—loads and expenses are predictable; returns are not. Loads are sales commissions paid to sales personnel and have only a negative impact on fund performance. Fund expenses that are significantly higher than the average for a category are difficult for fund managers to overcome.

Loads and fund expenses always make a difference, and the question is simply: How much?

It pays to pay attention to how much you pay. ✦

TABLE 5. FRONT-END LOADS AND 12B-1 CHARGES: THE BREAKEVEN POINT (IN YEARS)

Front-End Load (%)	12b-1 Charge (%) 0.10%	0.25%	0.50%	0.75%	1.00%
	Breakeven Point (Years):				
1.0	10.0	4.0	2.0	1.3	1.0
2.0	20.0	8.0	4.0	2.6	2.0
3.0	30.0	12.0	6.0	4.0	3.0
4.0	40.0	16.0	8.0	5.3	4.0
6.0	60.0	24.0	12.0	8.0	6.0
8.5	85.0	34.0	17.0	11.3	8.5