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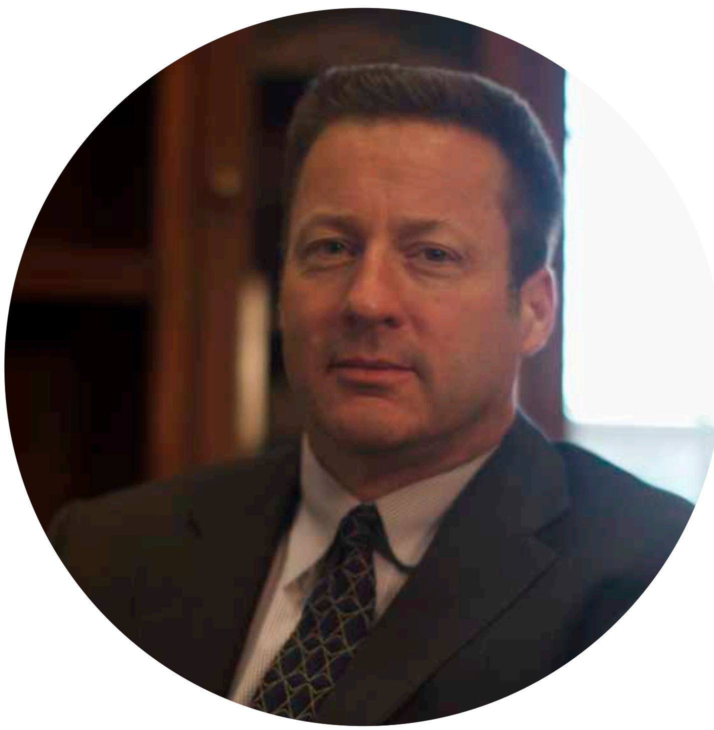
SMART INSIGHTS FROM PROFESSIONAL ADVISERS

How to Steer Around the Fees of an Actively Managed Mutual Fund



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How to Steer Around the Fees of an Actively Managed Mutual Fund

Mutual funds that try to outperform the overall market tend to have to work hard, and thus they cost more than a vanilla index fund. But institutional wealth managers can find ways around some of the costs involved.

Savvy investors are starting to realize this bull run is getting long in the tooth.

They may not want to admit it — it's been a heck of a ride — but it's time to at least consider an attitude shift, and a switch from a passive, buy-and-hold investment -management strategy to an active one.

When a bear market occurs, it requires the kind of rigorous research and expert portfolio construction that active managers can provide. It takes some skill to manage risk and find opportunities during a correction. A passive approach may not be enough to help you reach your retirement goals.

Many investors use mutual funds to help pick stock winners and minimize risk. But be warned – the costs and fees associated with actively managed mutual funds can easily offset the benefits those funds can provide. The work that goes into either outperforming an index (such as the S&P 500) or minimizing risk comes at a cost.

Think about it this way: All that extra effort — watching the market, tracking trends and, potentially, more frequent trading — typically generates greater fees and expenses.

Some of those fees are covered in a mutual fund's expense ratio, and most investors know to check that number in the fund's prospectus. But other costs or issues that can hold back performance are harder to get a handle on, and they can eat up any advantage an actively managed mutual fund offers. They include:

-Operating costs: These expenses are identified in the fee table in the fund's prospectus and include management and administrative fees; fees paid for marketing and selling fund shares; and custodial, legal, accounting and other administrative expenses.

-Transactional costs: You will likely never see these expenses, as they are hidden and are net against your returns. (They typically are not included in the expense ratio.) Transactional costs not only include brokerage commissions but also the spread cost, which is the difference between the best quoted ask price and the best quoted bid price — a cost that can be difficult to quantify.

-Cash drag: A mutual fund typically holds cash to make redemptions and pending investments easier. Since stocks and other underlying securities of a mutual fund usually have a better long-term return than cash, holding back that cash tends to reduce the performance of the fund.

-Adviser fee: On top of those fees, your financial adviser is likely still charging you the standard fee of 1% of assets each year.

So, how can you avoid these fees and become more efficient?

Instead of recommending a mutual fund that is laden with all these expenses, many advisers are working directly with institutional wealth managers to bypass costs associated with the retail-brokerage market. Operating costs can be much lower, as advisers pay the institutional wealth managers for their signals and purchase securities directly in the client's account; transactional costs are minimized by using asset-based fees at the custodial level; and there typically is no cash drag, as there are no reserves required to "buy out" exiting fund holders.

Institutional wealth managers are the same skilled, highly educated professionals — finance Ph.D.s and Chartered Financial Analysts (CFAs) — who bring their expertise to managing mutual funds. But in lieu of working in a big building with high overhead, they offer their buy/sell signals directly to independent investment advisers. And this allows your adviser to manage your money on an active basis, using similar investment strategies for about half the cost, in some cases.

You can get the best of both worlds by actively managing risk while keeping fees and expenses low. Talk to your adviser about the fees in your mutual funds (or check them out yourself at http://apps.finra.org/fundanalyzer/1/fa.aspx), and ask if you can get around those costs by using institutional wealth management.

Take a proactive approach to securing your future. Don't let a bear market or high fees and expenses eat away at your retirement.

Kim Franke-Folstad contributed to this article.

Pete A. Lang is an Investment Adviser Representative and president of Lang Capital. Now retired from the public practice of law and accounting after 20 years, Pete specializes in assisting his clients with investment, retirement and tax-planning strategies.