The Importance of Low Fees

John Bogle, founder and former chief executive of the Vanguard Group, recently wrote an article about costs in the mutual fund industry (*"On Mutual Funds, Cheaper is Better"*, Wall Street Journal, 8/27/10). His point was clear: "Returns come and go, as it were, but costs go on forever."

We couldn't agree more. Costs, or fees, matter a lot in investment management and are a crucial factor in determining future returns. This is true whether investing in mutual funds, stocks, bonds or other investment vehicles.

In the article, Bogle discusses a recent study by Morningstar, a mutual fund evaluation company. Morningstar found that using expense ratios to choose mutual funds was actually better than relying on its own "star ratings" system. Basically, no matter the asset class or time period, "the cheapest quintile produced higher net returns than the most expensive quintile."

For domestic equity funds, the study found that the returns of lower-cost funds outpaced the returns of the higher-cost funds by about 1.3% on an annual basis. This is a significant difference.

Over a fifty-year period, the historical 8.1% average return of stocks would result in almost 50% more in capital appreciation than a return of 6.8%.

Bogle notes that even though the idea that costs matter is not new, mutual fund expenses have continued to march upwards. Some studies found that the expense ratio of the average equity fund weighted by fund assets rose from 0.54% in 1960 to 0.86% in 2009 -- an increase of 59%. Equity mutual fund assets during this period grew from $10 billion to $5 trillion, a 500-fold increase. But at the same time, mutual fund costs rose from $50 million to $42 billion -- an 800-fold increase.

Although mutual fund expense ratios have declined since 1990, the total fees paid by investors in equity mutual funds have soared -- from $2.3 billion to $42.7 billion. According to Bogle, this refutes the popular notion that mutual funds expenses are declining.

Even more noteworthy, equity mutual fund expenses as a percentage of dividend income have almost doubled from 19.5% in 1990 to 38.5% in 2009. This is important as dividend income accounts for about one-half of the historical return on stocks. Mutual fund expenses thus consume roughly 40% of total dividend income and as a result, the average equity fund is currently delivering a dividend yield of just 1%.

As we have said time and time again, fees are an important component of any investment strategy and investors should compare and contrast all options.

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