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The Truth About Investment Fees, Loads and Charges

"You get what you pay for in life," and *"there are no free lunches"* are quotes we have all heard for generations. That holds true for the investment world as well. So the real question to ask yourself about your investments is, *"Do you really know what you are getting for the fees, loads, and charges you are paying for?"* Let's look at some of the costs that are associated investments...

Investment Fees

Investment fees come in many forms. There are **management fees** charged by the people who manage mutual funds, **advisory fees** charged by investment advisors, and **12b-1 fees** charged by mutual funds to market and promote their mutual funds. In each case, an amount is deducted from the value of your account.

Example: Many advisors charge an annual fee of 1.5%–2% of the value of the account. So, if a client has a $100,000 account and the investment advisor charged a 1.5% fee, it means the client is paying the advisor $1,500 per year.

Investment Loads

A **load** is an amount added (as to the price of the security or the net premium in insurance) to represent selling expense and profit to the distributor. It's usually not an amount added to the price, rather it is an amount deducted from the account or payment.

A **load mutual fund** deducts a certain percentage from the amount you invest in order to pay the brokerage firm and the stock broker. If the fund has a 5% sales load and you invest $10,000, the fund deducts $500. Your mutual fund would then start with $9,500.

Some **life insurance policies** deduct a load from each premium payment in order to pay the insurance agent. The net result of an investment load is that from the moment you begin, you have less in your account then you paid or invested.

Investment Expenses

Think of an expense in an investment as a headwind when you're flying in a plane. It slows you down and makes the plane work harder to get you where you want to go. Investment expenses can be a significant headwind that holds your investments back in a very meaningful way over time.

Example: A $10,000 account that has an 8% return will grow to be worth $46,610 over 20 years (assuming no taxes). If the same fund has an expense ratio of 1.5%, it would only grow to be worth $35,236. That fee erased 24.4% growth—nearly a quarter of the return!

Types of Investment Fees, Expenses and Loads

Now that you have a pretty good idea of what these are and how they work, let's look at how they impact different investments.

Mutual Funds

One of the most widely owned investments, mutual funds have a number of different charges.

Management Fees

These are charged in order to pay the people who make the day-to-day decisions about what to buy or sell within your fund. They tend to average between 0.4%–3% depending on how active of a role the manager plays in the fund.

12b-1 Fees

These are fees used to promote the fund and are often utilized to pay the rep an ongoing commission.
In some cases, closed funds no longer accept new investors yet they still may charge 12b-1 fees.

Turnover Costs

Turnover is how often the manager of the fund bought and sold holdings inside the fund. Say a fund owns 100 stocks and over the course of the year, the manager sold 75 of those stocks and bought 75 new ones, that would be a 75% turnover ratio.

When the manager buys and sells a stock, the mutual fund pays a commission for the trade. The costs are deducted from the fund itself so the shareholders end up paying. Unlike the management fee and 12b-1 fee, the mutual fund doesn't typically show this cost. If you dig through the mutual fund prospectus you can find it, but it's hard to really know how much it's costing you.

Example: Mutual Fund ABC has a management fee of 1% and a 12b-1 fee of 0.25%. It has a turnover of 50%, so it's generating additional costs of roughly 1.1%. Adding them all, that mutual fund has expenses of roughly 2.35%.

Upfront Loads

Some mutual funds charge an upfront sales charge. The sales load is used to pay the stockbroker and the firm for advising you about what funds to buy. These loads are expressed as a percentage of your investment as the earlier example showed.

Back-End Sales Loads

Also known as **Contingent Deferred Sales Charges (CDSCs)**, or **B Shares**. A **CDSC** is deducted from your account only if you liquidate it within a certain time after you buy it. For example, some **CDSC**s last for six to seven years. If you buy the mutual fund and hold it for this time (or exchange it within the same fund family) you will never have to pay the **CDSC**. **CDSC**s tend to be six to seven percent of the account value and decrease over the holding period until they become zero.

On the surface this seems like a good idea to most investors, but **CDSC** funds typically carry significantly higher 12b-1 fees. If you look at a sample mutual fund, you might find that it can be bought with a 5% upfront sales load and a 0.25% 12b-1 fee, or it can be bought with a **CDSC** that has no upfront 5% sales load, but it has a 1.25% yearly 12b-1 fee.

Annual Fees

These are usually found in load funds that are called **C Shares**. C shares typically charge an annual 12b-1 fee that is about 1%more than the 12b-1 fee of the A shares of the same fund. Unlike B shares there is usually not a **CDSC** (back-end sales load) when you sell or, at most, there might be a 1% **CDSC** if you sell the shares within on year.

Variable Annuities

Variable annuities (**VAs**) are essentially mutual funds that are held inside a tax-deferred annuity. There are several expenses in VAs.

Mortality & Expense Charges

These are fees deducted from your account to cover the expenses of the insurance company setting up and maintaining your account as well as to pay for life insurance. The life insurance is used to guarantee that when you die, even if your account value is less than you invested, your heirs will receive at least the sum of your investments (called **premiums**).

Enhanced Death Benefit Fees

Many VAs offer a death benefit greater than the sum of your premiums. *This will cost you an extra annual fee.*

Living Benefit Riders

VAs also commonly offer living benefits that allow you to withdraw a certain amount from your account for as long as you live even if the account runs out of money, or they may guarantee that your account's value for income purposes will grow by a certain percentage as long as you follow their rules. These benefits can be very expensive and are charged in addition to any other fees.

Mutual Fund Fees

Because VAs essentially use mutual funds as the investment vehicle, the funds themselves have fees as we've already discussed. They are typically similar to an A share without a front-end sales load, meaning the funds have an expense ratio and turnover costs but typically do not have 12b-1 fees or **CDSC**s.

Surrender Charges

VAs often charge a surrender penalty if you close your account or withdraw more than a set percentage during a surrender period (usually in the first 3–10 years). These are often a percentage of the account value or a percentage of your initial premium.

Front End Loads

Some VAs do not have surrender charges because they charge an upfront sales load. VAs usually have one or the other—not both.

Stocks and Bonds

Stocks are a no-load investment, meaning if you invest $100,000 your account will start with that amount. They are bought and sold with commissions that are charged in addition to the investment. Commissions range all over the place from discount brokers that charge $1.25 per trade to full service retail brokers that charge a percentage of the investment.

Bonds are sold on what's called a "mark up" basis. This means that while you will usually not see a commission listed, the broker has bought them at a lower cost than he sells them to you. The law does not require brokers to disclose their mark up, but some do. Just know that even though there isn't a commission shown, it doesn't mean the broker didn't make any money.

Summary

We could certainly go on and discuss more obscure investments and their costs and fees, but this paper is designed to cover the most common types of investments and their expenses, fees, and loads. Between stocks and bonds, mutual funds, and variable annuities, these investments probably cover nearly 90% of the total value of investments held by retail investors today.

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