Sean Cote, AIF

Ask questions to better understand investment fees

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My sister-in-law recently asked me to review her investment portfolio. I asked her if she knew what types of fees and expenses she was paying. "I have no idea," she replied.

This response is common among investors. Fees and expenses vary between investments and, in most situations, they are netted from the rate of return of the investments, leaving them out of sight and out of mind.

Because fees have a direct impact to your rate of return, it is important to understand what types of fees you're paying. Below is a description of common investment fees.

Fees Associated with Mutual Funds

Expense ratio—The expense ratio of a mutual fund pays for the cost of running a fund, which includes portfolio management, administration, sales, and marketing. The average annual expense ratio of all mutual funds is close to 1.25% of total assets. The following factors can affect the expense ratio:

- *The fund's investment category*—In general, specialty funds tend to have the highest expense ratios. Equity funds typically will have higher expense ratios than bond funds and international funds tend to have higher expense ratios than comparable domestic funds.
- *Index fund versus institutional fund*—Index funds and funds available to institutional investors generally have lower expense ratios than other types of funds.
- *The fund's asset size*—As the assets of the mutual fund increase, the expense ratio typically declines.
- *Sales load*—Sales loads typically are used to compensate brokers who sell the funds. A load that is assessed when a fund is purchased is called a front-end load, and a load assessed at the time of sale is a back-end load. Front-end loads typically range from 2% to 6% of the amount invested, with a maximum of 8.5%. Funds with back-end loads will not deduct the load at purchase but will have it deducted when shares are sold back to the fund.

  The most common type of back-end load is the contingent deferred sales load. The amount of this type of load will depend on how long the shares are held. For example, a fund may charge a 5% load if shares are sold within the first year of purchase and will be reduced by 1% per year until it is decreased to 0 after holding the shares for 5 full years. In this example, the fund will typically have a higher expense ratio during the first 5 years.

Fees Associated with Variable Annuities

Management fees of underlying investment options—Variable annuities use underlying mutual funds for investment options in the contract. The management fees are similar to expense ratios and pay the fund companies for portfolio management, administration, and operation of the fund. The average management fee for underlying funds in a variable annuity in 2006 was 0.82%, as calculated by industry source Morningstar.

Mortality and expense (M&E) charge—This fee pays for the insurance guarantee for potential annuity payments, commissions to the selling agent, and administration expenses of the contract. This fee is in addition to the management fees of the underlying investment options and is typically charged on an annual basis as a percent of the average value of the contract. According to Morningstar, the average M&E charge in 2006 was 1.20%.

Surrender charges—Many annuities impose a surrender charge if all or a portion of the contract is liquidated before a set time period. That period tends to range from 1 to 12 years. A common surrender period is one that will charge 7% if the contract is surrendered in the first year of purchase, and declines by 1% per year until it reaches 0.

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Fees and charges for other features—There are other options that can be offered by variable annuities, such as death benefits or a guaranteed rate of return. These options typically have additional fees that the contract holder pays. It is important to fully understand what the additional fees are and what terms have to be met to receive the benefit of the option.

Fees When Working with a Fee-Only Advisor

Asset management fee—This fee is charged by fee-only advisors and is normally charged as a percent of assets under management. This fee may start at 1% to 1.5% of assets under management. The percentage typically is reduced when the assets under management increase. A fee-only advisor does not receive commissions from the fund company and is compensated solely by the client. This asset management fee is in addition to any internal fees of the investments recommended by the advisor, such as the expense ratio of a mutual fund and transaction fees.

Flat rate or hourly rate—Advisors may charge a flat rate or hourly rate for providing investment advice or performing financial planning services.

Conclusion

Is my sister-in-law paying too much in investment fees? The answer depends on the scope of services provided, the complexity of the portfolio and the level of service and expertise. To gain a better understanding of her investment fees, she needs to ask her broker or advisor "What are the total fees I'm paying on my investments?", "How are you compensated?", and "What services are you providing for your compensation?"

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