How much do hidden mutual fund trading expenses cost you?

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Summary: The average mutual fund paid .27% of net assets in hidden commissions in 2001. When measured on a capitalization-weighted basis, the average hidden commission cost was .19% of net assets. The effective trading costs related to the bid/ask spread and the temporary shifting of these spreads added .36% more annually in the hidden costs of the average fund. For funds with the highest turnover, hidden commission and bid/ask spread expenses exceeded 3% of assets annually.

In “Mutual Fund Brokerage Commissions,” Professors Jason Karceski and Miles Livingston of the University of Florida and Professor Edward O’Neal of Wake Forest University reported on a study that they conducted for the Zero Alpha Group.1 2 They estimated the size of hidden trading costs that are borne by investors in addition to the mutual funds’ published expense ratios. These hidden trading costs included brokerage commissions, bid/ask spread costs incurred when trading, and the “market impact” or costs incurred by funds when the market price shifts temporarily as they trade large positions. (See: “Beware of large and hidden mutual fund costs”) Professors Karceski, Livingston, and O’Neal investigated fiscal year 2001 trading costs for 3,276 mutual funds. In addition, they looked in detail at 30 of the largest U.S. domestic equity funds sold to retail investors. They also studied more closely a random sample of 10 mutual funds with assets greater than $100 million that had very high turnover.

Mutual funds are not required to make trading cost data available to investors at the individual fund level. Because individual fund data were not available, Professors Karceski, Livingston, and O’Neal made cost estimates using data on groups of funds. Aggregated trading cost data are reported by fund families to the U.S. Securities and Exchange Commission. The authors did deeper research into the samples of very large and very high turnover funds, but again they still could only estimate costs. Table 1 draws upon some of the estimates in the Karceski, Livingston, and O’Neal study.

Table 1 Estimated Trading Costs for an Average Mutual Fund (% of Net Assets per Year)

	Annual Turnover Rate	Brokerage Commission Costs	Effective Bid/Ask Spread Costs	Total Trading Costs
30 Very Large Mutual Funds	57%	.10%	.20%	.30%
Average Mutual Fund	106%	.27%	.38%	.65%
Sample of 10 Highest Turnover Mutual Funds	498%	1.67%	1.91%	3.58%

Concerning just annual mutual fund payments for brokerage commissions, Professors Karceski, Livingston, and O’Neal estimated that the average mutual fund paid .27% of net assets in commissions in 2001. When they measured mutual funds on a capitalization-weighted basis for the sample of 3,276 funds, the brokerage commission cost percentage was lower or .19% of net assets. Professors Karceski, Livingston, and O’Neal commented that this .19% figure is what the average mutual fund investor would pay in brokerage commissions each year. Note the in aggregate, all mutual fund investors must hold the capitalization weighted portfolio of equity mutual funds, which combines all passive index and all actively managed equity mutual funds. The numbers from the

Karceski, Livingston, and O’Neal study get even more interesting when the effective trading costs of the bid/ask spread and the temporary shifting of these spreads are also considered. They used data from a 2001 SEC study that estimated the market impact of trading in NYSE and NASDAQ stocks.3 For a fund with 100% turnover annually, Professors Karceski, Livingston, and O’Neal estimated market impact trading costs to be .36% annually. Obviously, the more or less a mutual fund trades, the higher or lower fund trading costs will be, respectively.   Larger mutual funds tend to trade less than the average mutual fund. Professors Karceski, Livingston, and O’Neal reported Morningstar data indicating that average annual fund turnover was 106%. Their sample of 30 of the largest mutual funds had lower average turnover of 57% annually. However, a few of these very big funds had quite high turnover. Annual turnover for the four most active of the 30 largest funds averaged 169% per year.   For the sample of 10 funds with the highest turnover that they also studied in detail, they found that average fund turnover was 498%. This means that the entire portfolio turned over about five times per year or approximately once every 10 weeks. Annual commission expenses for these 10 funds averaged 1.67%. When the 1.91% annual cost of the bid/ask spread was added to brokerage costs, then total annual trading costs were estimated at 3.58% for these very high turnover funds.   See these related articles: ->"Excessive investment costs are a huge problem for individual investors"   ->“Invest in fixed income securities through bond mutual funds with low investment fees”   ->“Is it worth paying higher bond mutual fund management fees?”   ->"Passive individual investors are “free riders” who benefit from the higher costs of active traders"   ->“The investment industry is not your investment partner”   ->“What is the cost to investors of sub-optimal diversification?"

1) http://www.zeroalphagroup.com

2) Jason Karceski, Miles Livingston, and Edward S. O’Neal. “Mutual Fund Brokerage Commissions.” Working Paper, January 2004. (April 12, 2004). http://www.zeroalphagroup.com/news/ZAG_mutual_fund_true_cost_study.pdf   A subsequent version of this study with similar and expanded conclusions is also posted there. See: http://www.zeroalphagroup.com/news/hiddenstudy111704.cfm

3) “Report on the Comparison of Order Executions Across Equity Market Structures.” Office of Economic Analysis, U.S. Securities and Exchange Commission, January 8, 2001. http://www.sec.gov/news/studies/ordrxmkt.htm (As of October 2005)