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Mutual Fund Fees and Expenses

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Introduction

Investing costs can be a key factor in your net return. To minimize those costs, you need to understand how mutual funds assess fees and expenses. Though cost alone shouldn't drive your investment decisions, a little research can really pay. The best choice at first glance may have hidden costs, and what seems expensive could turn out to be a case of getting what you pay for.

There are two general categories of mutual fund costs: sales charges and annual expenses. A sales charge, often referred to as a load, is the broker's sales commission or fee deducted from your investment when you buy the fund (or sometimes when you sell it). Not all funds have an associated load. However, all funds charge annual expenses to cover the fund's operating costs, including management fees, distribution and service fees (commonly known as 12b-1 fees), and general administrative expenses. These expenses are deducted from the fund before its returns are calculated.

Mutual funds may be offered in multiple share classes (commonly Class A, Class B, and Class C shares). This structure allows each investor the opportunity to select a share class that is best suited to his or her investment goals. The differences typically revolve around how much you will be charged for buying the fund, when you will pay any sales charges that apply, and the amount you will pay in annual fees and expenses.

Understanding loads

Many investors know that mutual funds can be purchased with a load or without a load (no-load). And many of these same investors assume that no-load is good and load is bad. However, this is not always the case. Again, a little research can help determine what makes the most sense for you.

The first step is to understand the two types of loads: front-end and back-end. As the names imply, front-end loads involve a fee up front when you purchase the fund, and back-end loads are paid when you sell the fund. Front-end loads are generally associated with Class A shares, while Class B shares typically carry back-end loads. Bear in mind that no fund is totally free, and both types also may involve other fees and expenses.

Front-end loads

A front-end load may make sense if you're considering a long-term investment in a large number of shares. When you purchase Class A shares, the front-end load reduces the actual amount of your initial investment. However, Class A shares also offer you discounts, called breakpoints, on the front-end load if you buy shares in excess of a certain dollar amount. Typically, a fund will offer several breakpoints; the more you invest, the lower the percentage of sales load.

> **Example(s):** Joan is considering spending $35,000 on Class A shares that have a sales charge of 5 percent. She will be charged $1,750 on her purchase; the remaining $33,250 will be invested in the fund. However, the fund offers a breakpoint at $50,000 and another at $100,000. If she were to invest $50,000, the load would be reduced to 4.5 percent; she would pay $2,250 in sales charges, while the remaining $47,750 was invested. And if she had $100,000, the load would drop to 4 percent. She would pay $4,000, but a higher percentage of her money--$96,000--would be put to work. (This hypothetical example is intended only as an illustration and does not reflect the results of any actual investment).

You also may qualify for breakpoint discounts by signing a letter of intent to purchase additional shares within a certain period of time, or by combining your current purchase with other investment holdings that you, your spouse, and/or your children have within the same fund or family of funds (this is known as a right of accumulation). Since rules vary, read your fund's prospectus and/or contact your financial professional for the specifics of how to qualify for breakpoint discounts.

Front-end loads cannot be any higher than 8.5 percent, and are often lower. The 12b-1 fees (see "Expenses common to mutual funds" below) on Class A shares tend to be lower than those of other share classes.

Back-end loads

A back-end load, sometimes referred to as a contingent deferred sales load (CDSL) or contingent deferred sales charge (CDSC), is designed to entice investors to hold on to a particular fund for an extended time period. It may appeal to you if you wish to invest a smaller amount of money; because the sales charge is imposed when you sell your shares, all of your initial investment is put to work immediately. The load usually decreases over time (the time period varies from fund to fund), and by the end of the specified time period, no sales charge applies. At that stage your Class B shares may convert to Class A shares.

> **Example(s):** Fred wants to invest $10,000 that he wants to keep invested for 10 years. If he invested in Hypothetical Fund X, which has a 5 percent CDSC that decreases by 1 percent a year, he would pay a sales charge equal to 5 percent of the value of those assets (or the value of the initial investment, whichever is less) if he sold the fund in the first year. If he sold in the second year, a 4 percent charge would apply; in the third year, the sales charge would be 3 percent, and so on until the sixth year, when the sales charge owed upon sale is 0 percent.

Before purchasing a fund with a back-end load, make sure that this investment fits with your overall goals. Class B 12b-1 fees can be considerably higher than those for Class A shares, so the cost of investing large amounts over time might be more than you would like. In addition, you don't benefit from the breakpoint discounts available with front-end load funds. Also, you will owe the sales charge when you sell, so if you find yourself selling the fund prematurely or when the fund is down, the sales charge could represent a larger portion of your return than you had anticipated. You'll also need to keep track of when your shares qualify for a reduced sales charge, and when it is scheduled to be reduced or eliminated.

Class C shares have a CDSC that is generally lower than that of Class B shares and is imposed if you sell your shares within a certain time period. Like Class B shares, Class C shares offer no breakpoints for larger purchases; however, they don't typically convert to Class A shares, and the sales charge may remain static from year to year until after a certain time period has elapsed.

Expenses common to mutual funds

The following fees are generally known as operating costs, and are common to most mutual funds. They are paid out of the fund's overall assets, not charged directly to an individual shareholder. A particular fund, including a no-load fund, may charge some or all of them, depending on how the fund is structured.

- Management fees--These pay the fund's investment manager or management firm for making investment decisions about which securities to invest in and when to buy and sell.
- 12b-1 fees--Named after the section of the law that allows them, 12b-1 fees pay for the fund's advertising and sales expenses.
- Reinvestment fees--These may be charged when you reinvest distributions, such as dividends, back into the fund.
- Exchange fees--These may be imposed when you switch your assets from one fund to another within the same fund company.
- Custodial fees--These are charged by the custodian (generally, the bank or other financial institution holding the fund assets in-house) for the service it provides.
- Administrative fees--These include everything from rent to shareholder services.

What is an expense ratio?

A fund's expense ratio is equal to a percentage of the assets managed by the fund, and represents the fund's cost of doing business. These ratios can be as high as two or three percent annually. You want to pay attention to a fund's expense ratio; high expenses can have a profound impact on your net return, especially over time.

Bear in mind that sales commissions, trading costs incurred when a fund buys and sells securities, and taxes are typically not included when calculating a fund's expense ratio. You'll need to factor all of them separately into your analysis.

Load vs. no load?

A no-load fund has no sales charge, and a fund's 12b-1 fees may not exceed 0.25 percent in order to be considered no-load. At first glance the choice between load and no-load may seem like a no-brainer, since your entire investment goes to work for you from the start. However, don't forget that a no-load fund can involve other fees and charges.

For example, redemption charges may be imposed if you redeem your shares within a certain period of time (60 or 90 days is common, but the time frame can be longer). The redemption charge is paid to the fund, and is designed to discourage excessive trading. Also, some funds may charge a purchase or transaction fee that is paid to the fund when you buy your shares, a reinvestment fee if you choose to reinvest your dividends into the same fund, or an exchange fee if you switch your assets from one fund to another within the same fund family.

Also, paying even a very low percentage of assets every year can add up if you hold an investment for a long time. Because front-end loads are paid only once and annual expenses are paid every year for as long as you hold the fund, higher annual expenses could add up to more than the front-end load over time. And though past performance is no guarantee of future results, a fund with a sales charge might just have a stellar track record that helps compensate for the cost.

On the other hand, if you are contemplating a fund with a sales load, consider whether the return you anticipate justifies the additional expense, especially if the load will reduce the amount you're able to invest initially. Be sure your analysis is thorough enough to determine which fund is truly the better bargain.

Read the prospectus

An investment company, such as a mutual fund, must file a prospectus for the fund with the Securities and Exchange Commission (SEC) and distribute it to investors and potential investors. Typically, the prospectus will contain financial statements, management's discussion of the fund's strategy and future prospects, and other key information that an investor should know. The SEC requires every fund to list a fee table in its prospectus, so this is a good place to find out what fees you can anticipate. Before investing in a mutual fund, carefully consider not only its fees and expenses but its investment objectives and risks, which also can be found in the prospectus available from the fund. Read it carefully before investing.

> **Caution:** Certain fees listed in the fund's prospectus may not be included in the fund's published return figures, as is often the case with asset-based fees (fees that you pay every year based on the value of your account). So, you may have to crunch some numbers and make the necessary adjustments yourself.

The bottom line

All things being equal, it's wise to avoid unnecessary charges when investing wherever possible. But deciding how best to do that isn't always simple. The bottom line for any investment is how it performs for the investor, and assessing that performance requires thoughtful consideration of all commissions, fees, and expenses, both short- and long-term.

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