Stealth erosion of wealth (**Palo Alto Weekly**, Mar. 26, 2003)

by Austin Lemoine

High mutual fund fees result in money slipping away.

Fees related to investing in mutual funds can seriously erode a person's accumulation of wealth over time – but the charges are often stealthy.

The fees and expenses go largely unnoticed by investors, steadily diminishing the value of their investments in both up and down markets. The potential damage is greatest in long-term investment accounts such as 401(k)'s and 403(b) plans.

What you pay for investing in a mutual fund, exclusive of any sales charges, is indicated by the "expense ratio" of the fund. The expense ratio is the percentage of mutual fund assets paid for operating expenses, management fees, administrative fees, and all other asset-based costs incurred by the fund, except brokerage costs.

Those expenses are reflected in the fund's net asset value (NAV), and they are not really visible to the fund investor. The reported "net return" equals the fund's gross return minus its costs. (And expense ratios do not account for every cost mutual fund investors bear: additional costs include any sales charges, brokerage commissions paid by the fund and other significant kinds of indirect trading costs.)

Some specific examples will help illustrate this stealthy erosion.

Mutual fund expense ratios range from less than 0.20 percent for low-cost index funds to well over 2 percent for actively managed funds. The average is 1.40 percent for the more than 14,000 stock and bond mutual funds currently available, according to Morningstar. In dollar terms, that's $14 a year in fees for each $1,000 of investment value; leaving a net value of $986. That might not seem like a big deal, but over time fees compound to erode the value of the investment.

Let's say the gross return in real terms (after inflation) of a broadly diversified stock mutual fund will be 7 percent a year, excluding expenses. (The 7 percent figure is consistent with returns for the U.S. stock market from 1802 through 2001, as reported in Jeremy Siegel's book, *Stocks for the Long Run*, 3rd edition.)

Say the fund has an expense ratio of 1.25 percent. And say you invest $1,000 in the fund at the start of every year. (The figure of $1,000 is arbitrary, and investment values below can be extrapolated to any annual contribution amount.)

Compounding at 7 percent, your gross investment value would be $6,153 after 5 years; $14,783 after 10 years; $43,865 after 20 years; $101,073 after 30 years; and $213,609 after 40 years. But with a 1.25 percent expense ratio, your investment compounds at 7.0 minus 1.25 or 5.75 percent, not 7 percent. So your investment would actually be worth $5,931 after 5 years; $13,776 after 10 years; $37,871 after 20 years; $80,015 after 30 years; and $153,727 after 40 years. Fund expenses account for the difference in value over time, with greater expenses (and/or lower returns) having a greater negative impact on net investment value.

That 1.25 percent expense ratio consumes $222 (or 3.6 percent) of the $6,153 gross value over 5 years; 6.8 percent of gross value over 10 years; 13.6 percent over 20 years; and 20.8 percent over 30 years. Over 40 years, the $59,882 of fund expenses devour 28.0 percent of the $213,609 gross value. In other words, only 72.0 percent of gross investment value is left after 40 years, a withering erosion of wealth.

By contrast, let's say there's a broad-based index fund with 7 percent real return but a 0.25 percent expense ratio. Putting $1,000 at the start of each year into that fund, the 0.25 percent expense ratio would consume just 2.9 percent of gross investment value after 20 years. Over 40 years, index fund expenses would total $13,759, a modest 6.4 percent of gross value; so that the fund would earn 93.6 percent of gross value.

With expenses included, investment value is 30 percent higher after 40 years with the lower cost fund. (Even lower expense ratios can be found among lowest-cost index funds and broad-based exchange-traded funds. And funds with higher expenses do not outperform comparable funds with lower expenses.)

Over the next ten to twenty years, the higher-end expense ratios and similar fees could be a huge millstone on wealth accumulation and preservation.

The stealth attack on investment funds is even more important when looked at on top of what's happened since March 2000.

Like a massive hurricane, the stock market has inflicted damage on almost every portfolio in its path. From the peak of March 2000 to the lows of early October 2002, it's estimated that falling stock prices wiped out over $7 trillion in market value. While the market has moved off its lows, we hope the worst is over.

How long will the market take to "heal itself?" It could take a long time. A growing consensus holds that stocks just won't deliver the returns we grew accustomed to from 1984 to 1999. If history is a guide, real stock returns could average 2 to 4 percent a year over the 10 to 20 years following March 2000. (For more on this issue see earlier articles, "After the fall" and "When happier days are here again," posted at www.austinlemoine.com.)

If lower expectations for stock returns materialize, mutual fund fees and expenses will have an even greater adverse impact on wealth accumulation – especially on wealth preservation and income security at retirement.

If you want $40,000 income from your 401(k) assets without drawing down principal, consider the following scenarios. If real investment return is 4 percent you'll need $40,000 divided by 0.04 or $1 million principal. But if you're paying 1 percent in fees your real return is 3 percent, so you'll need $40,000 divided by 0.03 or $1.333 million principal; and if 2 percent, $2 million.

The arithmetic is brutal!

Fund "sales charges" can exacerbate the problem. Check that stealthy little "expense ratio" and get a clear understanding of all fees and charges, then choose the lower-cost funds if you care about the all-important end result of your investments.

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