How Much Are You Paying? **–John Augenblick**

Let's give the investing public some credit. They've come a long way with their understanding of the various commissions that accompany the purchase of investment products. The public, through experience or perhaps education, generally recognizes the difference between load and no-load funds. However, the costs of investing can linger long after you've paid that commission and left your broker's office.

The on-going costs of investing come in three genres:

Transaction costs. These aren't what you think. They're not the $25 trading fee levied to buy or sell shares of your fund. I'm referring to the transaction costs that happen internally within the mutual fund. When a mutual fund buys and sells stocks they do so in enormous volumes relative to the average investor. Consider a fund manager trying to sell 500,000 shares of a stock that is trading at $60. He or she might be able to sell the first 100,000 shares at $60, but may have to accept as little as $59 or $58 to sell the rest since the large volume influences the market price. This transaction cost is paid by the investors in the fund since their $60 stock was sold at $58.

Management and Distribution Costs. These are the best understood of the three types of costs, as they are disclosed in the fund prospectus. These fees and are used to pay for the stock research, employee salaries, and anything else needed to keep a mutual fund company up and running. Let us not forget that they also pay for the fancy marble foyers, TV ads, big executive bonuses, and seemingly incessant junk-mail campaigns.

Tax Costs. Mutual funds are flow-through instruments for tax purposes. Specifically, if the buying and selling within the fund generates taxable events, those taxes flow through to you and me. The tax consequence is the same as if it were we who bought and sold the underlying stocks.

Consider a taxpayer in a 28% federal bracket who owned $1,000,000 of a very average fund: Morgan Stanley Dividend Growth Fund (DIVDX) in the year 2007. I'm not making any assertions regarding the merits or performance of this fund, I just want to look at what it costs to own. In that one year, an investor would have incurred: (1) transaction costs of $13,000, (2) fund management fees of $6900, and (3) taxes due for holding the fund of a stunning $86,000.
(Source: personalfund.com)

Please bear in mind that these expenses are on top of the fees charged by your advisor. Staggering—isn't it?

You don't get a bill from your mutual fund company that says you owe them more than $100,000 due December 31st for services rendered. You'd probably blow a gasket if that happened. With the exception of taxes due, those costs are just periodically skimmed from your investments. The tax costs don't show up until you get your 1099's in the following spring, and that bill doesn't come from your mutual fund company - it comes from Uncle Sam.

I find that taxes incurred for holding a fund are underappreciated with respect to their importance in keeping expenses down. A fund that buys and sells with significant frequency not only piles up transactions costs, but passes a heavy tax burden onto investors. If you don't know how frequently your mutual funds trade the underlying stock portfolios, you might get a nasty surprise next April.

Excellent investment and financial planning advice can be priceless. I just don't think you need to invest in funds that are expensive to own in order to achieve your goals.

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