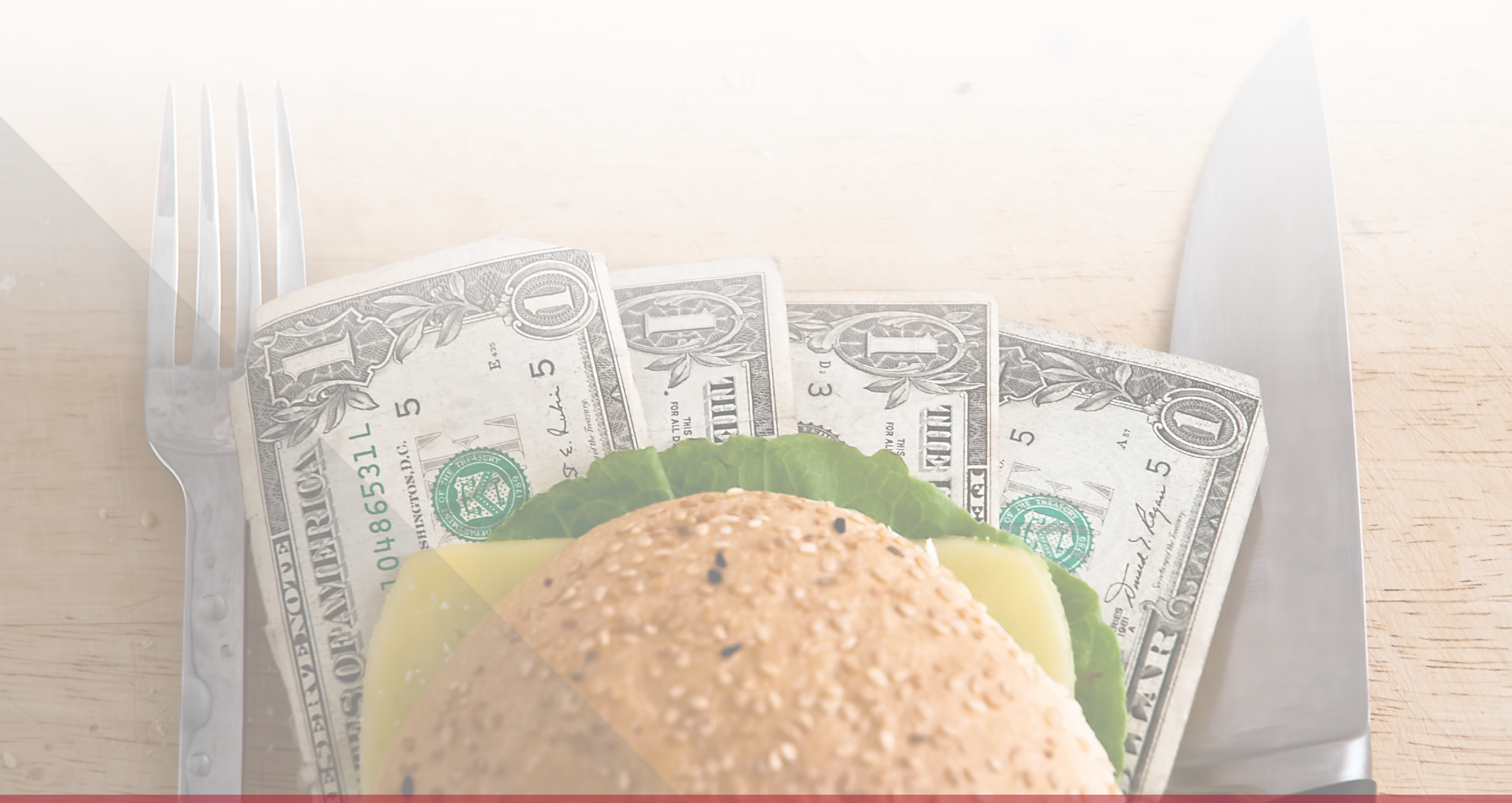
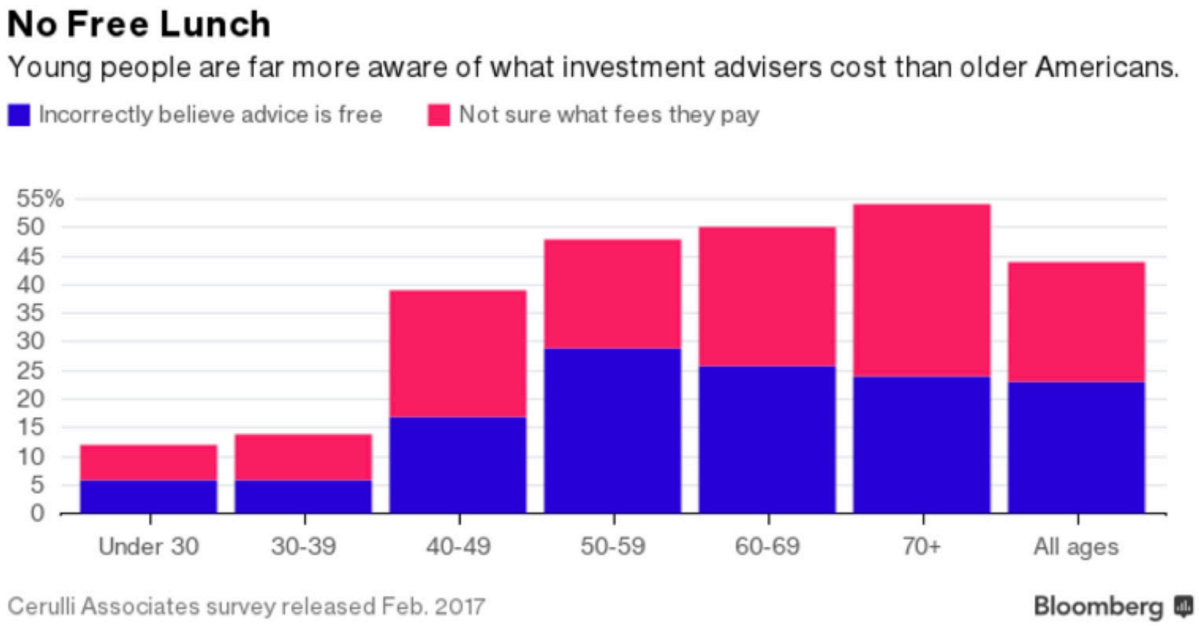
TS PROSPERITY GROUP
Managing risk for your greater reward

There Are No Free Lunches, and Some Lunches Come With Hidden Fees

If someone was to tell you that you have to pay for goods and services, you would probably look at them in a manner that would say "Of course! Why do you feel like you even need to tell me what I already know?" What if someone told you the services provided by your financial advisor come at a cost? For some, this isn't new information, but a February 2017 study performed by Cerulli Associates and reported by Bloomberg indicates that nearly half of American investors either aren't sure what fees they pay or believe (incorrectly) that the investment advice is free.





When you buy a pair of shoes, you have a cost for the shoes as well as sales tax. If you want an extra pair of shoelaces and a bottle of leather protector, you can easily know what those cost. However, do you know what you're paying for when you choose to buy investment advice? Using the shoe example, what if you had to read through pages and pages of disclosures to find out the additional fees you have to pay in addition to just buying the shoes?

Investment advice is already complex enough to many, so adding a discussion on fees can make heads spin for the everyday investor. While there should be disclosures explaining your fees, you may not take the time to read through them. Even if you do, you still might be scratching your head. The intent of this paper is to help inform and educate the everyday consumer (investor) about the different fees you may encounter when placing funds with an advisor.

Advisor Fees

One fee that advisors should be disclosing and making sure clients know is how much they will be compensated each year for keeping an eye on (Managing) your money.

This fee is really straightforward: If you have an advisor who charges 1.00% of the Assets Under Management (AUM), an account of $100,000 will pay $1,000 ($100,000 x 1.00%). Many managers will offer a tiered fee schedule. For example, a manager may have the following chart in their marketing materials.

AUM	Annual Fee %
Up to $100,000	1.00%
$100,001 to $250,000	0.85%
$250,001 or greater	0.75%

Depending on the financial advisor, this annual cost can include different services, but at the very least, you should be expecting for your advisor to invest the funds to fit your risk tolerance and investment intentions.

This is the easiest concept to understand when it comes to fees charged, though the Cerulli study points out clients still don't know they pay a fee or they that the client actually believes the service is free.

Mutual Funds and Their Fees: Peeling the Onion

An advisor might pick individual stocks, but that's time consuming and can be risky. Instead, the advisors will use a lineup of mutual funds (A fund investing in numerous stocks so the investor or advisor doesn't have to seek them out individually.). Maybe the advisor picks a handful of funds in an attempt at further diversification.

Sounds easy, right? Maybe not easy, but efficient for the investor or advisor, as the investments inside of these mutual funds are rarely managed directly by your financial advisor. That means there is an entirely separate company overseeing the fund and managing the investments inside the fund. This other entity has been established and registered with the SEC to offer mutual funds to the investing public. Below is the typical fund company structure.

Mutual Fund Company

- **Investment Adviser:** Oversees investments within the fund
- **Administrator:** Handles the "back office" activities (client mailings, financial reporting, etc.).
- **Underwriter:** Sells shares of the fund.
- **Transfer Agent:** Executes transactions and maintains records.
- **Custodian:** Holds the fund's assets.
- **CPA:** External, independent review and certification of fund financials.

Wow! That is a lot of moving parts behind a mutual fund and it comes at a cost. These companies have to pay internal and external costs to keep the fund up and running. If they want a great investment team? That costs money. If they want better distribution of the fund to financial advisors, that's a cost called 12b-1 fees. When you own a mutual fund, you're paying fess that pay for the annual expenses to keep the mutual fund management company going.

The name of this annual fee is called the Expense Ratio. It's a percentage paid based on the amount you have invested in the fund. According to the Investment Company Institute, at the end of 2016 the average expense ratio was 0.83% for active equity mutual funds and 0.58% for active bond mutual funds. These fees are pretty high compared to passive index funds, though they were about one-third more expensive in the early 2000's.

That's a lot to digest. Take a breath, because in the words of infomercial star Ron Popeil: "But wait, there's more!" Again, the expense ratio just covers the annual fees of the mutual fund. There's another cost to consider, in which commission is paid to those selling the fund. Commission has become such a dirty word, the fund instead charges what is now called a load. No-load funds are available, but investors purchases them on their own rather than going through an advisor.

The idea of loads is this: commissions paid to an advisor will incentivize them to put their clients in a particular fund rather than another. One fund may pay a slightly higher fee than the others. While the client's best interest should be prioritized, financial incentives likely influence many advisor decisions.

There are even different kinds of mutual fund loads. Front-end loads pay the commission up front. If you're looking to put $100,000 into a fund which states there's a 5% front-end load, your money that actually is invested will be $95,000.

If you don't want to pay up front, there are back-end loads (aka deferred sales charges). These commissions are paid when you sell the mutual fund. In many cases, if you hold them long enough, you pay no load at all. What does this mean? A fund might have a 6% back-end load that decreases by one percent each year. If you sell in the first year, you pay 6%. In year two, the charge would be 5%. This continues until there is no load left and you'd pay a 0% fee from the seventh year onward.

Separate from loads, funds can also include purchase and redemption fees. These aren't paid to the broker, but are paid directly to the fund company for investors to buy and sell shares.

When you start adding up all the expenses associated with buying, owning, and possibly selling mutual funds, a worrisome picture develops. This picture is reflected in what is called the net return. The net return is what's left after expenses are taken. More expenses mean lower net return, which can be extremely impactful over a long period of time. Add in the annual advisor fees and you can see that a large chunk of your hard-earned money isn't being invested on your behalf.

Performance Fees

These fees likely won't be found outside of the hedge fund or private equity (private placement offering) world, but they're worth mentioning because it's another way certain investment managers will charge clients. While other investment firms just charge based on the dollar amount clients have invested, these other investment companies receive additional compensation because of specialized strategies and the expectation of excess returns versus more traditional strategies.

In this case, they take a percentage of gains in your account on a quarterly or annual basis. For the sake of example, if the manager charges a 20% performance fee and you're up 5.00% for the year, they will receive 1.00% (5% x 20%) of this return for their services. This will typically be in addition to the annual asset management fee you pay.

In some cases, managers who charge this fee will have what is called a "hurdle rate". This is a set percentage that an account needs to gain before the performance fee is activated. Keeping with the prior example, the firm might have a hurdle rate of 7.00%. If your return is 5.00% for the year, they won't charge a performance fee. However, if you're up 8.00%, the performance fee will be triggered.

Is There a Better Way?

Using the annual investment advisor fee schedule above and assuming average annual mutual fund costs, it's not hard to see that investors could be paying 1.50-2.00% annually. That doesn't even factor in any loads or other fees associated with the funds. If you start with $100,000 and pay a 5% load, you're starting with $95,000. You'll continue to be charged roughly 2.00% per year. If that's the case, you'll need consistent returns for many years to justify the investment. However, markets have shown that up isn't the only direction, thus markets move sideways and down.

An alternative approach is investing with an AUM fee-only advisor. What does that mean? They are charging the annual fee based on assets under management. Depending on the advisor, the services offered will differ, andthere could be additional fees for some services, but in general, you'll be assessed one type of fee each year. This is a more cost-effective approach to investing with a financial advisor.

Additionally, when you remove fund loads (commissions) from the discussion, a conflict of interest is removed. In this case, an advisor is placing client money into a mutual fund because it's a prudent and suitable investment instead of potentially being influenced by their own financial incentive of making more income from the "commissions" paid by the mutual fund company. This will make for more objective advice that's transparent and in the client's best interest.

The TS Prosperity group is an AUM fee-only advisor. TSPG charges that percentage annually based off the value of a managed account. We are not required to charge this way, but we do, because we believe in disclosing exactly what is being charged with full transparency.