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# NEW LIGHT ON HIDDEN FEES



**SOME FEES REALLY PAY FOR BRIBES (AND YOU THOUGHT YOUR FINANCIAL COUNSELOR HAD YOUR BEST INTERESTS AT HEART WHEN PICKING FUNDS. COUGH, CHOKE)**

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What do you really pay for your mutual fund? Even if you tried to find out, you couldn't do it. Sales charges and fees are disclosed in the first pages of the fund's prospectus. But no one can tally the real cost because so many other charges are hidden from your eye--costs that can more than double what the prospectus says you pay.

High expenses drag down your investment return. "On average, fund managers can't recoup those expenses in the form of better performance," says finance professor Edward O'Neal of Wake Forest University, coauthor of a major new study showing costs to be (*aaagh*) even heavier than I thought. John Freeman, law professor at the University of South Carolina, really got my blood up: "Rampant price-gouging by mutual-fund advisers costs shareholders $9 billion a year," he says.

New fee-disclosure rules are being published by the Securities and Exchange Commission this week. The commission is sifting through every aspect of mutual-fund management and behavior--fees, governance, advertising and sales--in a process likely to lead to "the largest period of change since the 1940 Investment Company Act," says SEC commissioner Harvey Goldschmid. (The 1940 act set the ground rules for mutual funds.)

Today prospectuses show you what's called the "expense ratio"--meaning the portion of your investment the fund spends on operating and sales costs. The average for stock funds: 1.54 percent.

That sounds like too little to worry about, but in this game little things mean a lot. Say you put $10,000 into funds that rise by 8 percent annually and cost 0.5 percent a year. In 20 years, you'd have $8,120 more than if your funds had cost 1.5 percent, says Cincinnati planner Michael Chasnoff.

The prospectus also shows the cost of the "alphabet shares" sold by brokers and commissioned planners. "A" shares carry an upfront sales charge (or load), generally ranging up to 5.75 percent. If you have at least $25,000 or $50,000 to invest (or already invested in other funds in that same group), you get a discount. "B" shares drop the upfront charge, but pay the broker's commission through high annual fees. "C" shares also carry no load but charge fees for many more years than the "B" shares do.

Alphabet shares have been widely abused. "B" shares earn brokers more money, so that's what they often push, even if "A" shares would have cost you less. In the prospectus, you'll find a table comparing the two types of shares. But it doesn't include the discounts given on "A" shares, so "B" shares look better than they really are.

So much for known fees. What about those you can't find? They include:

*The cost of buying and selling stocks.* The funds pay commissions to big, institutional brokers, who buy and sell securities for their portfolios. The more a fund trades, the more brokers earn. Guess who pays the commissions? You. The average hidden brokerage cost for an equity fund comes to 0.27 percent a year, O'Neal says. Ten fast-trading funds that he checked paid brokers a mammoth 1.67 percent of your assets.

*The cost of the spread*. Managers buy stocks at slightly more than what might be called true value, and sell for slightly less. The difference is the spread, which goes to the brokerage firm. O'Neal puts spread costs at 0.2 percent per year for large funds and 1.9 percent for fast-trading funds. When you add up the expense ratio, the brokerage fees and the spreads for certain funds, here's what you paid in 2001: 0.21 percent for the no-load Vanguard 500 index, 1.01 percent for the Davis New York Venture Fund ("A" shares), 1.64 percent for Fidelity Contrafund and (wow!) 8.59 percent for PBGH Large Cap, which trades stocks rapidly.

*Soft dollars*. Many fund managers deliberately overpay for brokerage commissions. In return, they get "free" research and other gifts, such as computers and data services. This soft-dollar arrangement keeps their reported expense ratio down but drives your costs up secretly.

*Revenue sharing.* Brokers and planners aren't content with merely collecting sales fees. They also want part of the revenue that would normally go to the fund-management group. Basically, it's a bribe. The brokers are paid to sell trusting customers on certain funds. Another type of bribe called "directed brokerage" uses your money to reward brokers who push sales the most. (And you thought your "financial counselor" had your best interests at heart when picking funds. *Cough, choke.*)

The SEC is banning directed brokerage and forcing brokers to tell you when they're paid to sell particular funds. "The challenge is how to communicate these costs and conflicts of interest in a way you can understand," says Paul Roye, the director of the SEC's Division of Investment Management. The SEC's Web site (www.sec.gov) shows two proposed disclosure forms--one that you might get before you buy; the other a new form for confirming your purchases. Do look! The SEC will make changes if people find the forms unclear.

Correction: In my last column I wrote that the business and law schools at the University of Virginia had gone private. Not so. The schools are financially self-sufficient but operate as public institutions.

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