Know a Fund's' Cost? Look Deeper

By RICHARD TEITELBAUM

WHEN investors place their money in the RS MidCap Opportunities fund, it is not unreasonable for them to believe that they will pay about 1.47 percent of their net assets each year for doing so. That, after all, is the fund's expense ratio, as stated in its latest annual report, for 2001.

Those investors, however, would be only about half right. According to current accounting practices, expense ratios exclude a big chunk of the cost of running mutual funds: the commissions paid to brokerage firms and other costs associated with trading stocks. These are instead deducted from a fund's total return, so they are often overlooked by fund investors.

Those expenses can be high, especially for funds that trade often. In the case of RS MidCap, which had turnover of 409 percent in 2001, the fund's adviser said commissions and the estimated cost of over-the-counter trades were almost $3.2 million. Based on a rough average of the net assets it managed that year, $177.1 million, such costs amounted to 1.80 percent — more than the fund's expense ratio for the year.

Now, some legislators and fund shareholder advocates are demanding greater disclosure of commissions and other transaction costs. Some say such costs should be folded into funds' expense ratios, while others say they should be displayed separately.

Congress is turning its attention to the matter. In January, Representative Michael G. Oxley, head of the House Financial Services Committee, and Representative Richard H. Baker, head of the subcommittee on capital markets, asked the General Accounting Office to study the subject, along with other fee-related issues.

"Portfolio transaction costs are basically ignored," Representative Oxley said. "The bottom line is, we're trying to get as much information out there as possible." He said he expected a report by mid-April but thought the Securities and Exchange Commission should decide on including brokerage costs in expense ratios.

Some critics say it is time to overhaul regulations on disclosing costs. Theodore R. Aronson, a principal of Aronson & Johnson & Ortiz, an institutional equity manager, says that including brokerage costs in the expense ratio would help explain why funds so often lag behind the overall market.

Estimates of commissions vary. Mr. Aronson figures that they average 5 or 6 cents a share for big investors like mutual funds or about 11 cents per round-trip trade.

That, Mr. Aronson said, is just the "tip of the iceberg." He said the difference of the bid and asked prices — the spread — adds 12 cents or so to the cost of each round-trip trade. Market impact, the amount that a stock's price fluctuates when traded, adds 24 cents. And he estimates that the opportunity
cost, the amount a stock moves while an investor is waiting to place an order, costs 12 cents more. That adds up to 59 cents.

All told, based on a $27 average share price for larger-capitalization stocks, transactions cost 2.2 percent of the amount traded — none of it readily apparent. "It's a dirty, sleazy area that most people would not like to see the light of day," said Mr. Aronson, who runs a small-cap value fund for the Quaker Funds.

There is no consensus on how to disclose such data. John C. Bogle, founder of the Vanguard Group, said he did not believe brokerage costs should be added into expense ratios. "The expense ratio is going to have a lot of stationary qualities," he said. "It's not going to be too different from one year to the next." But brokerage commissions can vary greatly from year to year. Mr. Bogle said funds should make available an annual estimate of their transaction costs, including spreads and market impact.

Increased disclosure might change the way investors select their funds and the way portfolio managers run them. "The day after commissions are disclosed," said Mercer Bullard, president of Fund Democracy, a fund shareholder advocacy group, "you will see turnover fall dramatically."

MR. BOGLE calculates that average equity fund turnover was 110 percent last year, up from 14 percent in 1960. Still, some industry officials say performance numbers tell investors most of what they need to know. "Funds have a very, very strong incentive to keep brokerage costs low because it is reflected in the total return number," said Craig S. Tyle, general counsel for the Investment Company Institute, a trade group.

Opponents of more cost disclosure say such data would be confusing, and they are adamant that commissions have no place in expense ratios. They say there are too many variables in figuring commissions to allow apples-to-apples comparisons. Commissions often exclude costs of Nasdaq trades because brokerage firms in that market are sometimes compensated by a portion of the spread. A fund trading only Nasdaq stocks might show a low commission figure.

Wayne H. Wagner, chairman of the Plexus Group, a trading consultant, said that by paying a high commission, a fund might be able to fetch a better price. Nor do commissions reflect the effects of "soft dollar" brokerage arrangements, whereby funds channel trades to brokerage firms in return for, say, research.

"You're trying to nail Jell-O to the wall," said Jeff Keil, a vice president at Lipper Inc. "What value is a number once you add in all the qualifiers?"

Regardless of what the General Accounting Office's report on the issue says, industry opposition to increased disclosure would probably be intense. "I anticipate a tremendous amount of mutual fund industry and brokerage firm lobbying against any proposal," Mr. Keil said.