Joseph Capital Management, LLC
2450 N. Citrus Hills Blvd. • Hernando, FL 34442-5348
Phone: 352-746-4460 • Toll-Free: 1-866-746-4460

The Often-Hidden Fees and Costs of Mutual Funds

Published in *Meadowcrest News and Views*, Fall 2004

Recent mutual fund scandals have shed some light on the often-cozy relationships which often exist between mutual funds and many brokerage firms and their stockbrokers. In August 2004 the U.S. Securities and Exchange Commission (SEC) banned one such arrangement - "directed brokerage." This now-prohibited practice that grew out of the industry's desire to find less visible ways to pay for distribution of its funds. Under this form of "revenue sharing" payment, a fund agreed to conduct portfolio transactions through a particular broker in return for an agreement by that broker to sell the funds in that fund family. In practice, such agreements often meant that the fund missed an opportunity to obtain lower transaction costs when it purchased or sold stocks, bonds or other securities. Since transaction costs are paid directly from fund assets, any practice that drove up fund transaction costs would depress shareholder returns.

Other forms of "revenue sharing" continue to exist and receive scrutiny. One is "payment for shelf space," in which a mutual fund's adviser makes cash payments to a brokerage firm in return for increased access to their sales staff. The SEC, in a recent examination of 15 large brokerage firms, found that 14 of the 15 firms examined had received such cash payments, often in substantial amounts. Revenue-sharing deals also extend to other forms of compensation, including payment for seminars for potential clients of the firm, recreational activities of stockbrokers, and other "non-cash" items. While the SEC has not yet expressly mandated disclosure of all of the fees and costs associated with mutual funds, hopefully it will soon. In the interim, many brokerage firms are beginning to disclose the existence of these relationships (but very seldom the amount paid) on their web sites.

All of these fees affect you, the individual investor. Hence, it's a good idea for you to obtain answers to the following questions, in writing, from their advisors regarding any product which might be sold to them: (1) Is there an up-front sales charge (i.e., "load")? (2) Is there any deferred contingent surrender charge (i.e., surrender fee)? (3) Does this product have a 12b-1 fee? (4) What are the total annual management and administrative expenses of this product? (5) What is your estimate of the transaction costs resulting from trading in the fund (including both bid-asked spreads and market impact), and how do you compute that? (6) What is your estimate of the opportunity cost resulting from the mutual fund holding cash, and how do you compute that? (7) Specify all fees and compensation, of any type, your firm may receive from this product. (8) Specify the type and amount of fees you, the advisor, may personally receive from this product, either at the time of sale or later, including any possible bonuses, sales awards, trips, or other forms of compensation. (9) Detail any and all conflicts of interest which you might you possess in selling this product to me. If you, the investor, don't receive candid, written answers to these questions, start looking for someone who will fully disclose any and all fees, costs and conflicts of interest (and seek to avoid or reduce them whenever possible). Better yet, work with a "buyer," not a "seller," of products. (That's the subject of our next column.)

This article written by Ron A. Rhoades, B.S., J.D., CFP®, Director of Research, Joseph Capital Management, LLC. Ron can be reached by calling 352-746-4460.