



Farm Creek Securities, LLC
Farmcreeksecurities.com
fc@farmcreeksecurities.com
89 Roton Avenue, Rowayton, CT 06853
(203) 838-1025

The Sound Investor Series #27

The In's and Out's of Mutual Funds Fees

Ed Hynes, CFA
December 8, 2005

You know how some articles are more technical and others a little more whimsical? Well today's is technical - it's all about mutual funds fees.

Before jumping into details, let's agree that the goal of investing is to get good returns, not have the lowest costs or expenses. Performance is what counts. No one minds paying high fees when convinced the investment will beat the market. However, such opportunities are rare and for most investors, controlling costs is the best path to better performance.

There are many ways to look at the fees mutual funds charge. I like to separate them into two categories. The first accounts for fees that go to brokers and/or distributors of the fund and the second is for fees used to manage the fund's investments.

Fees that go to brokers and advisers are charged in two principal ways: Outright sales charges (front-end or back-end loads) and 12(b)1 fees. The load charges are clearly out in the open and easy for investors to see and evaluate. 12(b)1 fees on the other hand are partially hidden from view as they are bundled with other charges in the expense ratio. Way too many investors are unaware of their existence.

Let's look at the very popular Growth Fund of America to help shed light on these fees. Like most mutual funds, The Growth Fund sells a number of Classes of shares called Class A, B, C and several others. Each class is set up to charge investors different fees at different times.

Class A shares of The Growth Fund charge a front-end load of 5.75% of your investment if it is less than \$25,000. This goes for broker and distribution fees. In addition, each year investors pay another 0.66% of their investment for the management of the fund.

An excellent feature of A shares are the discounts available if you have other assets in the same fund or fund family. At \$100,000 The Growth Fund's front-end load drops 40% from 5.75% to 3.50%.

Consumers hate paying fees up-front so B shares were invented. Buyers of B shares do not pay anything upfront but if they sell in the first 6 years, they pay a fee similar to the front-end load that declines over time. What a deal, why would anyone buy the A shares? But we know there is no free lunch and Class B investors must be paying somewhere else.

What happens is that Class B shares are charged higher annual fees. Class B shares pay the same 0.66% as the Class A shares for fund management plus an additional 0.75% of 12(b)1 fees to compensate the broker/distributor. The total expense ratio for Class B shares comes to 1.41% a year. Class B shares do not offer discounts and this accounts for their bad rap.

A last point on B shares is that they generally convert into A shares after 8 years. Comparing A & B shares, in the case of The Growth Fund, the Class A's with a 5.75% load and B shares have performed about the same over 10 years, but this does not necessarily happen.

Class C shares cater to investors who plan on being in a fund for over a year, but not for the long-term. The Growth Fund's C shares do not have a front-end load, but there is a redemption fee if the shares are sold within 12 months. The C share's expense ratio is 1.46% which is slightly higher than B share's 1.41%. C shares have no discounts, never convert to A shares and are not good long-term investments.

To analyze your fund's expenses I recommend a new web based tool called NASD Mutual Fund Expense Analyzer (<http://nasd.com>). The tool is designed to help investors explore and understand how mutual fund fees impact returns - over 16,000 share classes are covered. One interesting feature on the site compares funds with one another. After the user forecasts a future return and holding period, the tool shows total expenses and which fund performs better.

You will quickly note that since you can only put in one return for all three funds; the fund with the lowest expenses always looks best. But that's not fair you might exclaim! Index funds have the lowest expenses but can never outperform the market. Investors buy actively managed funds to beat the market and active funds should have their expenses subtracted from a higher expected return.

I agree and this is where investment management morphs from being science to being a combination of art and science. You need to predict how much each fund will outperform the market, before fees. This is really difficult and if you find a reliable method - please call me!

To learn about mutual funds in-depth, readers should consider a new book by Gary Gastineau, "Someone Will Make Money on Your Funds – Why Not You?" This is an excellent work and I had the pleasure of commenting on an early draft.

(By the way, I personally research and write these articles each week and welcome your feedback and ideas for future articles.)

Ed Hynes, CFA, is President of Farm Creek Securities, LLC based in Rowayton, CT. (203) 838-1025. This series of articles is available at farmcreeksecurities.com. Before putting money in any investment, you should carefully consider your investment objectives; and the risks, charges and expenses of any investment. Past performance is not an indication of future performance and there are risks to investing including the loss of principal. Please contact Farm Creek for a prospectus on any of the funds mentioned.

© Copyright 2005