The Truth About Fees

One of the most confusing issues to many investors is determining exactly what fees they are paying on their investments and investment programs. Fees are often a key factor in the choice of advisors, so making a decision without full and accurate information can have a significant impact on the ultimate success of an investment program. Our goal in this White Paper is to take some of the mystery out of fees and to arm investors with the knowledge to ask the right questions and make informed decisions.

The Growth of Fee-Based Accounts

The fee issue has taken on added significance as the number of advisors that charge an asset-based fee has increased appreciably over the past decade. Historically, many advisors did not charge a fee per se for their services, but rather were paid a portion of the commission costs on trades made in client accounts. Charging an asset-based fee is considered to be more beneficial to the client as both parties share a common goal of growing the overall value of the account.

Many of these asset-based fee arrangements, which bundle most costs into one overall fee, are commonly referred to as “wrap-fees accounts.” The key word here is “most.” Often times the investments (e.g., mutual funds) have imbedded costs associated with them which are an additional cost above and beyond the quoted wrap-fee. Investors considering these types of accounts should be careful to distinguish between the wrap-fee and the overall cost of the investment program.

The other common form of asset-based arrangement is when the advisor quotes a fee for his services only. Advisors offering these types of accounts usually refer to themselves as “fee-only” advisors or planners. When comparing the overall costs of these two fee-based alternatives, it is important to add in the total costs of the investments here as well. This is the only true “apples” to “apples” comparison. While in theory an advisor that says “I only charge 1% for my services” is technically correct, if he does not disclose and explain the additional fees of the investment themselves, he is not portraying the true end-cost to the client.

As a rule of thumb, advisors typically charge about 1% per year for their advice. This 1% is before the costs of the investments are added in. For many retail investors, depending on the size of the portfolio, the total cost of their investment portfolios will generally be somewhere between 1.5% and 2.5% per year (inclusive of this advisor fee).

Portfolios invested in exchange traded funds (ETFs) will be on the lower side of this range, while those utilizing individual securities and specialized mutual funds will be on the higher side. (These ranges are for retail accounts; fees for institutional accounts and accounts for ultra high net worth individuals are typically lower.)

Even with the growth of fee-based accounts, investors often have the choice of a commission account as well (although some advisors no longer offer them).

When working with an advisor, or interviewing an advisor, make it clear that you would like to know the detail of **all** fees being charged and who gets them. This should include explicit fees – such as the wrap-fee – as well as implicit fees; investments such as mutual funds and ETFs have charges imbedded in them and their total costs are therefore harder to discern.

Let’s take a look at the types of costs associated with each alternative type of account.

Commission Accounts

If the advisor is buying individual securities for you in a commission account, discuss the commission and mark-up policies (for bonds) of his firm. An upfront or initial “apples” to “apples” comparison of a traditional commission account with a wrap-fee or fee-only account is difficult, because in a commission account securities are being bought throughout the year. It is thus impossible to quote a definite price. If considering a commission account, try to get a feeling from the advisor of how many securities he typically buys and sells in a year (commonly referred to as turnover).

Also ask whether his historical turnover changes from year to year based on conditions in the market. These will again only be estimates, and only after a year in such an account will you be able to determine your actual trading costs and compare this to the cost of a fee-based arrangement.

If the advisor is buying other investments such as mutual funds and ETFs, the costs of each of these investments must be determined and included in your fee calculations. Since ETFs trade like regular stocks, the advisor will be paid a commission on these transactions. For mutual funds, advisors are typically paid what is called a trail by the mutual fund company and in some cases, depending on the share class you purchase, they may be paid an upfront or back-end load. Additionally, for both of these types of investments, there will be internal operating and trading costs as well. (More detail on these costs are provided in the “Wrap-Fee Accounts” section below.)

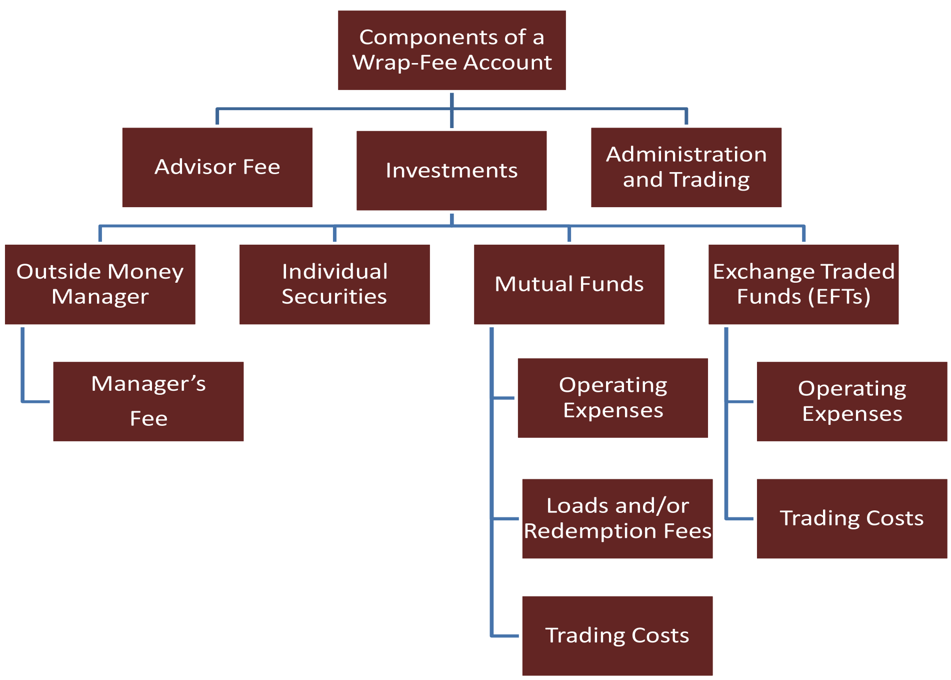
Fee-Only Accounts

Investors who choose to go the fee-based route will often have the choice between a fee-only arrangement – where the advisor is paid a fee for his services - and a wrap-fee account – where the purchase and sale of individual securities and ETFs is included in the overall fee. For either option, however, the other costs associated with the investments must be added to determine the overall cost of the program. Since the investment options for these two broad types of fee-based accounts are typically the same, we will only cover them once - in the section below.

Wrap-Fee Accounts

Table 1 illustrates the components of a typical wrap-fee arrangement. A portion of the fee goes to compensating the advisor and a portion to the firm that the advisor works for (often called the sponsor firm) to cover administration and trading costs. The remainder of the fee represents the costs of the actual investments.

TABLE 1



The four most common types of investments found in wrap-fee accounts are:

- Outside money managers (also called investment managers)
- Individual securities (stocks and bonds) purchased on either a discretionary or non-

discretionary basis by you and/or your advisor
- Mutual Funds
- Exchange Traded Funds (ETFs)

The fee quoted is usually truly all-inclusive for wrap-fee accounts that utilize individual securities only, either purchased via an outside money manager or by the advisor himself. This fact is easy to verify since the fees are typically debited directly from the account and are clearly shown on the monthly statements. In addition, investors receive trade confirmations, either after each trade or bundled on a periodic basis, which will confirm that no commissions were charged.

In some cases, more common with bonds than stocks, since the firm has the fiduciary responsibility for best execution, if securities can be bought cheaper at another dealer they must be. In this case, the client will be charged a commission or mark-up and this will be clearly indicated on the trade confirmation. In reality, this happens rarely. We wanted to point out the possibility, but because it happens so infrequently, we don't think it should be a factor in any cost comparisons that are made. For practical purposes, the wrap-fee is the true cost to the client for accounts that purchase individual securities only.

However, investors must be careful when wrap-fee accounts include mutual funds and/or ETFs, because these types of investments have additional internal costs associated with them. While outside money managers traditionally buy individual securities, there are cases where they will buy mutual funds or ETFs as well. If wrap-fee accounts include any investments other than individual securities, the likelihood is that there will be additional costs associated with them and investors should ask their advisor for a full breakdown of these costs.

Turning to mutual funds, many retail investors are familiar with mutual funds in general, but have never really understood the charges associated with them. As these investors have migrated to fee-based relationships, this confusion has increased. For example, if you have a wrap-fee account that is charging 1.5% per year (typically ¼ of the fee being charged each quarter), the statements you get are very upfront about this fee. Your gross return for the year might have been 12% for example, the 1.5% is deducted and your net result is 10.5%. For mutual funds, however, the fees are imbedded in the returns of the fund.

Utilizing these same numbers, an investor will be told that his mutual fund returned 10.5% for the year. While this is true on a net basis (after fees), what is not as obvious unless you read the prospectus or ask your advisor for the details, is that the fund actually had 1.5% in expenses so that the gross return was the same 12% as the wrap-fee account. Investors in this case had the same results, and paid a similar fee. But the perception is that the mutual fund was cheaper because the fee is not displayed as prominently.

Mutual funds and ETFs have a number of operating expenses which are disclosed in their prospectuses. These costs can include a management fee and administrative costs, which include custody, distribution and some transaction costs. Some mutual funds and ETFs may also have additional marketing fees (called 12-b-1 fees), and some mutual funds have loads (upfront or back-end) depending on what share classes you purchase and/or redemption fees if you sell the fund too quickly. In addition, mutual funds and ETFs may have an additional cost that is not included in the prospectus – internal trading costs. These can vary significantly from fund to fund and can only be obtained by calling the Fund/Sponsor company.

FINRA – the Financial Industry Regulatory Authority – offers an on-line resource that allows investors to analyze more than 18,000 mutual funds and ETFs, including fees charged (http://apps.finra.org/fundanalyzer/1/fa.aspx).

We have focused on individual securities, mutual funds and ETFs because they are the most common investments purchased by retail investors. Other investments – such as alternative investments and annuities – are typically outside of this particular debate because they are rarely seen in fee-based accounts. They each contain a number of fees and detailed disclosures and prospectuses are provided. Investors are advised to read all information carefully to determine the total cost and relative merit of each of these types of investments.

To summarize, when comparing alternative fee arrangements, keep the following in mind:

1) Clients must often first choose between a commission account and a fee-based account. Most of the fees paid to the advisor in a commission account are imbedded in the cost of the investments (e.g., commissions, loads or trails), and ascertaining an annual cost for comparison sake is very difficult since the number of transactions vary from year-to-year;
2) The two most common types of fee-based accounts are fee-only – where the advisor charges a fee for his services only – and a wrap-fee – where most of the costs of the investments are included in the fee quoted;
3) When you invest with a fee-only advisor, the fee he quotes must be added to the costs of the individual investments to determine the total cost of the investment program;
4) Wrap-fee have three primary category of fees – the fees paid to the advisor, the fees paid to the firm that he works for and the cost of the investments;
5) The fee charged for wrap-fee investment programs which include individual stocks and bonds managed by outside money managers or the advisor typically include all fees;
6) For wrap-fee accounts which include mutual funds or ETFs, the internal costs of these investments must be added in order to determine the total cost; and
7) If other types of investments are used (e.g., annuities or alternative investments), clients should carefully read the prospectus to determine all costs.

Using these rules of thumb will allow you to make an informed decision on fees associated with various investment programs and investment advisors.