

Dirty Little Secrets of Mutual Funds

By Martin V. Johnson, Jr.

Nine out of 10 Americans underestimate hidden 401K fees and may not know that mutual funds cost more to own than



index funds – a lot more, according to the American Association of Retired Persons (AARP). A typical active mutual fund charges a fee between 1.5 and 2 percent while exchange traded funds (ETF) and index funds can run as low as 0.04 percent.

Knowledge of these fees is critical because they can eat away at large amounts of families' savings over time. Just how much can these fees add up over time? A retirement savings model created by researchers from the University of Virginia and Virginia Tech calculated that, over a lifetime, all 401(k)-related fees can cost a median-income two-earner household almost \$155,000 – almost a third of their total investment returns.

Meanwhile, a case study from the U. S. Department of Labor finds the potential for staggering losses in savings due to these fees. The study provides the following example: "Assume that you are an employee with 35 years until retirement and a current 401(k) account balance of \$25,000. If returns on investments in your account over the next 35 years average seven percent and fees and expenses reduce your average returns by 0.5 percent, your account balance will grow to \$227,000 at retirement, even if there are no further contributions to your account. If fees and expenses are 1.5 percent, however, your account

balance will grow to only \$163,000. The 1 percent difference in fees and expenses would reduce your account balance at retirement by 28 percent."

When it comes to retirement planning, most people remain in the dark about how many fees their 401(k) providers are charging them – and just how much money they are losing as a result. Please note that advisors at the major primary firm of which we are all subjected to, on Sunday mornings are not allowed to market index funds because they have no vested interest to do so because of the low fees. Yet these same advisors readily admit to utilizing index funds when it comes to their own personal portfolios.

Where are all these fees coming from, and how can those saving for retirement minimize the expenses eating away at their returns? The 2012 Department of Labor rule regarding Service Provider Disclosures under Section 408(b) (2) states that all of your 401(k) fees must be disclosed in your annual prospectus statement. It's very hard to gauge whether or not you're being given a good deal without also being given industry averages for context and comparison. In addition, many don't even know that 401(k) providers charge fees at all. A 2011 AARP survey found that seven out of 10 of 401(k) holders didn't know they were paying any fees to their 401(k) plan providers.

The expense ratio, which measures a fund's total annual operating expenses, is the most well-known fee you will encounter in your fund selection process, but it would be a mistake to believe this is the only fee you're being charged within your 401(k) plan. Expense ratio is the fee displayed most prominently by each mutual fund because these types of fees do not vary much year to year, this is a static fee listed in each fund's annual report.

While fee structures vary widely from plan to plan, the following three-layer 401(k) fee structure is most standard. The first two fee types are associated with the funds within your

plan, while the plan level fees consist of the fees and costs of the 401(k) plan provider and administrators.

This is the full list of fees you can expect to see, and the rough averages you can expect each fee to take of your returns:

EXPENSE RATIO FEES: OPERATING EXPENSES

(Averages around 1.105 percent of assets)

Management Fees include:

- Fees to fund's investment advisor for managing the fund's portfolio
- Administrative fees due to the investment advisor

Distribution/Service Fees include:

- Marketing fees
- Sales charges
- Shareholder service fees

Other Administrative Expenses include:

- Custodial expenses
- Legal expenses
- Accounting expenses
- Transfer agent expenses
- Any additional shareholder service expenses

MUTUAL FUND-LEVEL FEES NOT INCLUDED IN EXPENSE RATIO

(Averages around 1 percent of assets)

Transaction/Trading Costs include:

- Brokerage Commissions
- Bid/ Ask Spreads

Shareholder Fees can include:

- Sales loads
- Redemption fee
- Exchange fee
- Account fee
- Purchase fee
- Maintenance fee

401K PLAN-LEVEL FEES

Highly variable range: median 'all-in fee' averages 0.72 percent of assets (Of the service provider)

Plan-level Investment Fees include:

- Plan set-up
- Portfolio management fees
- Advising plan sponsor fees – either by record keeper or portfolio manager
- Educational materials and services expenses

Plan-level Administrative Fees include:

- Recordkeeping services
- Employee enrollment services – meetings, paperwork, etc.
- Customer service – e.g. phone and web support
- Legal advice to employer
- Compliance testing expenses – e.g. audits

Plan-level Service Fees include:

- Fees for additional features or services – e.g. investment advice, loan fees

The Securities and Exchange Commission (SEC) provides full definitions of each type of fee and the Financial Industry Regulatory Authority (FINRA) has a useful tool for looking them up. Technically, these are not so much hidden fees most should be listed out in any fund's prospectus under "Shareholder Fees" as they are difficult to understand fees. However, it is incredibly important to know how the money is being spent, because all of these fees, whether directly or indirectly, are passed on to holders of IRA'S and 401(k) plan participants, you. ■

Editor's Note: Martin V. Johnson Jr., president and founder of Johnson's Global Advisors Corp., has been a securities professional for over 25 years. He covers high net worth clients; he is also a global generalist stock and bond institutional sales/trader. He is a general securities licensed series 7, uniform securities agent blue sky state law license series 63 registered representative, and Series 65 Registered Investment Advisor registered with the Colorado DORA Division of Securities. For more information, visit www.johnsonsglobaladvisors.com, email info@johnsonsglobaladvisors.com or call 720-222-9502.

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