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The Arithmetic of "All-In" Investment Expenses

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Abstra

This arti … n mutual fund … y expense ratio … nsaction costs, sa … funds, over time, low … nvestors.

In "The … ch/April 2013), W … a critical compon … ally lower expense … anaged funds, could enhance an investor's retirement savings by more than 20%. This article extends Dr. Sharpe's analysis by considering "all-in" investment expenses, including not only expense ratios but also fund transaction costs, cash drag, and sales loads. The conclusion is that index fund investors would enjoy an enhancement in wealth of 65% over four decades.

This comprehensive approach to the consideration of mutual fund costs has, to the author's knowledge, not previously been attempted. The reason for this vacuum seems to be that although mutual fund expense ratios can be calculated with precision, the other data are inevitably imprecise. For example, commissions paid to brokers by mutual funds on their portfolio transactions are disclosed in prospectuses, but bid–ask spreads and market impact costs are ignored and must be estimated.

Sales loads paid to brokers and recurring fees paid to their account executives and to registered investment advisers are other major drags on fund returns. Most individual investors in actively managed funds rely on these distribution-related services to select their fund investments. But because the costs are paid directly by investors rather than by the funds themselves, they are ignored in the published performance data. Changing distribution patterns in the fund industry make it challenging to estimate these amounts with precision, but they must be part of all-in cost measurement.

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author also shows the returns in real dollars (assuming a 2% annual inflation rate) and describes the resultant gap in accumulations as scary and almost unbelievable.

Finally, the author discusses another, more subtle, drag on the returns of active funds—the tendency of fund investors to move their investments out of funds with lagging performance and into funds with better records. Investor (asset-weighted) returns lag, with some consistency, fund (asset-weighted) returns, representing yet another source of diminished returns for investors in actively managed funds.

The author argues that Sharpe was correct in his analysis of mutual fund expense ratios and the damaging impact they have on the long-term returns earned by investors. The author takes the analysis one step further by estimating the other significant costs incurred by actively managed funds and their investors, which, although much more challenging to quantify than expense ratios, add to the damage done to investors' returns. The author's advice to investors is (1) to take into account all the costs of fund investing, (2) to invest for a lifetime, and (3) do not allow the tyranny of compounding costs to overwhelm the magic of compounding returns.


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