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Beware the 'F' word: Fees

Investors are unaware of the prices they pay

Investors pay fees, as they do for any professional service, but many have not given them sufficient thought. A 2009 survey conducted by JD Power and Associates found that 48% of investors are unaware of the fees they pay. In some ways, it's understandable because there are many kinds and they vary significantly.

If you're among the 48%, you should do two things. The first is to have a frank talk with your advisor and ask for an explanation of all commissions, posing as many questions as necessary to ensure clarity.

Then think about the best fee structure for you. There is no "one size fits all" so this step requires considerable thought. To demonstrate the importance of thinking about fees relative to the kind of investor you are, let's consider two variations on the popular fee-based model, whose cost is based on portfolio size.

Assume you are a conservative investor with a $600,000 portfolio, making a few trades a year totaling $200,000 in market value. At an average of 2%, the commissions would be $4,000. However, if you opted for a fee-based account, you pay a percentage based on the $600,000 value of your portfolio. If that percentage were 1.5%, your annual fee would be $9,000. It wouldn't matter that you only traded $200,000 worth of investments; you are overpaying by $5,000.

Now let's assume you're an active trader averaging thirty trades a year. Instead of paying 1.5% a year on the total value of the portfolio, you choose a commission-based account paying on a per transaction basis. Assuming all thirty trades amounted to the total value of the $600,000 portfolio and are subject to the same 2% commission, the fees would be $12,000. In this example, you are overpaying by $3,000.

Clearly, the investment account set-up is an important aspect of your fee costs and you must consider all the choices. While some investors are suited to either fee-based or commission, others are better served by different options: such as a blend of the two.

Fees will vary based on the type of investments in a portfolio, so you might think about constructing your portfolio so that like kinds of assets are grouped in separate accounts. A portfolio comprised of fixed income products, for example, will have a much lower fee than one that is equity-based and requires more active management.

It's important to give thought to any percentage you pay. What might appear to be a slight difference in fees can have a significant impact on the growth of your portfolio. You may compare 1% to 2% and muse, "it's only one percent", but you should think of it as a compounded 100% increase in fees.

Consider $500,000 held inside a registered account for 25 years returning 7% annually. Assuming a 2% rate of inflation and a fee of 1%, you will be left with a 4% return representing a compounded gain of $832,918.17. However, if the fee is 2% you are reduced to a 3% return, or a $546,888.96 gain. The additional 1% in fees cost you $286,029.21 or $11,441.17 per year. That's not small change.

It doesn't automatically follow that the fee is unjustified, but the advisor should be able to clearly articulate the value derived from the additional 1%. Is

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the portfolio quite active, requiring a large number of transactions? Does the entire portfolio undergo extensive rebalancing every year? Were fees offset by the benefits of tax strategies? Any advantages reflected in that 1% increment are meaningless if you don't understand and appreciate them.

Mutual Funds are part of many portfolios but they come with management expense ratios (MERs) that can severely reduce your earnings. Therefore you should be thinking about ways to reduce their impact.

You can switch underperforming funds with high MERs to funds whose MERs are more in line with performance. You may even eliminate some MERs altogether by discarding unnecessary funds. For example, if you hold a money market mutual fund, you are likely better served by a no-fee high interest savings account. Returns may be similar, but they won't be reduced by an MER.

Fees are paid for services rendered. If you're getting good advice and top-notch service, chances are you're happy. If you're not, it may be time to think about a change.

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