Determining expenses for funds can be difficult

Expense ratio unlikely to exceed dividends, capital gains from funds

Q: *I have invested exclusively with Fidelity for more than 20 years in both taxable and nontaxable funds. In the past several years, I have been investing a greater share of my portfolio in index funds to minimize expenses and turnover. After reading your column, I phoned them and asked when and how expenses were deducted during each calendar year. The only answer I could get was that it was deducted from the NAV. They were more interested in why I wanted to know, which made me more uncomfortable.*

How and when are expenses accounted for? It would make sense that this should be a line item on statements, as this expense can easily exceed dividends and capital gains.

Your article suggested that expenses are accounted for in the spread when securities are bought and sold in the fund, but I cannot figure how that would be equitable for all shareholders. The more I think about this, the more frustrated I become. I hope the answer is simple and that I'm overlooking the obvious.

A: Measuring transaction costs for securities has always been, and remains, very difficult. The only thing certain is that the costs occur when the transaction occurs. While commission costs are explicit and are recorded, knowing the execution costs – the bid/ask spread – is problematic and highly variable. Sell a small number of shares in a highly liquid stock, and the execution costs will be nominal. Sell a large number of shares in an illiquid stock, and the execution costs will be substantial – the fund transaction may change the market.

SCOTT **BURNS**

The explicit expenses that go into the "expense ratio" of a mutual fund are stated and visible in your fund reports. Brokerage commissions, another explicit expense, might be listed in the fund's prospectus.

Contrary to your belief, however, the expense ratio is unlikely to exceed dividends and capital gains in a typical year. Over the last five years, for instance, the average net return of nearly 10,000 domestic equity funds was a sorrowful 1.97 percent – but it was still larger than the 1.50 percent average annual expense ratio of the same funds.

Had you invested in the 50 largest domestic equity funds over the same period, your average annual return would have been 2.56 percent, net of annualized expenses of 0.59 percent. Note the very close relationship between lower expenses and higher returns.

The important thing to know is that major index funds have much lower costs than managed funds in all areas. We'll let the academics solicit research money to do the fine-tuning.

Meanwhile, there is a good way for you to test these invisible costs: Check your fund's track record against its index. Its performance should be very close to the index less the expense ratio. If it's a lot less, the fund has either spent too much money on transactions, or it has a significant "tracking error" from its index.

An examination of the large funds that try to duplicate the performance of the S&P 500 index, for instance, shows a close relationship between fund performance and index performance. Several actually trail their index by less than their expense ratio. Over the last three years, for instance, the Vanguard 500 Index fund has trailed the index by only 0.10 percent, while its expense ratio has been 0.18 percent. Fidelity Spartan 500 Index fund trailed the index by only 0.12 percent over the same period when its expense ratio was 0.19 percent. In both cases, the fund trails its index by less than its expense ratio.

The original SPDR Trust exchange-traded fund, on the other hand, didn't do as well. It trailed the index by 0.22 percent a year, while its expense ratio was 0.12 percent.

As a practical matter, when the measuring gets down to amounts this small, we shouldn't forget the big picture – that we've left the world of disappointing, overhyped managed funds with expense ratios of 1.5 percent to 2 percent a year, often more. We're worrying about no more than 0.10 percent a year, but we've cut out 10 to 20 times that much.

Questions about personal finance and investments can be sent to Scott Burns at the Dallas Morning News, P.O. Box 655237, Dallas, TX 75265. Fax: 214-977-8776. E-mail: scott@scottburns.com. General-interest inquiries will appear in future columns.