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MUTUAL FUNDS

Deciphering Funds' Hidden Costs

Mutual-Fund Study Reveals How Much Investors Actually Pay in Undisclosed Charges

 By **JOHN HECHINGER**

Staff Reporter of THE WALL STREET JOURNAL

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The battle over the fees the mutual-fund industry charges its customers is coming to a head.

The mutual-fund scandal began with the exposure of trading practices that allowed big investors to profit at the expense of individuals. The latest target: commissions that mutual funds pay to brokers to buy and sell stocks. These costs get passed along to investors with minimal disclosure.

This week, scandal-scarred fund company **Massachusetts Financial Services Co.** said it would stop making "soft dollar" commission payments. The practice bundles in research expenses and other charges with trading costs. In addition, funds that trade stocks rapidly can drive down returns because of sky-high brokerage commissions. Both practices have been criticized for jacking up the price of owning mutual funds.


Just how much are investors unwittingly paying? Fund tracker Lipper Inc. studied 2,000 funds for The Wall Street Journal and found that brokerage commissions can more than double the cost of owning fund shares. The study didn't address how much each fund paid in soft-dollar payments.

Consider Van Eck International Investors Gold Fund, class A shares. It discloses to investors that 1.97% of its assets are used each year to cover the fund's expenses. But that doesn't count some \$7 million in annual payments to brokers. Suddenly, the cost of owning the fund rises to 5.8% a year, the highest of the funds studied by Lipper for the Journal.

Van Eck International isn't the only fund with high levels of brokerage commissions. RS MidCap Opportunities Fund and RS Diversified Growth Fund -- offerings of RS Investments -- had total annual costs of about 4%, including brokerage expenses, Lipper says.

Donald L. Cassidy, Lipper senior research analyst, said high brokerage costs can mean a fund is making above-average soft-dollar payments, or that it is doing more than its share of buying and selling. In the case of Van Eck, for example, the fund had a turnover rate of 720% in 2002, meaning it held its average stock less than two months. A Van Eck spokesman argued that the fund's stellar performance that year justified the steep commission costs. RS

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A BIG DRAG

- See 15 [highest-cost funds](#)⁰ based on brokerage commissions and total expenses.

Investments didn't return phone calls seeking comment.

These fees are controversial because they're tough to ferret out. A fund's expense ratios -- which include management fees and overhead -- are clearly spelled out in its annual reports, while information on brokerage commissions is buried. In general, customers don't notice what they are paying because the fees are just deducted quietly from the money they've invested. Most investors just monitor investment performance, which is reported after expenses are paid.

Over time, however, the impact of higher costs adds up. According to a calculator on the Securities and Exchange Commission's Web site, a \$100,000 investment in a stock fund with 3% annual expenses -- including brokerage costs -- and an 11% annual return before those costs will grow to \$634,407 over 25 years.

The same money, with the same return -- and the slim 0.18% in yearly expenses of Vanguard 500 Index Fund -- will grow to \$1,298,714, or more than twice as much.

Critics say funds and brokers should be forced to bare all to the public. Last week, fund giant Fidelity Investments called on the major brokerage houses to break out how much of soft-dollar commissions are used for buying and selling stocks and how much for research and other services. The SEC is also considering more prominent disclosure of all brokerage commissions in fund literature.

Some on Wall Street, however, disagree. Late last month, in a letter to the SEC, the Securities Industry Association, the main Wall Street trade group, warned that additional disclosures of brokerage commissions are "likely to confuse, rather than help, investors."

To follow the debate, it helps to understand the way the industry discloses and measures costs. Fund literature now provides a tally, in dollars, of annual expenses, such as management, legal, audit and other fees. Fund companies then divide those expenses by the average amount of money in the fund for the year to come up with an expense ratio. Expense ratios average 1.68% for all stock mutual funds, according to Lipper.

That data doesn't include the cost of brokerage commissions, or what funds pay to middlemen for buying and selling stocks and other securities -- a figure now buried deep in regulatory filings. Lipper says stock funds, on average, pay 0.41% annually in brokerage commissions. The SEC is now considering whether to require the disclosure of that figure in fund reports.

Lipper's Mr. Cassidy says above-average commissions can result from shareholders making quick in-and-out trades at the expense of long-term shareholders, one of the practices at the heart of the mutual-fund scandal. Indeed, both **Strong Financial Corp.** and **Pilgrim, Baxter & Associates's PBHG Funds** are under investigation by regulators related to such market timing. Both companies have funds with high costs. Strong's Mid Cap Disciplined Fund clocked in at 3.3% and PBHG's Large Cap Fund at 2.8%.

For their part, representatives of mutual funds with high brokerage commission levels say their fast-trading strategy generated strong returns. But Lipper performance data show their results to be a mixed bag. Strong Mid Cap Disciplined Fund, for example, has a stellar five-year record, compared to peers, whereas the Van Eck fund does not.

As for those firms implicated in government trading investigations, a PBHG representative says turnover in its funds is "unrelated to market timers." A Strong spokesman declined comment on whether rapid trading was a factor.

Thaddeus Leszczynski of Van Eck noted that in 2002, the year the international gold fund generated the high brokerage commissions, it also returned 90.5%, ranking among the top U.S. mutual funds. He added that turnover and portfolio costs were unusual in that year and showed a significant decline since.

John Hill, chairman of the Putnam funds board of trustees, says that funds resisting disclosure merely wish to hide the impact of high-turnover trading strategies. Recently, Putnam, tarnished in the mutual-fund scandal, cut management fees as a voluntary measure to restore customer confidence. The company said it would start reporting brokerage commissions as a percentage of assets within the next few months.

Edward O'Neal, an assistant professor of finance at Wake Forest University and co-author of a recent study on transaction costs, says consumers should steer clear of funds that generate above-average trading costs, even if they are currently performing strongly. In his view, to overcome such high costs, the funds "have to take extraordinary risks."

Write to John Hechinger at john.hechinger@wsj.com¹

A Big Drag

The 15 highest-cost funds based on brokerage commissions and total expenses.

FUND	REPORTED EXPENSE RATIO	BROKERAGE COMMISSIONS, IN DOLLARS	TOTAL COMMISSION PLUS EXPENSE RATIO
Van Eck: Intl Gold; A	1.97%	\$6,992,405	5.82%
Ing: Smcp Opptys; A	1.885	2,811,776	4.128
Van Wagoner: Emrg Growth	2	3,407,791	4.018
RS Inv: Midcap Opptys R	1.672	2,652,200	4.003
RS Inv: Dvsfd Gr	1.686	15,191,227	3.928
Quaker Inv: Aggr Gro; A	2.165	2,294,123	3.764
AXP: GI Tech; A	1.907	2,155,663	3.63
RS Inv: S Co Gr	1.949	1,695,086	3.446
Strong Mid Cap Discip	1.485	2,760,619	3.303
RS Inv: Val+Gro R	1.664	3,701,448	3.269
AXP: Prtnrs Smcp Gro; A	1.551	2,161,291	3.186
PBHG: Tech & Comm	1.699	4,690,606	3.164
Caldwell & Orkin: Mkt Op XR	0.921	5,735,703	2.973
Ing: Small Co; I	1.134	2,754,163	2.88
PBHG: Large Cap	1.198	5,683,423	2.757