Bloomberg

An Investor's Guide to Fees and Expenses

By Ben Steverman - Aug 28, 2012

About 140 years ago, a retailer named John Wanamaker figured his customers and salesmen had better things to do than spend hours haggling. His invention: Assigning one price, "plainly marked," to every product.

The price tag caught on nearly everywhere with one major exception: financial services. Investors still have a surprisingly difficult time figuring out what they'll pay for financial advice, for mutual funds and especially for their retirement plans.

New regulations required administrators of 401(k)s, such as Schwab or Aon Hewitt, to disclose detailed plan costs to their client companies in June. By the end of August, companies must pass that cost information on to plan participants.

Will those employees understand the notices arriving in the mail? "The majority will probably recycle it," says Bill McClain, a principal for Mercer Consultants. The fine print and legalese will deter many investors, while they also might not understand how important costs really are. A fee that eats up 1 percent of assets each year might not seem like much -- except that the charge bleeds assets from your account year after year. Say you invest $10,000 and earn 5 percent per year. That 1 percent fee will cost $1,487 after 10 years and $4,622 after 20 years.

To help readers figure out if they're paying too much, this guide details the typical costs of various investment products and services. If you're paying too much, don't sweat it -- go out and negotiate a new rate. Think of it as an instant investment return.

Actively Managed Mutual Funds

What they cost: On average, 0.66 percent per year for bond funds and 0.93 percent for equity funds.

Why: With actively managed funds, you are paying a fund complex to get access to their investment professionals. The average expense ratio is 1.43 percent per year, according to the Investment Company Institute. Most investment dollars favor the less expensive options. The cheapest 25 percent of equity funds held 72 percent of assets at the end of 2011.

The priciest mutual funds are so-called "alternative" funds, which have an average asset-weighted expense ratio of 1.33 percent, according to Morningstar. Alternative funds buy up commodities or other assets that, in theory, will perform differently from stock or bond markets and so provide a hedge.

Index Mutual Funds

What they cost: On average, 0.14 percent for equity funds and 0.13 percent for bond funds.

Why: Index funds are so much cheaper because they dispense with hiring a professional to manage the portfolios. Instead of trying to "beat the market" with individual stock picks -- which most managers can't do consistently anyway -- index funds invest in a set, broad range of bonds or stocks, such as the Standard & Poor's 500 Index and the Barclays U.S. Aggregate Bond Index.

One extra cost for all mutual funds, both active and index, is transaction costs. It's hard to put a number on how much these costs hurt returns. Researchers don't agree on how to tally transaction costs, and funds can incur different costs based on how they're managed. Estimates range from less than 0.2 percent to more than 2.7 percent.

Exchange-Traded Funds

What they cost: 0.49 percent (average expense ratio for U.S. non-leveraged ETFs).

Why: The vast majority of exchange-traded funds invest based on an index, which keeps their costs similar to those of index mutual funds. The average ETF expense ratio is increased by new actively managed ETFs coming on the market, as well as specialty ETFs such as commodity funds. They can have expense ratios of 1.5 percent. Because they trade on an exchange all day, unlike mutual funds, whose net asset value is calculated at the end of the trading day, one additional cost of ETFs can come from trading activity. Investors must trade carefully to get fair prices, especially in lightly traded, less liquid ETFs.

Hedge Funds

What they cost: A 1.5 percent annual management fee, along with 20 percent of any investment gains.

Why: The conventional wisdom is that hedge funds charge "two and 20" -- 2 percent of all assets and 20 percent of any gains -- but a 2011 University of Oxford study found that investors were more often paying 1.5 percent. The study also found that hedge fund companies with good track records tended to launch funds with higher management fees. Those high-fee funds, however, didn't perform any better in the long run.

401(k) Plans

What they cost: Administrative fees can range from 0.13 percent to 1 percent or more, with additional costs for fund expense ratios and other investment management services.

Why: The biggest factor is the size of the employer sponsoring the plan. Employees are charged for two different services: first, the costs of running the plan -- administrative expenses, paperwork, marketing, mailings -- and second, the costs of managing their investments, whether they're in mutual funds or elsewhere. Both are much higher at small firms, which have less bargaining power and fewer participants to cover fixed costs. According to BrightScope, the average plan has a total cost of 0.87 percent per year, and all but 0.13 points of that covers managing investments. Plans with just $1 million in assets have a total cost of 2.01 percent, with 0.82 points covering administration and other fees. A Government Accountability Office (GAO) study found one insurer charging 2 percent just for administrative expenses.

New regulations should make it clearer who is paying what. While employees are usually responsible for investment fees, their employers sometimes cover administration fees. Smaller plans are likelier to do this than large plans, according to an April GAO survey.

Administrative costs aren't always spread evenly among employees. That's because, as McClain points out, investors who choose low-fee index funds often avoid "revenue-sharing" fees. Those charges are included in pricier funds' expense ratios but actually help cover the retirement plan's administrative costs.

Financial Advisers

What they cost: 0.5 percent to 0.95 percent, according to Cerulli Associates.

Why: Financial service providers go by many names -- fee-only planners, financial advisers, wealth managers, family offices, private client groups, banks trusts. The basic business model is the same: Provide investment and other financial advice, usually for an annual charge based on the size of assets being managed. The wealthier you are, the less you tend to spend for advice, at least as a percentage of your fortune. Those with less than $250,000 in assets paid 0.95 percent on average, according to Cerulli Associates, while those with more than $50 million paid just 0.29 percent.

Brokerage Charges

What they cost: flat service charges of $5 to $10, up to 5 percent front-end sales loads.

Why: When you buy stocks or funds directly from a brokerage, your costs can vary widely. Discount brokerages often charge a flat fee for each transaction. For example, Charles Schwab charges a $9 commission for each online stock or ETF purchase and an extra $25 if you get help from a broker. Other traditional brokers may charge much more, with commissions to pay the broker built into fees or expense ratios of the products they sell. For example, a mutual fund company may charge a fund buyer a one-time "sales load" or a recurring "12b-1" fee, both of which are used to compensate the seller of the fund. According to FINRA, a typical sales load on a share purchase of less than $25,000 is 5 percent, while purchases of $1 million or more usually avoid such charges entirely. Such load funds are rapidly losing popularity to no-load varieties.

Real Estate Investments

What they cost: 6 percent to 7 percent in total transaction costs.

Why: Add up all the costs of buying a piece of real estate -- brokers, attorneys, paperwork -- and the total can reach 6 percent to 7 percent of the property's value. Of course, almost everything is negotiable, including broker fees. Also, rather than buy real estate themselves, investors can buy funds that buy real estate. Mutual funds that specialize in real estate investment trusts (REITs) have expense ratios that vary from less than 0.5 percent for index funds to more than 2 percent for the priciest actively managed options. The median real estate fund costs 1.15 percent. However, beware of private, non-traded REITs, which often contain extra fees for individual investors.