Is it worth paying higher bond mutual fund management fees?

Summary: Higher bond mutual fund management fees tend to be a "deadweight" loss to you. Choose only low-cost bond funds. In pursuit of higher risk-adjusted bond returns, is it worth paying higher expenses and fees to a bond mutual fund? Investment science provides a strong "negative" as the answer. In "Bond Fund Returns and Expenses: A Study of Bond Market Efficiency," Professor William Reichenstein of Baylor University studied the relationship between bond mutual fund returns and expenses. Professor Reichenstein analyzed bond mutual fund expenses and returns for the years 1994 to 1998. To ensure that he was comparing bond funds of similar characteristics, Professor Reichenstein grouped funds by their investment styles. Fund groups were differentiated by maturity (short-, medium-, long-term maturities) and investment grade quality (low, medium, high quality). Within each of the nine combinations of these maturity and quality style groups, he assigned each individual fund to one of three equal sized groups according to the fund’s expense ratio (low, medium, high expenses). Professor Reichenstein tested several theories about investment returns and expenses over 1-year, 3-year, and 5-year time horizons by comparing average investment returns between these nine maturity and quality groupings. For example, he compared the average net return of the low cost group to the medium cost and the high cost groups of the same style to see whether higher fees produced greater returns, and so on. Without failure, Professor Reichenstein found that higher expenses predicted lower returns in 42 out of the 42 group comparisons. Professor Reichenstein cited other studies of bond fund expense and return averages that yielded similar results. For example, Jonathan Clements used Morningstar data that grouped bonds into five categories: government backed mortgage, corporate, U.S. Treasury, general municipal, and high-yield bonds. Clements found that in 28 out of 30 comparisons higher expenses meant lower returns to the investor. In 1999, Clements updated his 1991 study and found that higher expenses still meant lower returns to the investor, this time in 15 out of 15 cases. In addition, in 1999 John Bogle analyzed bond maturity and quality groupings for government, corporate, and municipal funds. He found that in 24 out of 24 comparisons higher expenses meant lower returns. In summary, 109 of the 111 comparisons in these four studies indicated that higher average expenses meant lower returns to investors. Superior performance of specific bond mutual funds could have been obscured by comparing only the averages between groups. Therefore, Professor Reichenstein tested whether individual funds within his maturity and quality groupings delivered returns that compensated for their higher expenses. Again, his conclusion was no. In fact, his analysis indicated that higher bond mutual fund expenses were a dollar for dollar "deadweight" loss. The higher the expenses, the lower the net return was for the individual investor. Professor Reichenstein’s analysis also concluded that the performance of similar bond funds with and without front-end loads was not statistically distinguishable. Additional expenses and loads just tended to result in a dollar-for-dollar reduction in investor’s assets. See these related articles:
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