



What is the True Cost of your Financial Advisor?

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What do you pay annually to have a professional manage your money? Most Americans don't know. In fact, a recent Arizona State University study indicated that 6 in 10 Americans did not know what they paid their advisors, and of the four that thought they knew, three were wrong.

This ignorance has become an epidemic nationwide. During times of positive market returns, people don't question their advisors' fees or commissions, but when gravity inevitably takes hold and the market makes its cyclical pullback, the lawsuits and accusations of scandal seem limitless.

For many, their financial statements are like a quote from a mechanic. They don't understand the terminology, so they don't have the information to make an informed decision. They pick someone they trust, and hope they don't get ripped off. But why do this when your financial portfolio can be protected just by learning a few basic finance principles and some often-used terms.

"True cost" of money management

I once asked a perspective client what he paid to have his money managed. His answer was a flat rate of \$800 per year. When I reviewed his statements, I could tell he did not understand his "true costs."

What investors must be concerned with is the amount of money lost from the actual return of an investment. The bottom line: how much is put in my pocket.

It's not only the flat rate paid to advisors, but what we pay the mutual funds, various institutions, and Uncle Sam that represent our "true cost."

Flat Fees

The first cost common to most investors is the flat fee paid to their financial advisors. This can be a single amount for a

given time period or it can be a percentage of the managed assets. A flat rate is one of the best ways to pay an advisor. It helps minimize conflicts and encourages objective advice. Paying your advisor's salary guarantees that he is working for you alone. But customers sometimes think these flat rates are the only fees they pay or are the only way the advisor makes money. In many instances, this is incorrect.

The investments that your advisor recommends may also have their own fees. These fees are not inherently a bad thing. When investing in a mutual fund, it costs a certain amount of money to diversify the portfolio, maintain the fund, do research, choose stocks, and keep it balanced. How much it costs can vary greatly.

According to the mutual fund monitoring service Morningstar, the average mutual fund charges its customers 1.52% of assets annually. This figure includes management fees, commission kickbacks, and 12b-1 fees (a marketing fee). With this fee included, if you're paying your advisor 1%, your total true cost would be more like 2.52% annually. Over time it creates a large drag on your portfolio and your retirement.

Loads

Another way advisors make money off their clients is through loads and commissions. These fees are mostly unnecessary and should be just about completely removed from your financial portfolio.

A load is a sales commission paid directly to your advisor or broker for the sale of a mutual fund. There are three types of loads, which can typically charge as much as 6% of assets. These loads are assigned to three different mutual fund types known as A, B, or C shares. A-shares assign a front-end load, or fee paid when the shares are bought. Once you pay the fee, you can sell the fund at any time with no

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penalty. B- and C-shares are funds that assign back-end loads. There is no initial cost to buy these funds, but if you sell your shares before a designated time frame (usually five years or more), the fund keeps a percentage. C-shares generally have a lower fee than B-shares.

The catch with B- or C-shares is that their annual expenses are generally higher than average, usually running around 2%. The goal of the back-ended fee is to keep you in the fund, paying high annual expenses for years. If you get out early, they charge you the load. Either way, they get a sizable cut of your money.

Commissions

Commissions are the amount paid to an advisor or broker by a company for selling its product. The inherent problem with commission-based fees is twofold.

First, you don't know how much commission the advisor is making. But, ultimately, it is your money that is paying his commission. Second, the advisor could be pushing products you don't need because his latest Hummer payment is due. Just as it would be unwise to shop for a new car and trust the salesman's advice without doing independent research, it is also unwise to trust the advice of a financial planner who is paid mostly on commissions. It's a tremendous conflict of interest.

Some of the products with the highest commissions are annuities and whole life insurance policies. Did you ever notice that the biggest proponents of annuities and whole life policies are the people who sell them? It is rare for these products to be recommended by independent planners. That is not to say these products are bad in every circumstance, but you must ask yourself if the advisor is looking

out for you, or selling his most profitable product. In most cases, it's the latter. These products are also generally very complex with many confusing stipulations making it almost impossible for the novice to know his true risk or reward.

It is unfair to say that all commissioned products are bad. We all need some form of life insurance, which will make someone a commission eventually. But it is important to have some knowledge of the product before talking with a salesman. This will strengthen your position and hopefully keep you from buying an expensive financial product you might not need. The other option is to deal strictly with a fee-only advisor who will give you the recommendation that's right for you, with almost no conflicts.

Another cost to consider is transaction costs. Trading stocks often creates high costs to the client. If you are in a mutual fund, transaction fees are rolled into the return so will be of little consequence, assuming you are happy with your return. If you are not in mutual funds, these transaction costs can be very costly and should be watched closely.

Uncle Sam

The last true cost is taxes. Although taxes are inevitable, there are strategies that can help reduce your tax liability.

In mutual funds, for example, the turnover rate of the fund is a good indicator of the potential tax liability. The turnover rate is a measure of how often the fund manager buys and sells stocks in the fund. A high turnover rate means lots of trading, while a low turnover rate means little trading. Every time a fund sells a stock and generates a profit, a tax must be paid. If they bought GE stock at \$45 per share and sold it six months later for \$50 per share, they have a capital gain of \$5. This capital gain creates a tax liability for

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shareholders. If the shares are held for multiple years, there is no tax until the shares are sold. The money is allowed to accrue and Uncle Sam doesn't get his share until you are done with it. It is not always the best investing strategy to hold stocks for too long, but strictly from a tax perspective, lower turnover creates less tax liability.

If an investor were to hold \$10,000 in a fund that returned 11%, but had a 100% turnover rate, just about the entire return would be taxable creating a tax liability of \$1,100. In the 28% tax bracket, that is \$308 of your profit gone forever to the taxman. Assuming a different fund also returns 11% but only has a 10% turnover, the tax liability would be only \$110. The same investor would pay only \$30.80 in taxes. The savings-- \$277.20--is money that can be reinvested, grow and accumulate over time. Eventually, this tax liability must be paid, but taxes, like cleaning the garage, are better taken care of sometime in the future.

So now you might be thinking, "these fees all seem excessive, but if my return is higher, isn't it worth paying." This logic is accurate but the reality is different. There is a statistical measure for mutual funds called "alpha." Alpha is a measure of a fund's performance against its benchmark. For example, a mutual fund that holds 350 hand-selected large-cap stocks would compare its performance with the S&P 500. If, after fees, the fund returns 9.2% and the S&P 500 returns 11.2%, the fund has an alpha of -2%. That means that if you had invested in the S&P 500, you would have gotten a 2% greater return than that of this actively managed fund. For the last 40 years, the mutual fund industry on average has returned 2% less than the index, including expenses.

This means that most funds maintain an alpha of -2.00. Also, in any given year, for the past 40 years, 80% of the actively managed funds have performed worse than their index. So, if you want to play the pick-a-fund game, you have a one in five chance of being right. Statistics have also shown that this year's high performers will likely be next year's laggards. So with few exceptions, there is very little consistency for overachievers.

This begs the question, with all these costs for underperformance, why would anyone buy an actively managed mutual fund.

First, the desire by many people to gamble in hopes of out-performance precipitates lower returns. People love to gamble and are willing to pay for the chance to beat the index. Like Las Vegas, it is a loser's game, but people still like to play it.

Second, I think most people don't know any better. In a bull market where the S&P 500 returns 16%, most people don't realize or care that their portfolio only returned 14%. They had a good year, why complain? It is during the down years that most people begin to see the unsettling truth. When the market returns -9% and your fund shows -11% including fees, it can be troublesome.

Finally, many people don't understand their investments or statements. I've heard people say they are happy with their planner because last year their investments returned 12%. What they don't realize is that the market returned 16% and their brilliant planner greatly underperformed. The skim off

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the top went in the pockets of everyone who works for the client. That is a lot of money.

The costs of being in an actively managed mutual fund over time are, put simply, very severe. Consider this: Over 50 years, a \$10,000 investment will compound to \$1.17 million at 10% returns per year, but to only \$470,000 at 8% per year.

Vanguard founder John Bogle looks at these numbers and says: "Our hypothetical fund investor has earned \$1.17 million, donated \$700,000 to the mutual fund industry, and kept the remainder of \$470,000. The financial system has consumed 60% of the return, the fund investor has achieved but 40% of his earning potential. Yet it was the investor who provided 100% of the initial capital; the industry provided none.

Confronted by the issue in this way, would an intelligent investor consider this split to represent a fair shake? Merely to ask the question is to answer it: No.

What can we do, you may ask, to fight these bloated fees? It is important that you stay vigilant and mindful of the costs you are being charged. Now that you know what to look for, your statements give you almost all the information you need.

Find out what your true cost is. If it is too high, talk to a fee-only planner that looks to invest in index funds. Index funds are mutual funds that generally have no load and annual expense ratios under .25%. Although there are no free rides

in investing, index funds are as inexpensive a trip as you can get.

These funds normally track the performance of their benchmark, such as the S&P 500 or the Russell 2000 small-cap index, and provide very low turnover, generally 10% or less, so they are very tax efficient. If you decide you need a fee-only and can find one you trust for 1% of the assets under management, your costs will be significantly reduced if you invest in index funds that charge an average of .25%. This is a total cost of 1.25% annually. That is extremely inexpensive and very intelligent money management.

The world of investments can seem complex at first blush, and it is worthwhile to have someone knowledgeable to guide you through the financial gamut, but that does not mean you should curl up in the corner and hide when your statement comes every quarter.

It is important that you know what you are being charged and what you are getting for these fees. You might be all right with high fees if your advisor is consistently saving you money and providing fantastic service. But in the investment world, higher fees don't usually translate to higher profits. In fact, history has proven the opposite. Keeping your fees down is crucial to good long-term returns and your financial comfort in retirement.

Ryan Zacharczyk is President of Zynergy Financial Planning, LLC, a financial planning firm specializing in working with mature adults 50 years old and above. Zynergy provides comprehensive financial planning services for individuals 50 and older, helping them achieve their objectives in estate planning, investment management, tax minimization, and insurance planning.