



# The Investor Advocate®

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## Count the Cost

Both the Congress and the Department of Labor (DOL) periodically focus their attention on the cost of investing. The investing public is looking for more and more disclosure of investment costs. Improving net returns for tax-deferred retirement plans and tax-exempt entities requires that investment management, execution, trading, custody and other costs be taken into account. All of this activity and attention should lead the prudent fiduciary and investor to manage costs as an important aspect of achieving improved net returns.

## Uncle Sam Gets Into the Picture

Over the years, Congressional hearings and DOL publications<sup>1</sup> have emphasized the importance of investment costs. In particular, it has been noted that investors, during periods in which market returns exceed expectations, may not place proper emphasis on investment cost control.

A number of factors enter into this equation. First, to control costs, one must understand the costs. Studies have shown that many plan sponsors and fiduciaries are not adequately aware of the total cost of their investments and other service arrangements. This appears to be especially pronounced in defined contribution plans and annuity-based products. *A Look at 401(k) Plan Fees*,<sup>2</sup> a DOL publication, is available to help ERISA fiduciaries to increase their understanding of the issues associ-

ated with this important analysis. The DOL's website (<http://www.dol.gov/dol/pwba>) also makes more information available on this topic.

## Investment Management Fees

Many fiduciaries have, for good reason, chosen to delegate investment management responsibilities to registered investment advisors and other qualified investment professionals. As a result, investment managers are paid fees for their services. Competitive fees for such services vary, most often based upon the size and type of investment. For instance, fee reductions may be available for investments of larger amounts, passive investment methods generally charge less than active management strategies and fixed income management costs are usually less than equity investment management fees.

There are inconsistencies, however. There are examples of U.S. large cap passive strategies charging in excess of one percent, where a fraction of this amount would be considered competitive.<sup>3</sup> While examples such as this may be rare, it points out that cost-inefficient investment vehicles continue to be sold even in our modern investment markets. It is critical to determine what is competitive, to make comparisons and to continue to monitor investment and other costs.

*Continued on reverse side*



*Advocating Your Success*

## Brokerage and Execution Costs

“The...execution phase...is one of the most critical and least understood aspects of portfolio management.”<sup>4</sup> The brokerage function for many has included the completion of securities trading for accounts as well as obtaining advice from the broker and/or brokerage firm. The cost of execution goes beyond the brokerage commission, or explicit costs, to what has been described as “hidden costs.”<sup>5</sup> These can be incurred due to illiquidity, trade size, trading delays, missed trades or simply poor execution. Decoupling the trading and advice functions is most advantageous due to their functional dissimilarity and the potential for conflicts of interest. Effective fiduciaries use only those service providers that allow them to best achieve established investment objectives.

## Soft Dollars, Commission Recapture and Other Issues

A variety of strategies, some more effective than others, are employed by investors to impact costs. While allowed by securities laws and ERISA, soft dollar brokerage has frequently come under scrutiny by the Securities and Exchange Commission (SEC), the DOL and retirement plan professional associations. In addition to cost, there is also the issue of conflicts of interest, both real and potential. Hard dollar arrangements are more easily measurable and, presumably, more controllable. The SEC website ([www.sec.gov](http://www.sec.gov)) provides recommended practices and procedures for soft dollar transactions.

Commission recapture is an alternative used in cases where negotiated reductions in trading rates are viewed as less advantageous, or unavailable. In many cases, a valuable service, such as a transaction analysis, is often being provided along with this function.

Mutual fund, insurance company, broker wrap and similar bundled approaches have attempted to cap, wrap, or bundle the costs of investment management, trading, certain strategic advisory services, and, in some accounts, administrative services, into an asset-based fee arrangement. Insurance products of this type often include substantial asset charges related to risk

and mortality. While well intended to aggregate costs, these arrangements tend to bundle certain costs that may be more effectively assessed and managed separately. Too often, for example, even basic custody and trustee fees have been found to be overpriced.

## Closing Costs

Cost and, more importantly, value assessments are a key responsibility of ERISA and other fiduciaries. Any investor can benefit from developing a better understanding of their cost structure, total costs and rationale. In this regard, the DOL provides the following useful perspective:

*“When you consider...fees...and their impact...remember that all services have costs...compare all services received with the total cost.”*

*“...higher investment management fees do not necessarily mean better performance. Nor is cheaper necessarily better. Compare the net returns relative to the risks among available investment(s)...”*

*“...don’t consider fees in a vacuum. They are only part of the bigger picture including investment risk and returns and the extent and quality of services provided.”<sup>6</sup>*

With increased disclosure and analysis leading to greater understanding, expenses can be better managed, negotiated and, in some cases, eliminated, resulting in enhanced net returns or reduced out-of-pocket expenses.

<sup>1</sup> A Look at 401(k) Fees, U.S. Department of Labor Pension and Welfare Benefit Administration

<sup>2</sup> Ibid

<sup>3</sup> CBS MarketWatch, “Your Manager is Paid Too Much,” December 11, 1998

<sup>4</sup> Managing Investment Portfolios, Maginn and Tuttle, 2007 edition

<sup>5</sup> The Journal of Investment Consulting, “The cost of Trading and the Quest for New Market Structures,” Wagner, December 1998

<sup>6</sup> A Look at 401(k) Fees, p. 17

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