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Fees can slash returns of actively managed funds over long haul

By John F. Wasik | July 31, 2007

Once you pull the curtain from an actively managed mutual fund, you won't like what you see if you are able to tally total expenses.

The corrosive effects of trading and research-related costs are the equivalent of buying a sports car and finding out you got the performance of a subcompact. These charges are poorly disclosed, yet have a negative effect on fund returns.

For every dollar a fund spends on trading, assets were pared by an average of 41 cents, according to a recent study. Soft dollars, which are excess commissions paid to cover research and other services, also hurt investors.

These expenses reduce performance and can also predict lower future returns. All too often, the more that managers trade, the more fund holders suffer.

The study, titled "Scale Effects in Mutual Fund Performance: The Role of Trading Costs," was written by Gregory Kadlec of Virginia Tech University, Roger Edelen of Boston College, and Richard Evans of the University of Virginia. The research examined trading costs of 1,706 funds from 1995 to 2005.

How much trading costs cut returns depended upon the size of the stocks. Large-company funds averaged 0.77 percent annually on transactions. Small-firm managers averaged 2.85 percent.

The study also found a relationship between the size of the trade and returns.

"For funds with relatively small average trade size, trading is positively related to fund returns," the researchers found, noting large transactions were negatively linked to performance.

"This suggests that scale effects in trading, rather than other factors in fund management, are the primary cause of diminishing returns to scale in the mutual fund industry."

Part of the reason for cost-inefficient trading may have to do with the nature of the open-ended mutual fund. With money constantly flowing in and out for contributions and redemptions, managers must buy or sell accordingly.

Earlier research by Edelen estimates that flow-related issues may account for 30 percent of fund trades.

Besides trading costs, they also wanted to know how much soft-dollar deals affect total returns. A typical arrangement would cover the cost of research in exchange for trading through the broker who offers the transaction. The commissions typically are higher than average and are passed along to investors.

How much trading and soft dollars cost aren't included in expense ratios, which cover all other management expenditures.

One way of getting a feel for transaction expenses is to look at turnover, the amount of trading expressed as an annual percentage of fund assets. A turnover rate of 100 percent tells you that the value of the entire portfolio was traded in one year. Heavily traded funds generally pass along higher brokerage expenses to investors, although turnover gives you only part of the total cost picture.

While taking on 34 percent more risk, the highest-expense funds only delivered a return about half as much as the most-expensive funds from 1995 to 2005, according to John Bogle's latest book, "The Little Book of Common Sense Investing."

In dollars, the cost-related drag can be measured. Say you had \$100,000 in a stock fund returning 10 percent, with 1 percent in annual expenses over 20 years. With additional yearly trading costs of 0.4 percent, your total investment over that time would be reduced about \$43,000 if you figure in forgone earnings and reduced return.

The Securities and Exchange Commission has been exploring better methods of disclosing fund expenses for years, but has yet to come up with an understandable way of telling investors how much performance is being diminished.

You can ask your fund manager to lay out all trading and soft-dollar charges and tell you how much your return is being pinched.

Should you hit a brick wall on these questions -- and you will -- it's time to consider passive investments such as index and exchange-traded funds, which have almost no trading and soft-dollar costs.

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