Fund Expenses

Mutual funds have multiple fees and commission structures. All expenses are passively charged to your account with the mutual fund. You will never receive an external bill directly mailed requesting you to pay an amount in addition to your deposit with the fund itself. All fees are charged against the money you are currently investing or have invested.

The expenses are stated in a firm's prospectus. It will state the front and back end loads, annual operating expenses, and annual 12b-1 fees. The front end load is the percentage of the original investment charged for entering the fund. The back end load is the commission removed from investor's holdings when cashing out of the fund. Annual operating expense is the yearly charge of assets under management. Investor's holdings are annually reduced by that amount, and additionally by the annual 12b-1 fee.

Front End Load

The front end load is a sales commission charged against your investment into a fund. Your investment will be reduced by this expense, ranging anywhere from 0% up to 8.5%. This fee is distributed to the brokerage, advisor, or financial planner who referred you to the fund, other marketing fees, the company who manages the fund, and potentially other parties. The rest of the cash is invested directly into the fund. A fund carrying a front end load is typically referred to as an "A-share class" for simplicity.

If you are investing into a fund and charged a 3% load, 97% of your money will go into the investment. As an example, if you were investing $10,000 you would lose $300 to the load, and $9,700 would be invested into the fund. Your investment would have to return the initially lost $300 for you to break even, exceed any other expenses, and then deliver a rate of return higher than the market. Higher front end loads and annual expenses equal higher performance barriers. Some mutual funds will decrease the front end load if you invest a larger amount of money, staggering the amount you may pay for your entry fee. Very rarely, funds may eliminate them completely. Investing higher amounts will make sense if your mutual fund allows you to pay lower front end loads.

Back End Load

A back end load is a deferred sales charge applied on withdrawals from a fund. Mutual funds with a back-end load are commonly known as "B-share class" funds. This commission is applied to your withdrawal, and reduces the amount actually received. If you are withdrawing $10,000 you have invested in a fund and have a 5% back end load, you will only receive $9,500. These loads commonly decrease over time, reducing the loss for investors who hold shares of the fund long term. Instead of a 5% load fee, if you held the fund for an additional time period you may be charged only a 3% load fee. Sometimes back end loads are reduced to zero if you hold the fund long enough. These reductions compensate you being a long term stakeholder and not rapidly exiting. You should note that funds which reduce back end loads typically charge higher annual operating expenses.

Back End Loads decrease your withdrawn amount, which means they can reduce your earnings and cancel your gains. If you invest $1,000 into a fund, watch it rise to $1,060 and have 6% back end load, your withdrawal would bring you down to $996. Combined with annual operating expenses and other fees, you could suffer a greater loss. You would be forced to hold the fund longer to see increased gains, reduced back end load, or both. However, if your fund takes off while you hold the fund to see the back end reduced you could gain substantially. As an example, if you invested $10,000 into a fund with an initial 6% back end load and held the fund until your back end load decreased to 3%. During this time it the investment to $12,000. Your withdrawal would be $11,640 before other costs.

Level Load

Funds with level loads have both front and back end loads. Shares of this class are typically referred to as “C-share” for simplicity. You will be charged a front end load deducted from your initial investment. You will be charged a back end load on your withdrawal, and in between these loads you will be charged regular annual operating fees. That is just as expensive as it sounds. The front end load is lower than most front end load funds, and marketers will say this makes it inexpensive. However, these funds typically don’t reduce the back end load if you hold them for a long period of time. It compensates your fund’s management team for the reduced front end load. To finish, funds will often charge additional annual fees in exchange for the “favor” of splitting the load.

As an example, you invest $10,000 in a fund charging a 3% load for $300 fee and a $9,700 initial investment. You hold the fund until the investment reaches $14,000 several years later. You decide to withdraw your cash from the fund, and are charged an additional 3% withdrawal fee. Your investment would be reduced by $420 and you would receive $13,580. Your total paid in loads is $720. If you had been charged a 6% front-end load you would only have been charged $600 on the initial $10,000. To add insult to injury, the better the fund does the more you would pay on the back end. Keep in mind that your annual expenses may be higher while investing in these shares.

No-Load Funds

A “No Load” fee is not an expense, but a lack of load expenses. These funds charge neither a front end nor a back end load. All of the cash you invest in the fund remains in the fund both at initial investment, and you receive all of the cash at financial withdrawal. These are generally extremely rare funds and are not often advertised by investment brokers. Brokers, advisors, and financial planners are compensated directly by loads, so they will direct you to every fund with a load before showing you the No-Load fund selection. They typically must be directly requested if you want information on no load funds. You should note that operating expenses and 12b-1 fees are still charged against No-Load funds. 12b-1 fees still compensate the brokers, advisors, and planners who market them. These groups may refer you to high end 12b-1 fees before showing you cheaper no-load funds.

No loads are extremely cost effective for you. Your initial investment is not reduced, so you don’t start in the hole. A front end fee of 6% would reduce a $10,000 investment in a fund to $9,400. The no load fund applies the full $10,000 to your investments. On exit, instead of a 3% back end fee, you suffer no reduction in your withdrawal. Your maximum concern is the annual operating expense and 12b-1 fee, both of which will be closer to the maximum possibly available. Since there is no load fees the chances of outperforming load fees is still very high. The fund does not have to outperform the market substantially to compensate for the costs of a front end load or a back end load. Your money is returned to you unreduced at entry or exit and you keep all gains except annual expenses.

Operating Expense

Operating expenses finance the fund’s costs and compensate management teams for their provided services. They are expressed as an annual percentage of all assets under management. Operating expenses are deducted from your investment once a year, every year that you’re invested in the mutual fund. You should never receive a direct bill requesting payment. These expenses come in 3 divisions: Advisory Fees, Operational Fees, and Communications Fees.

The Advisory Fees are directed to the actual management team and staff. This compensates them for their annual salaries and bonuses. This section typically makes up the bulk of the operating expenses that are listed every single year.

The next bulk pays for Operational Fees. These prepay or reimburse expenses for travel, researching investments directly, purchasing research from others, and analysis related expenses. If spent on proper research, these expenses ensure that your investment improves in value over the long term.

The final division of operating expenses pays for Communications with shareholders. It is also named “Shareholder Servicing”. This category pays for expenses delivering information to shareholders and maintaining relations. They also pay to create and maintain records, print multiple copies of documentation, and mail them to your doorstep. They also pay for that website you may be able to log onto, and the phones the communication team answers when you call.

© WealthCE.com

Since these expenses operate indefinitely into the future, you should definitely compare fees for multiple funds in the same category. Since these fees are charged against assets under management, they essentially cancel out a portion of your returns. This reduces compounding of your investment which creates a drag on long term performance. A higher expense has worse impact on your long term returns.

12B-1 Fee

A 12b-1 fee pays the marketing expenses of a mutual fund. This fee operates like a secondary operating expense, deducted from the assets under management once a year. 12b-1 fees are essentially an ongoing commission that compensates financial planners, advisors, and brokers for referring customers. It also pays for future marketing from these sources.

12b-1 fees are difficult to completely avoid, but careful shopping can reduce them. This is important since 12b-1 reduces compounding annually, creating a long term drag on performance and returns. You should judge these fees in relation to the other expenses charged annually, adding 12b-1 fees to any other annual charges. Combining these two charges will display the total amount of expenses deducted annually each year from the fund's assets under management. Be hostile to these charges, keeping in mind that they pay for marketing to new investors, and do literally nothing for existing investors while reducing your long term returns.

Redemption Fee

A redemption fee is similar to a very temporary high end load. These fees reduce your withdrawal amount if you sell the shares entitling you to partial ownership of the fund within an extremely short time frame. If you sell out quickly, these fees are applied in addition to any back-end load and commissions you may face. You should always check in advance to see if redemption fees will be applied on sale, how long they last, and the amount they reduce withdrawals.

The redemption fee exists to compensate other investors that suffer losses from rapid trading. This fee prevents additional capital from being withdrawn from the fund, leaving it in securities. Fund Management does not have to drain the redemption pool as heavily with these fees in place. The redemption pool is a collection of liquid cash or cash equivalents initially drained by withdrawals from the fund. By slowing the amount paid out and reducing the drain on redemption pools, funds reduce the likelihood they will have to actually liquidate securities to meet redemptions and withdrawals.

Total Expenses

The total expense ratio is the total of all annually charged expenses deducted from the portfolio once per year. This normally consists of the combination of Operating Expenses combined with 12b-1 expenses. You should judge funds based on their total expense ratios just as much as their estimated performance. You always know in advance what a fund will charge you. Meanwhile, variables such as estimated future performance can rapidly become irrelevant due to market crashes and errors. These costs directly affect your performance anyway. They are taken directly from money within the fund, reducing the compounding of interest and earnings. The higher these total fees are, the greater the drag on performance. These fees hurt your ability to compound interest long term by reducing your actual earnings. It's equal in importance to future performance.

If your investment is suffering losses, you can add these expenses onto your loss. They will still apply. Fees do higher damage to lower return vehicles, such as bond funds, which rarely see higher returns. These expenses can easily bring a bond fund below the rate of inflation. The higher these expenses are the greater the damage they do to any fund, especially a low return fund.

Total expenses don't actually include all annual fees encountered either. These fees do not include the trading fees created by traders who work for the fund. Brokerage fees and commissions passively absorb small amounts of assets under management. They subtract from net asset value each time there is a purchase or sale of an investment.

You should always shop around when looking at total expense ratios. The higher the expense ratio the greater the

© WealthCE.com

drag on investment returns. There is a rule: only compare funds within the same category. An actively-managed small-capitalization emerging-market fund should not be compared with an index fund focused on large capitalization firms from a New York office. The small capitalization emerging market fund requires more flight, travel, research, and oversight. Accurate research will require a substantial amount of expenses. A large capitalization index fund requires significantly less expenses since it is easier to acquire data about their potential investments. They can obtain a lot of information without needing to travel. A large amount of research comes simply by buying data, news media, and analyst feeds. A comparison between them is unfair. You should always compare the fund against its most direct mutual fund competitors.