

Carmel Valley News / Del Mar Village Voice November 2004

Are You Paying Too Much For Your Investments?

By Terry Green, CFP[®], AIF[®]

Whether you realize it or not, every time you invest, you are faced with the important decision of choosing between passive management and active management. The philosophy and approach you decide to implement often determines how costly your investments will be.

If you choose passive management you are in essence saying that you believe it is highly unlikely to beat the market over time. You try to replicate market returns with index funds within a strategic asset allocation. You do not risk your capital on hunches, hot tips, or the latest investment fad. Rather, you are satisfied with market returns.

If you choose active management you are saying that it is possible to beat the market over time with such strategies as market timing and stock and fund picking. You believe that you or someone you hire can consistently beat the market over time and you will make more money than if you'd just bought index funds. You are willing to risk your capital on essentially the predictability of the future.

By now you've probably heard or read about the arguments over which approach is better. Whatever camp you're in, at the end of the day, it comes down to one thing – cost. Your bottom line is affected by transaction costs, mutual fund expenses, taxes, and advisor fees. Active management practically guarantees higher costs.

Depending on whether you use a discount brokerage firm or a traditional broker, a single purchase of stock may cost you \$10, \$100, or even a \$1,000. You are likely to have a number of stocks in your portfolio. Commission mutual funds could cost you 3% - 6% on the purchase amount. Mutual fund transaction fees of \$15 - \$40 could also apply if you're working with an advisor in a fee arrangement or simply buying them yourself. These are just the initial costs. An active manager will be constantly evaluating and adjusting his or her portfolio. All of this tweaking leads to higher costs. It is estimated that transaction costs reduce a portfolio's return by 1% a year or more.

All mutual funds (yes, even no-load funds) have an annual expense ratio to cover their ongoing expenses and make a profit. You do not see this charge taken out of your account. Instead, it is absorbed by the mutual fund, therefore lowering the return. Expense ratios can be as little as 0.05% or over 3.5% (a search on Morningstar found almost 100 funds in excess of 3.5%, some with very familiar names). Actively managed funds typically cost more than index-type funds because you are paying for high-priced management and research. The average equity fund charges about 1.5%. So if you had a \$250,000 invested in such a fund, it would cost you roughly \$3,750/year.

Active management, with its higher turnover, can also create a tax burden. Remember your surprise a few years ago when you found out you had to pay taxes on funds that were declining in value? Even in normal years, taxes can eat away at your return. The higher the turnover in your portfolio, the more likely it is that you will have short-term capital gains. Short-term capital gains, dividends, and interest are all taxed as ordinary income. The higher your tax bracket, the more relevant taxes become.

Advisors who use active management often charge more than their passive management peers. Most fees are between 1% - 2.5% of the amount invested. This is to compensate them for all the extra work they create. But if you start to add up the costs of active management, you'll see that you probably have to earn over 4% just to break even, and that doesn't include taxes! With such costs, it is easy to understand why most active managers, even if they do add value, do not beat their benchmark index.

Passive management, on the other hand, enjoys lower transaction costs, expense ratios, and taxes. Plus, you can usually find an advisor charging under 1%. Your total cost with this approach is probably between 1% - 1.5%.

Successful companies always keep an eye on the bottom line. Think of your portfolio as a business. Wouldn't you prefer to run lean and mean instead of being saddled with a bunch of overhead? Managing expenses is paramount to successful investing, so if your portfolio is too costly, maybe it's time to fire your advisor, or yourself! Remember, it's not personal, it's just business.

Terry Green, CFP[®], AIF[®] is an independent, fee-only financial planner with Blue Water Capital Management. He can be contacted at (858) 552-1488 or terry@sandiegofeeonly.com.