

# Fat Fund Report

by Scott Burns



## A Yardstick for Mutual Fund Expenses

Whose money is it, anyway?

In case you have forgotten, all that money in mutual funds belongs to you and me. It may be diminished, but what remains is still our money. Unfortunately, that doesn't mean we get the most reliable benefit from our money--- income.

Like the old divorce joke--- "She got the mine and I got the shaft."---the financial services industry gets paid first, but we take the fall when markets collapse.

Here's a troubling snapshot. The largest category of mutual funds is what Morningstar calls "domestic large cap blend" funds. The Morningstar database indicates 1,768 of these funds with 3-year track records. Average the group and you'll find they have average net expense ratios of 1.22 percent... and average SEC measured yields of 0.90 percent.

So, the managers get the income--- and then some--- and we get the risk. Worse, while our dividend income is declining, fund managers are raising their fees. They do this because their income is based on a percentage of our declining assets.

Yes, there are fund categories where the managers don't take all the income. But the vast majority of investors are over-paying for under-delivered service.

I have been demonstrating a simple reality for 30 years. High cost funds tend to provide lower returns than low cost funds. Like most things probabilistic, this isn't guaranteed. It's just probable.

So I'd like to introduce a new measuring tool. Think of it as the Fat Fund Report. Using it, you'll be able to learn where your fund ranks in costs. You'll be able to find out if your fund manager is in the least expensive 10, 25 or 50 percent of managers by category. Ditto the other end of the scale, where funds proudly taking more of your money than 90 percent of other funds.

If you own a large blend fund with a net prospectus expense ratio of 1.18 percent or less, you own a fund with below-median expenses. If your fund expenses are 0.82 percent or less, it ranks among the least expensive 25 percent. And if your fund has a net expense ratio of 0.46 percent or less, it ranks in the slimmest 10 percent.

If your fund ratio is greater than 1.57 percent, it is more expensive than 75 percent of comparable funds. It is in the greedy 10 percent if its expense ratio is 2.03 percent or more. Don't know the expense ratio for your fund? Visit the Morningstar website, type in the name or ticker for your fund, and find the expense ratio in their fund report.

It should be noted that some distribution channels are more expensive than others. The "B" share version of most funds--- where an annual charge replaces an up-front load--- will generally be found among the 25 percent most expensive funds. So will shares that build in adviser fees as a 12b-1 charge.

So what funds are doing right by investors? One of the largest is American Funds Investment Company of America A shares. This managed fund has an expense ratio of 0.59 percent. It lost 7.13 percent annualized over the last three years. That's 1.09 percent a year better than the S&P 500 index. Similar figures obtain for American Funds Fundamental Investors A shares (0.61 percent expense ratio, minus 6.43 percent three year annualized return), Vanguard Life Strategy Growth (0.21 percent expense ratio, minus 6.26 percent three year annualized return), and Fidelity Fund (0.55 percent annual expense ratio, minus 6.5 percent three year annualized return).

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What about big expensive disappointments?

Davis New York Venture B shares top the list with a net prospectus expense ratio of 1.66 percent and a 3 year annualized loss of 10.02 percent. Oppenheimer Main Street B shares clocked in with a similarly high 1.66 percent net prospectus expense ratio and a 3 year annualized loss of 9.25 percent. Pioneer B shares (2.12 percent expense ratio, 8.95 percent 3 year annualized loss) and Legg Mason Value C shares (1.73 percent expense ratio, 18.91 percent 3 year annualized loss) are two other large and well-known funds that have done poorly for their investors.

How big is the performance gap between the lowest cost and highest cost large blend funds? Averaging the ten percent most expensive and the ten percent least expensive, the parsimonious funds bettered their spendthrift counterparts by an annualized advantage of 1.05 percent over the last three years.

Bull or bear market, costs matter.

## Measuring the Mutual Fund Universe

If something is profitable to do, you can bet lots of people will be doing it. The same principle that explains the rising tide of drug marketing also explains the incredible number of mutual funds--- it's a profitable business. And the profits in the business all come from one place, our money. Perhaps it shouldn't be surprising that the number of funds in many fund categories now exceeds the number of funds that existed when I began writing a personal finance column in 1977.

While it isn't reasonable to expect people to manage our money for free, an exploration of the universe shows that there are gigantic differences in fees. More important, paying more doesn't mean you get a higher return. It usually means you'll get a lower return because those fees all reduce the return on our money when we have a return. When we don't have a return, the fees simply reduce our principal.

Today, there are 17,583 mutual funds and 12,428 of them have been around long enough to have a track record that is at least 3 years long. One reason the number of funds is so large is the burgeoning number of distribution channels. Where 40 years ago the vast majority of funds were the front-end commission type (now called "A" shares), today we have "B" shares and "C" shares, as well as 529 plan shares, Institutional shares and no-load shares. We even have an entirely new kind of mutual fund, the Exchange Traded Index fund.

Confusing? Yes. But the proliferation of distribution channels has created an abundance of opportunities for self-directed investors to make choices that can chop their investment expenses dramatically. (To see how much, see "You Can Pay a Little, or a Lot: The Range of Mutual Fund Expenses.")

To keep the research task manageable--- and the benchmarking figures statistically reasonable--- I've limited this exploration to the 17 categories that have at least 300 funds with track records that are at least three years long. This excludes a whopping 52 categories plus all the state specific tax-free municipal bond funds. That may seem like a lot of excluded funds but the reality is that those 17 categories happen to contain most of the money invested in mutual funds. You can understand this by considering a few simple examples. The largest fund in the "large blend" category is the S&P 500 Exchange traded fund, SPY. It has \$61.5 billion in assets. The first of the managed funds in the category ranks number three. It's the American Funds Investment Company of America A shares with \$43.2 billion in assets.

# Fat Fund Report

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The largest category excluded is “Diversified Emerging Markets” and the largest fund in that category is the iShares MSCI Emerging Markets Exchange traded fund, EEM. It has \$28.2 billion in assets and the next largest fund, the Vanguard Emerging Markets exchange traded fund, VWO, has only \$9.5 billion in assets. I’m excluding a lot of large funds in different categories, but I believe Pareto’s Law applies here--- we’re likely talking about 80 percent of all mutual fund assets.

When, and if, time allows I’ll expand this exercise to include more categories. The important thing, for now, is that our result includes the majority of all funds.

Morningstar Group	Morningstar Category	#funds	# 3 yr funds
Domestic Equity	Large blend	2219	1768
Domestic Equity	Large growth	1972	1576
Domestic Equity	Large value	1469	1171
General FI	Intermediate-Term Bond	1181	983
Hybrid	Moderate Allocation	1276	960
Domestic Equity	Mid-Cap growth	956	803
Domestic Equity	Small growth	864	696
International	Foreign Large Blend	894	624
Domestic Equity	Small blend	720	580
International	World Stock	839	547
Hybrid	Conservative Allocation	661	485
Specialty Bond	High Yield Bond	576	478
Domestic Equity	Mid-Cap blend	517	392
General FI	Short-Term Bond	439	361
Government FI	Intermediate Government	383	340
Domestic Equity	Mid-Cap value	460	339
Domestic Equity	Small value	429	325
International	Diversified Emerging Markets	421	260
International	Foreign Large Value	364	252
Muni Bond	Muni National Long	269	245
Specialty-Sector	Technology	276	239
Muni Bond	Muni National Intermediate	284	239
Specialty-Sector	Real Estate	292	236
International	Foreign Large Growth	296	227
Specialty Bond	World Bond	289	187
Specialty-Sector	Health	201	174
Specialty Bond	Multi-Sector Bond	277	171
Government FI	Short Government	168	151
Hybrid	World Allocation	312	137
General FI	Inflation-Protected Bond	166	137
Hybrid	Target Date 2000-2010	248	131
Specialty-Sector	Financial	166	126

continued on page 3...

# Fat Fund Report

by Scott Burns



Morningstar Group	Morningstar Category	#funds	# 3 yr funds
Muni Bond	Muni National Short	148	121
International	Europe Stock	146	118
General FI	Ultra-short Bond	132	118
International	Pacific/Asia ex-Japan Stock	203	116
Muni Bond	High Yield Muni	152	116
Specialty-Sector	Natural Resources	209	111
Hybrid	Target Date 2016-2020	243	110
Hybrid	Target Date 2026-2030	229	104
International	Foreign Small/Mid Growth	152	101
Specialty-Sector	Utilities	125	98
Hybrid	Target Date 2036-2040	220	95
General FI	Bank Loan	140	90
Hybrid	Retirement Income	146	85
Specialty-Sector	Equity Energy	118	77
Specialty Bond	Emerging Market Bond	120	74
Hybrid	Convertibles	94	72
International	Foreign Small/Mid Value	93	70
Hybrid	Target Date 2011-2015	181	66
International	Global Real Estate	129	65
Hybrid	Target Date 2021-2025	148	48
Specialty-Sector	Communications	64	45
Hybrid	Target Date 2031-2035	140	41
International	Japan stock	62	39
General FI	Long-Term Bond	60	37
Specialty-Sector	Consumer Discretionary	44	35
Hybrid	Target Date 2041-2045	133	35
International	Diversified Pacific/Asia Stock	51	32
Specialty-Sector	Industrials	49	28
Hybrid	Target Date 2050+	181	25
Government FI	Long Government	34	25
International	Latin America Stock	34	22
Specialty-Sector	Consumer Staples	36	16
Hybrid	Miscellaneous Sector	18	8
Hybrid	Target Date 1015-2029	1	0
Hybrid	Target Date 2030+	1	0

Source: Morningstar Principia, 06/30/2009

Total Funds	17583
Funds>300	12428
	71%

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## You Can Pay a Little... or a Lot: The Range of Mutual Fund Expenses

The table below divides the mutual fund categories studied into three major groups, equity funds, hybrid funds that mix equities and fixed income, and fixed income funds. One thing you can see immediately is that equity funds tend to cost more than hybrid funds and hybrid funds tend to cost more than fixed income funds. The reason for this is simple: fund management companies can get away with charging more for equity funds because they have traditionally offered the highest returns and because people attach the most hope to equity funds.

Some would argue that it is more expensive to manage an equity fund than a fixed income fund. Reality doesn't support that claim because there are a lot of ways to manage both types of funds and there is no reason that fixed income funds are inherently less expensive.

### The Distribution of Mutual Fund Expense Ratios, by Fund Category

(Prospectus Net Expense Ratios)

Morningstar Group	Morningstar Category	# 3 yr funds	10th Ptile	25th Ptile	50th Ptile	75th Ptile	90th Ptile
<b>Equities</b>							
Domestic Equity	Large blend	1768	0.46	0.82	1.18	1.57	2.03
Domestic Equity	Large growth	1576	0.79	1.00	1.25	1.70	2.05
Domestic Equity	Large value	1171	0.70	0.95	1.20	1.60	1.95
Domestic Equity	Mid-Cap growth	803	0.92	1.13	1.77	1.85	2.42
Domestic Equity	Small growth	696	1.00	1.23	1.49	1.93	2.27
International	Foreign Large Blend	624	0.80	1.15	1.45	1.90	2.24
Domestic Equity	Small blend	580	0.70	1.04	1.37	1.75	2.20
International	World Stock	547	0.94	1.21	1.55	2.04	2.32
Domestic Equity	Mid-Cap blend	392	0.56	1.03	1.33	1.75	2.16
Domestic Equity	Mid-Cap value	339	0.85	1.04	1.28	1.73	2.05
Domestic Equity	Small value	325	1.00	1.20	1.45	1.83	2.22
Average=			0.79	1.07	1.39	1.79	2.17
<b>Mixed Portfolios</b>							
Hybrid	Moderate Allocation	960	0.77	1.00	1.29	1.80	2.08
Hybrid	Conservative Allocation	485	0.79	1.00	1.25	1.80	2.02
Average=			0.78	1.00	1.27	1.80	2.05
<b>Fixed Income</b>							
General FI	Intermediate-Term Bond	983	0.47	0.65	0.90	1.29	1.65
Specialty Bond	High Yield Bond	478	0.71	0.87	1.10	1.72	1.86
General FI	Short-Term Bond	361	0.46	0.65	0.82	1.13	1.59
Government FI	Intermediate Government	340	0.51	0.72	0.96	1.55	1.73
Average=			0.54	0.72	0.95	1.42	1.71

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Now let's look at expense ratios from left to right, from the least expensive to the most expensive. If you know the net prospectus expense ratio for the funds you own you can use the table above to see whether your funds are high expense funds or low expense funds. You can tell whether your fund is in the least expensive quartile, the second lowest expense quartile, third quartile, or the most expensive quartile. You can also check to see if your funds are in the least expensive 10 percent or the most expensive 10 percent.

Some important questions:

## 1. Why do expenses matter?

Simple. Over long periods of time high expense funds tend to have lower returns than low expense funds. I have frequently found that the cost difference between expensive and inexpensive funds is about the difference between a fund performance in the top 25 percent and a fund performance in the bottom 25 percent. Think about what that can do to your retirement.

## 2. How do you find funds whose expenses are in the lowest quartile--- funds that cost less than at least 75 percent of their competitors?

The easiest way to do this is to buy an index fund. And the exchange traded index funds are often the least expensive altogether. Using the broad category ETFs, for instance, is a pretty good way to be nearly certain of having expenses in the least expensive decile or 10 percent of category. While the least expensive decile of "large blend" funds begins at an expense ratio of 0.46 percent or less, the Vanguard 500 Index mutual fund (minimum purchase \$3,000) has an expense ratio of only 0.18 percent. The ETF version is even less expensive, with the SPDR available at an expense ratio of only 0.09 percent. Of course, you have to pay a commission to buy and sell the fund, so the mutual fund will be less expensive for small investors.

Another way is to look for funds in the firms that are established low cost vendors. Vanguard is the obvious leader but there are a surprising number of firms that are reliably positioned in the lowest cost quartile. Fidelity, American Century, Janus and T. Rowe Price are strong candidates with their no-load funds. The American Funds group is a low cost vendor among funds that are distributed through brokerage firms.

## 3. How do you avoid funds whose expenses are in the highest cost quartile--- funds that cost more than at least 75 percent of their competitors?

The easiest way to do this is not by firm but by distribution channel. If you buy "B" shares, the ones that substitute an annual charge for a front-end load commission, the 12b-1 fee is likely to put you in the most expensive funds group. It is the same with "C" shares, sometimes called the Poor Man's Wrap Account. These funds charge a constant additional fee that goes to the broker or manager.

This isn't limited to being a hapless individual investor. If you work for a small company the odds are you will have a relatively expensive set of choices in your 401(k) plan. Similarly, if you are a school teacher and have a 403(b) plan it is very likely that the products you will be offered will be expensive, insurance-based products such as variable annuities with average annual costs well over 2 percent.

In all of these cases, you have alternatives and choices. If your 401(k) or 403(b) plan has no employer match and costs 2 percent a year, you'd be far better off investing through a traditional Individual Retirement Account, IRA because you can do that with best quartile no-load funds.

# Fat Fund Report

by Scott Burns

## How Much Does Cost Matter?

How much will it cost you to “pay up” for a mutual fund? A lot. While there is no guarantee that every high cost fund will perform more poorly than every low-cost fund, high cost funds, on average, provide lower returns than low-cost funds.

Obvious, you say? Logical, you say? Well, yes.

But what is obvious and logical doesn’t prevent high pressure marketing from the fund companies that reward themselves first, and most. And, sadly, there are literally thousands of funds that are expensive-- unnecessarily expensive. You can see the performance difference by considering this examination I did of the 10 percent most expensive funds in major categories with the 10 percent least expensive funds in major categories.

Over the three years ending June 30<sup>th</sup> the performance gap for the 11 types of equities funds examined averaged 1.24 percent, annualized. The biggest performance gap, 2.29 percent, annualized, was in the funds Morningstar categorizes as “World Stock” funds--- funds that can invest in equities anywhere in the world, including the domestic market. The smallest performance gap was in domestic mid-cap growth funds, only 0.52 percent.

One surprising result was that the average high cost mid-cap value fund actually returned more than the average low cost mid-cap value fund, leading by 0.69 percent. Does this atypical result mean anything? I don’t think so. It simply demonstrates the probabilistic nature of mutual fund results. While high-cost funds will probably trail low-cost funds in performance, it isn’t inevitable. It’s just probable.

These figures will change from quarter to quarter, depending on how the markets have performed over the trailing 3 year period. The average performance gap in the two categories of hybrid funds examined was 0.82 percent.

The most surprising result was found among fixed income funds. There, I examined 4 categories of fixed income funds and found an average performance gap of a whopping 1.78 percent. That’s a pretty clear indication that costs trump manager performance in the fixed income arena.

So what can we do to improve investment performance with little or no knowledge of investments?

Answer: We can be concerned with expenses. If someone who calls himself an “investment adviser” recommends a portfolio in which every fund has expenses in the top 10 percent or top 25 percent, you can be pretty sure that the advisor is working in an environment where the only choice he has is high-cost fees.

It isn’t inevitable, however, that you’ll face high-cost fees from an investment adviser whose primary source of income is sales commissions. As I have pointed out many times in columns, it is possible to find a commissioned salesman who will put you in low cost, but broker distributed, funds such as the American Funds group. While the front-end load on these funds can be as high as 5.5 percent, their typical ongoing expenses run about 0.70 percent.

As a consequence, it will take about 4 ¼ years to “catch-up” on the total expenses of fund choices that cost 2.00 percent a year but have no front-end commission. That 4 ¼ year figure, however, is the maximum “catch-up” period because the American Funds group, like most fund firms, reduces the commission as the amount invested rises. Invest \$1 million, for instance, and there is no commission.

So if your financial adviser only offers high cost funds, you know that serving your interests is probably not his primary concern.

# Fat Fund Report

by Scott Burns



## Measuring the Performance Gap

Morningstar Group	Morningstar Category	# 3 yr funds	Avg least Exp. Performance	Avg most Exp. Performance	Performance Spread
<b>Equities</b>					
Domestic Equity	Large blend	1768	-8.20	-9.25	1.05
Domestic Equity	Large growth	1576	-6.45	-7.60	1.15
Domestic Equity	Large value	1171	-9.47	-11.17	1.70
Domestic Equity	Mid-Cap growth	803	-7.54	-8.06	0.52
Domestic Equity	Small growth	696	-9.27	-11.17	1.90
International	Foreign Large Blend	624	-7.37	-9.19	1.82
Domestic Equity	Small blend	580	-10.50	-11.37	0.87
International	World Stock	547	-6.04	-8.33	2.29
Domestic Equity	Mid-Cap blend	392	-8.79	-10.05	1.26
Domestic Equity	Mid-Cap value	339	-10.11	-9.42	-0.69
Domestic Equity	Small value	325	-10.29	-12.04	1.75
Average =					<b>1.24</b>
<b>Mixed Portfolios</b>					
Hybrid	Moderate Allocation	960	-3.84	-4.97	1.13
Hybrid	Conservative Allocation	485	-0.63	-1.14	0.51
Average =					<b>0.82</b>
<b>Fixed Income</b>					
General FI	Intermediate-Term Bond	983	4.68	2.46	2.22
Specialty Bond	High Yield Bond	478	0.87	-1.73	2.60
General FI	Short-Term Bond	361	3.10	2.83	0.27
Government FI	Intermediate Government	340	6.88	4.84	2.04
Average =					<b>1.78</b>

Source: Morningstar Principia, 6/30/2009

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