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Your Investments: What Are You Paying For?

Costs really do matter, in every area of life. Not only that, but understanding what is behind

the costs is very important. For example, most of us realize that the sticker price on a car isn't the result of some sort of divine revelation or a fixed number set by law. Instead, it's a function of what the manufacturer thinks the car is worth, what the dealer paid for it, and what the dealer thinks the car will sell for. Not only that, but there are other costs associated with owning a car: maintenance, insurance, repairs, fuel, state and local taxes and fees, etc. When you buy a car, you should take all those costs into account as you determine whether you can really afford the car.

Similarly, with your investments, costs matter. Once again, this includes much more than the cost of acquisition. Especially where mutual funds are concerned, the "sticker price" is only one of several factors that you should weigh carefully before making any purchase—or sale, for that matter!

One important measure of a mutual fund's cost is its expense ratio. The expense ratio includes the fund's management fees, its expenses for fund accounting and shareholder reporting, and other items. Generally, studies and comparisons over time have shown that funds with high expense ratios, relative to other funds in the same investment class, have a harder time outperforming their indexes. It makes sense, when you think about it: the more money the fund requires to run itself, the less money available for investment, and the lower the return to the original investor.

But expense rations aren't the whole story. Fund investors should also consider the "total cost of ownership" in the fund, which includes the expense ratio, but also takes into consideration factors that are harder to assess, such as trading costs and tax impact. Like the insurance, fuel, and maintenance expenses for your new car, these less visible expenses have a very real impact on the real return to the investor. Funds that trade very actively will typically incur greater trading costs than funds that operate with more of a "buy and hold" philosophy. To return to our car analogy, it's sort of like people whose driving features lots of jackrabbit starts and jamming on the brakes; they are going to have higher maintenance costs than folks who create less wear and tear on their vehicles.

Tax consequences of fund activity are related; by doing lots of buying and selling, fund managers often create short-term gains, which are taxes less favorably than long-term gains (gains on investments held for a year or more). These short-term gains are then passed along to fund investors, who must then pay their share of the taxes—again, reducing the amount of money available for future use or investment.

In fact, multiple studies over several years have confirmed that actively traded accounts—whether mutual funds, hedge funds, or what have you—fail to outperform their benchmarks over long periods of time. High transaction costs, portfolio turnover, and elevated management fees, along with disadvantageous tax impacts, will consistently erode the net return to investors. Also, even though a particular fund or manager may have a year or two of superior returns, these are rarely sustainable over the long term. For that reason, the standard phrase—"past results are no guarantee of future performance"—is particularly applicable to actively managed mutual funds and other types of managed accounts.

On the other hand, reliance on quality investments held for the long term, along with efficient markets, will usually afford investors superior performance and returns. The financial markets, which are based on millions upon millions of individual decisions and transactions, have proven themselves exceedingly efficient at aggregating the sum of all available knowledge into the moment-to-moment pricing of securities. By carefully considering all the expenses involved in an investment, diversifying appropriately, allowing the markets to do their work over time, having an investment strategy appropriate to your goals, and remaining disciplined, you will be concentrating on factors that are actually within your control.

Those who try to "time the market" or who jump in and out of investments in an effort to improve total returns most often succeed only in diluting the power of the market to do what it does best. By trying to control factors that are essentially beyond control, they are setting themselves—and the investors whose funds they manage—up for subpar performance.

This is where a good advisor can prove invaluable for investors. By looking beyond the most recent year's performance figures, by helping investors understand all the costs involved in

owning the fund—not just the "sticker price"—and by evaluating the fund's strategy in light of the investor's particular circumstance, goals, and plans, an experienced, professional advisor can help investors avoid unnecessary expenses and position the portfolio for long-term, reliable performance.

Stay Diversified, Stay the Course!

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