December 2, 2003

More on the Hidden Costs of Investing

If your costs are too high, your return will be less than you think.

The markets more or less took a month off in November; the S&P 500 index returned just +0.88% for the month. That performance follows a seven-month stretch in which the index was up nearly +25%. Year-to-date, a balanced portfolio, with a 60/40 mix of equities and fixed income, could have a return in the mid-teens. Specifically, a reasonable composite benchmark representing such a mix has had a return from December 31, 2002 to November 30, 2003 of +15.76%[1].

After three truly awful years in the markets, a return in the teens surely feels like a major improvement. But how much of that hypothetical return has your portfolio actually earned? The answer depends to a large extent on the costs, explicit and hidden, you pay in your investment program.

No matter how you invest – with an advisor, through mutual funds, or in a self-directed account at a brokerage firm – you will face some costs. Many, like the fee you pay your advisor or the commissions you pay your broker for executing trades, are explicit charges. They have the general feel of a payment for a worthwhile service: value for value. But as my note last month on the mutual fund trading scandal indicated, it's important to be aware that there are other ways that various parties in the financial food chain use your money to their benefit. Some, like the alleged mutual fund trading abuses, are improper or illegal. But many legitimate practices also operate as hidden costs of maintaining your investments. In this note, I will focus on some of the more important ones – space does not permit discussing them all.

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[1] Obviously, the specific return depends on the precise choice of benchmark and the precise mix. The figure reported here represents a benchmark comprising 48% the S&P 1500 Supercomposite Total Return Index (US equity, source Standard & Poors), 12% the MSCI EAFE Net Dividend index (international equity, source MSCI), 36% the Lehman US Aggregate Index (fixed income, source Lehman Brothers), and 4% one-month T-bills (Cash, source US Treasury and TIA calculation). The main purpose of this note is to point out that these benchmarks represent hypothetical portfolios rebalanced to their target proportions monthly, and ignore the costs of investing. They do not necessarily represent the actual performance of anyone's portfolio.

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Beyond commissions: The true costs of trading

Depending on how much turnover you have in your portfolio, trading could be the single most important investment cost you face. If you trade through one of the popular discount brokers, you may feel that you pay reasonable commissions on your trades. But commissions are not your only cost. Say you want to buy 100 shares of Microsoft (MSFT) through your favorite discount broker. MSFT closed at $25.71 on November 28, so we're talking about a trade of a bit under $2600. If you pay a $25 commission for that trade, you're paying the broker about 1% of the value of the position to buy, and you'll pay another 1% to sell.

What do you get for your $25? With a highly liquid stock like MSFT, if you enter a market order, your broker will very likely fill it quickly. The broker has an obligation under securities regulations to provide you with "best execution," a nebulous term that basically means the broker cannot fill your order at a price abusively worse than is available in the prevailing market. But the broker has room to make a number of choices within the terms of best execution. With MSFT, the broker may simply drop your trade off to an Electronic Communications Network (ECN), an electronic "exchange" where an order may be waiting on the other side of your trade. The ECN may charge your broker one cent per share, and the broker may pocket the difference. Or (you're buying, remember) the broker may have a position on its own book that it wishes to sell. It will sell to you from its inventory – at the highest price consistent with "best execution." Or your broker may know of another broker that has a strong desire to execute your order – so strong that the other broker is willing to pay your broker for the order. Your broker may route your order to this other broker, in exchange for a cash payment of a few pennies per share. This "payment for order flow" is entirely legal, so long as the result of your trade falls within the bounds, nebulous though they are, of best execution. However the broker routes your trade, remember that the broker will act with its own interest, not yours, in mind.

No matter where your broker chooses to route your order, odds are good that if you turned around and sold your 100 shares immediately you would do so at a loss. Not only would the round-trip result in a second commission, but in the normal course of business, securities dealers also profit by buying and selling stocks at different prices. Generally speaking, dealers buy at the "bid" and sell at the "asked" price. You buy at the "asked" and sell at the "bid." The difference between the two is the "bid-asked spread." Spreads are normal, and they are part of the cost of trading. In general, they are smaller for more liquid stocks, and larger for stocks that have less trading volume. For the largest stocks, they can be as low as a penny per share, but the smaller the stock, the more you may have to adjust your expectations for how close to the current quote your actual traded price is likely to be.

The amount you pay in trading costs depends on how much you trade. But if your round-trip trading cost is 1% (that would actually be less than half the cost in the MSFT example above), and you turn over your portfolio every year (that is, your average holding period for any stock in your portfolio is one year), then trading costs knock a full percentage point off your equity portfolio's performance.

Don't forget fixed income

If you have a well-structured, well-diversified portfolio, you very likely have an allocation to bonds. You may invest through mutual funds – I will have more to say about them later. If you hold bonds directly, then you have to contend with the costs of trading bonds. These costs are much more difficult to assess than the costs of trading stocks. Most stocks have ongoing, active markets, whose prices are easy to observe. That transparency serves as a discipline on the brokers, forcing them to execute trades close to known prices. The bond market, on the other hand, is purely a dealer market – there is no bond exchange as such. The functioning of the bond market is a long, detailed subject, which would take far more space to discuss than I have available here. In general, though, US Treasury securities trade in a very deep and liquid market, and Treasury prices are widely quoted. So trading Treasuries, you can have some degree of confidence that the price at which you trade is close to the market. In other types of bonds, however, including municipal bonds, dealers almost treat pricing as a closely-guarded secret. With munis, the price you pay may at times be several percentage points worse than the best available market for the type of bond you want. The true cost of trading bonds is nearly impossible to measure. But it's a good bet that outside the US Treasury market, your trading costs will be high.

Maybe I'll just leave my account alone

The costs of trading, including the hidden ones, only affect you if you trade. One good strategy for reducing the costs of investing is simply to trade less. Of course, you can't avoid trading if your portfolio is in poor condition. Only a well-structured, well-diversified portfolio is likely to thrive with a low-turnover approach.

Even if you leave your portfolio alone in a brokerage account, however, you are still subject to hidden costs. One of these costs, believe it or not, concerns cash. Your account almost surely has some amount invested in a money market fund. For investment purposes, that amount is more or less the same as cash, but it can be a major hidden cost, especially if you keep a sizeable balance there. That money market fund is a type of mutual fund, and the manager of the fund charges an investment advisory fee to manage it. There's no surprise in this, but in an environment in which many short-term interest rates are 1% per year or less, some money market funds may be paying their managers more than they pay their investors. The manager does the work, and the investor bears the financial risk. If you have a genuine investment reason to hold short-term instruments, then you may be better off investing directly in US Treasury bills.

Another hidden cost concerns margin accounts. When you opened your brokerage account, very likely the representative that helped you open the account encouraged you to set up a margin account, even if you have no intention of doing any margin trading (I hope you don't, but that's another story). The broker may in fact hope that you run a margin balance, because the rates at which the broker lends you money for margin trading can be a source of profit. But the main reason brokers

prefer customers to have margin accounts involves the arcane business of securities lending.

Somewhere in the margin agreement you signed there is most likely a clause permitting the broker to lend the securities in your account to qualified borrowers. The main type of person that wants to borrow securities is a short-seller. A short-seller borrows securities and sells them, hoping that they will fall in price. If they do fall, then the short-seller can buy them back for less than they received when they sold them, and profit from the difference. If a short-seller comes to your broker to borrow a stock that you own, it may be your shares that the broker lends. The short-seller gives the broker cash as collateral against the loan of securities, and the broker keeps the cash until the borrower returns the shares. In the meantime, the broker invests the cash, splitting the interest it earns with the short-seller. Your risk in the transaction is small, but your only benefit is the satisfaction of knowing that by signing a margin agreement you are providing a facility the hedge fund business needs – and giving it away.

So am I stuck with mutual funds after all?

So far, I have concentrated mostly on the hidden costs of direct brokerage investing. But what about mutual funds? In one sense, all of a mutual fund's costs are hidden, since investors never write a check for the expenses inside a fund. But most investors are aware that they do pay fees for mutual funds, in the form of an expense ratio that the fund company takes out of the fund, thus reducing its investment performance. Investors are less well aware, however, of what is in this expense ratio. The main components are the management fee (this is the fee actually paid to the organization that manages the portfolio; many investors mistakenly believe that this is the only fee they pay), administration fees (to cover legal, accounting, and other fund expenses), and distribution or 12(b)-1 fees.

If we want to understand the full cost of maintaining your investment portfolio, it's important to understand 12(b)-1 fees. Although these fees are well disclosed as mandated by securities law (you can look them up in the fund's prospectus or on-line at Morningstar and a couple of other places), they still are, in a way, hidden costs. Most investors are only dimly aware of these fees and what they do. If you bought your fund through a broker, the 12(b)-1 fee functions primarily as an ongoing sales concession to the broker that sold you the fund. In a way, the 12(b)-1 fee allows the mutual fund company to use your money to support their marketing budgets. If a fund company feels they need to offer higher 12(b)-1 fees to marshal the sales energy of brokers, that higher fee comes from your investment return, rather than directly from the fund company's profit margin.

Depending on how you invest, sales charges of various types can be of considerable importance to your investment return. If your investment "advisor" is a broker that receives sales commissions, then you may well have paid a sales commission, a "front-end load," when you purchased the fund. Again, these loads are fully disclosed in the fund's prospectus, and you can look them up on Morningstar. Some of them are startlingly high. For example, the Investment Company of America,

a fund popular with brokers, has a 5.75% front-end load. If you invest $10,000 in that fund, your starting investment balance is actually $9,425. The other $575 is the sales load. In most instances, much of that load goes to the broker that sold you the fund. The burden of the sales load can be large. According to Morningstar, this year through November 30 Investment Company of America has had a total return of +19.6%. Our original $10,000 would have earned that +19.6% on only $9,425, resulting in an 11/30 balance of $11,272, an all-in return of just +12.72%. By contrast, the S&P 500 index has returned +22.30% year-to-date through November 30.

Your broker is entitled to some compensation, and the sales charges (loads plus 12(b)-1 fees) provide it. But a broker's obligation to you in recommending a fund is usually just to be reasonably sure that the fund is suitable for you, in the sense that the risks the fund takes are appropriate for you and your portfolio. In many instances the broker is selling you a product, not acting as a fiduciary. The broker may have no obligation to weigh the possible benefits to you of investing in a fund with a high sales load against a comparable fund that has no such hurdle. A registered investment advisor, who acts as a fiduciary with an obligation to place your interests first, would have to evaluate that tradeoff. Unless also registered as a broker, the RIA could not benefit from the sales commission anyway.

Perhaps the most deeply hidden charges in the mutual fund world are the "shelf space" payments that many fund companies pay to brokerage firms in exchange for featuring their funds on various electronic "platforms" that make it easier for you to buy the funds. Unlike 12(b)-1 fees, these payments do come directly from the fund management company, not from the funds, and so they do affect the fund company's margins, rather than your fund's investment returns. These funds are well known to regulators, and they are a direct business arrangement between the fund companies and the brokerage firms. One issue with these payments is that they may skew the fund choices easily available to you away from funds that may be superior toward ones whose sponsors simply pay up for shelf space.

So how do I keep the costs of investing under control?

The total, all-in cost of maintaining an investment portfolio can be startling. We have commissions, bid-offer spreads, markups on bonds, money market fund management fees, mutual fund expense ratios and sales charges. There are then also all the hidden costs, like the securities lending income you aren't receiving in your margin account, or the performance of the superior fund you never heard about because it doesn't charge a high enough load to interest your broker, or doesn't pay the shelf-space fee to your brokerage firm. What is the best way to keep all these costs under control? I suggest several steps.

1. Choose a robust, low-turnover portfolio structure, and stick with it. Once you set it in place, only adjust as necessary to keep up with the evolution of the market.

2. Create stable portfolios of individual securities in parts of your portfolio that have large enough allocations to permit diversification at a reasonable level of initial trading cost.

3. For portions of your portfolio with smaller allocations, make use of low-cost investment products like exchange-traded funds (ETFs) or mutual funds. Indexing seems like a simplistic investment strategy, but index fund managers like Barclays Global Investors (which manages the iShares series of ETFs) and Vanguard are sophisticated investors, who are fanatical about controlling trading costs in the funds they manage.

4. Be sure you understand the roles, responsibilities, and compensation of everyone involved in managing your portfolio. Pay particular attention to whether you pay your advisor to manage your portfolio in a way that holds your interests first, or if your advisor primarily earns commissions to sell you products.[2] In the end, it could be less costly to agree to an explicit advisory fee, rather than an array of other costs that are largely hidden.

Conclusion

Investors face a startling array of hidden costs in implementing their portfolio decisions. I have concentrated here on trading costs in portfolios of individual securities and sales charges for mutual funds. There are a number of others, but space does not permit discussing them all. These hidden costs can impose a material drag on your investment results. While investing is bound to have costs, over time the industry has developed ways to reduce the direct costs to investors and increase the hidden costs. These costs can add up, becoming an important factor in your overall returns. Being cost-conscious in investments requires some understanding of how the investments you buy are designed, built, and sold. If you aren't aware of all the costs, you are likely paying too much.

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[2] Please note that these recommendations are consistent with Tiemann Investment Advisors, LLC's investment philosophy. TIA is a registered investment advisor, compensated through direct fees from clients. As such, I am obliged to point out that TIA could potentially benefit if an investor followed these recommendations, choosing TIA as the advisor.