



Sigma Summaries

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The Price We Pay

"Price is what you pay; value is what you receive"

Author Unknown

Individual investors have rarely been presented with more investment products and services than they are today. There are many reasons why this exists, including corporations giving more options to their employees, changes in the tax law creating new saving vehicles, and more discriminating investors demanding a greater array of choices. So while there is an explosion in available investment options, there appears to be an increasing level of confusion regarding the fees and expenses associated with these products and services. We believe investors should be knowledgeable of the costs associated with these options so they can make a more informed decision.

In a perfect world, these expenses should be transparent to investors; unfortunately they are not. Therefore, our goal is to shed light on the cost structure imbedded in some of the more commonly used investment products and services, including index funds, mutual funds, variable annuities, hedge funds, separately managed (wrap) accounts, as well as commissioned-based versus fee-based investment advisory services.

Passively Managed Mutual Funds (Index and Exchange Traded Funds): Passive funds invest in a basket of securities that are identical to their respective index or benchmark. For example, the Standard & Poor's Depository Receipts (SPY) is an actively traded index fund that holds a market basket of the 500 stocks included within the S&P 500 index. This fund is rebalanced daily such that its return is nearly identical to that of the index. Other actively traded indices include the Nasdaq 100, DJIA, S&P 400 MidCap, etc. Typically, these index funds have very low management expense ratios of around 0.2 percent.

It is important to note that index funds are not actively managed and the company that is responsible for managing the fund does not provide investment advice following the purchase of this product. Index funds are perhaps one of the lowest cost investment choices of the mix that we will be reviewing in this analysis.

Actively Managed Mutual Funds: These funds are a basket of individual stocks, bonds or a combination of both, that are bought and sold under the direction of a fund

manger or a team of managers. It is their goal to outperform their respective benchmark.

For actively managed mutual funds, there are two primary mutual fund fees: one-time charges and ongoing expenses. Not all funds charge one-time fees but all funds charge annual management and trading expenses.

Ongoing Expenses:

Management fees: The fund company of the particular mutual fund uses these fees to cover expenses related to the ongoing management of the portfolio. In addition, the support staff and all administrative related costs are included such as the mailing of prospectuses, annual reports, and account statements.

Generally, bond funds have a lower management fee than equity funds. Typically, this ratio averages 0.75 percent. Specialty funds tend to carry a higher expense ratio than more "garden variety" funds. Moreover, international and small cap equity mutual funds will likely have a higher expense ratio than a large stock domestic equity mutual fund. Large cap equity mutual funds

usually charge a management fee of around 1.0 percent, while the other types of funds can go as high as 1.75 percent.

12b-1 fees: Initially, 12b-1 fees had one purpose: help mutual funds grow their asset base through marketing campaigns. This in turn would allow the mutual funds to experience economies of scale, the benefits of which would then be passed on to investors in the form of reduced management fees and expenses (measured as a percentage of unit value). However, this fee is still being assessed at a relatively high level to cover a variety of distribution and advertising related expenses. No-load funds use this fee to help cover the cost of selling their funds through brokerage firms. While this fee can be as high as 1.25 percent, we typically see a charge of 0.25 percent. According to Morningstar (a mutual fund rating service), roughly half of all funds levy this fee.

One-Time Fees:

Sales commissions (also known as loads): There are two ways that mutual fund families can distribute or sell their funds. The first is directly to investors, possibly via phone, media advertisements or the Internet. Examples of fund families that conduct their business this way would include Vanguard, Gabelli and Janus.

The other distribution method is to wholesale the mutual funds through a network of brokers. It is then the broker's responsibility to sell these funds to clients. As a way of compensating these brokers, a commission, or "load", is paid to the broker whenever they sell a fund. The best way to detect if you are

paying a load is to see if there is a share class associated with that fund. Most, but not all share classes, implies that there may be a load attached. If there is no share class, you are purchasing a no-load fund.

An A share class, or front-end load, means that an investor paid the broker a commission upon the purchase of that fund. For example, an individual invests \$10,000 into an A share class mutual fund that has a 4.5 percent commission. The investor only purchased \$9,550 worth of that fund as the remaining \$450 was paid to the brokerage as compensation for selling that mutual fund. The Securities and Exchange Commission does not limit the size of a sales load that a fund may charge, but the National Association of Securities Dealer limits the sales loads to a maximum of 8.5 percent.

A slight variance to the A share class is the B share class, or back-end load. When an investor purchases shares that are subject to a back-end sales load rather than a front-end sales load, no commission is deducted at purchase. Instead, all of the investor's money is immediately used to purchase fund shares (assuming that no other fees or charges apply at the time of purchase).

The amount paid for this type of load will depend on how long the investor holds his or her shares and typically decreases to zero if the investor holds his or her shares for a long enough time period. For example, a deferred sales load might be five percent if an investor holds his or her shares for one year, four percent if the investor holds his or her shares for two years, and so on until the load goes away

completely. The rate at which this fee will decline will be disclosed in the fund's prospectus.

Variable Annuities: A variable annuity is a financial contract between an insurance company and the annuity owner. This investment product allows for tax-deferred growth of principal until funds are withdrawn. Upon withdrawal, the earnings are taxed at ordinary income tax rates rather than the capital gains tax rate.

Fees: At its core, this type of investment vehicle is an insurance policy that will pay a death benefit to a designated beneficiary upon the death of the annuity owner. Due to this fact, there is an expense that the insurance companies must charge known as a mortality and expense fee. This fee is typically 1.25 percent of the account value per year and is used to guarantee the death benefit and the availability of payout options.

Another fee is the surrender charge, which is similar to the sales charge of a B share class mutual fund. If an investor withdraws money from this annuity, the insurance company will assess this charge based on how long the investor has been invested in this product. The surrender charge is a percentage of the amount withdrawn, and declines gradually over a period of several years. Usually this fee is not charged after the annuity has been held for a number of years.

In addition to the mortality and expense fee, and surrender charges, all of the ongoing fees related to mutual funds as noted above are also charged. The average annual expense for variable annuities has been on the

rise and currently stands at 2.3 percent of assets, according to Morningstar. (This figure includes fund expenses plus insurance expenses.) A typical mutual fund, on the other hand, charges 1.44 percent on average.

Hedge Funds: A hedge fund is similar to a mutual fund in that it pools funds from investors in order to purchase a basket of securities to achieve a certain objective. However, they are unregulated and in certain situations, an investor may have some difficulty in liquidating their holdings quickly. As a result, hedge funds can only accept a limited number of investors that must be pre-qualified as an accredited investor (typically an individual with a net worth of more than one million dollars).

Fees: Hedge funds charge management fees as a percent of assets under management like a mutual fund, but hedge funds also charge incentive fees. This fee is based on a percentage (frequently 20 percent) of the realized and unrealized gains of the funds that has been earned above a certain rate of return.

Separately Managed Accounts (SMA): An SMA is similar to a mutual fund in that a money manager manages a pool of securities. However, unlike a mutual fund, the investor owns all of the individual securities.

Fees: With a separately managed account, you pay an all-inclusive annual fee called a wrap, that compensates the money manager who picks the securities, the sponsor firm which assembles the lineup of private managers and handles trading and administration, and the broker or other adviser who helps you choose a manager from the sponsor's lineup. The annual fee typically ranges from 2.0 percent to 2.5 percent but can be as high as 3.0 percent.

Commissioned Based Advisory Services: As the name implies, this type of investment advisor sells investment products and is compensated by receiving a commission for his work. If that individual has done the necessary research and if the product(s) that are sold truly have the clients' best interest in mind, then they deserve to be paid for their work. However, it is easy to see how conflicts of

interest may arise if the investment advisor is promoting a product just because of a large commission associated with it.

Fee-Based Advisory Services: A fee-based advisory firm negotiates a management fee, either as a flat rate or as a percentage based upon the assets that they manage. Typically, this fee is approximately 1.0 percent of the assets under management, depending on the size of the relationship. In addition, there may be transaction costs when trading securities which we believe typically represents 0.1 to 0.5 percent annually, based on the level of turnover in the account and the commission charge associated with each trade.

Conclusion: Nothing in life is free. Rather, every product and service comes at a price. Astute investors need to ascertain the total cost of the services received and compare that cost to the value that they assigned to that service.

Written by: Steven A. Catallo

Abbott's Corporation
Dealer in Rare Coins and Precious Metals

Johnathon Abbott, of Abbott's Corporation made a presentation to the investment staff at Sigma Investment Counselors. Abbott's, located in Birmingham, Michigan, is a respected dealer specializing in rare coins, precious metals and jewelry. During the presentation, we learned some interesting information and thought it would be beneficial to pass some of it on to you. First, never clean your coins. It is similar to cleaning your oil painting with a Brillo pad. Second, it is strongly recommended that any jewelry or precious stones be appraised every three years if they are insured. Many insurance companies state in their policies that an appraisal older than three years may leave the final decision of true value to the insurance company's discretion. Finally, you should verify that the individual/firm, who is performing the appraisal, has the proper credentials and reputation within the community.

If you have any questions, please feel free to contact Johnathon Abbott at (248) 644-8565, or visit his website at **www.abbottscorp.com**.

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