A Closer Look: Mutual Fund Trading Costs - the Most Important Fee You've Never Heard Of?

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What if I told you that there is a fee present in mutual funds that is not included in the fund's published expense ratios and is often not publicly disclosed by the fund companies, since the SEC does not require its disclosure? You might laugh, but it is true. These added fees are known as trading costs.

Simply put, a mutual fund's trading costs are the costs a fund incurs from buying and selling securities. In general, the more often a fund buys and sells securities, the greater its trading costs. Trading costs are not reported as part of the fund's expense ratio. And, since the SEC does not require disclosure and trading costs are rarely disclosed in a fund's prospectus, good luck trying to find these costs! The SEC does require that the dollar amount of commissions (an element of trading costs) must be reported, but this information is often relegated to a fund's statement of additional information, a lengthy appendix to a fund prospectus that is only sometimes provided online. While some fund families translate the dollar amount of commissions into a percentage that can be added to the published expense ratio, others do not, making the investor do the math. Regardless of the level of disclosure, it is doubtful that the average investor will do the homework necessary to obtain this information.

How large is this expense? Commissions can range from less than one basis point (.01%) to over 1%. In fact, there are reported instances where the commissions actually exceeded the published expense ratio of the fund, essentially more than doubling the fund's true cost[1]! U.S. News and World Report reported an average total trading costs figure of 1.44 percent for all mutual funds, and a staggering 3.17 for the average small cap growth fund[2]!

While commissions are one component of trading costs, there are other factors that impact this cost, as well. These include:

- **Opportunity Costs** — When securities are traded, there are price fluctuations that occur prior to the trade execution. Thus, if the price fluctuation is unfavorable, there can be a missed opportunity cost resulting from not executing the trade at the most favorable price. By some accounts, opportunity costs are the largest component of trading costs.

- **Market Impact Costs** — Mutual funds typically make high-volume trades which can negatively affect the market for a security. This is known as market impact cost. The larger the trade relative to the outstanding shares of a security means the greater the potential impact and cost. It is important to note that the largest mutual funds typically only execute large trades. While these market impacts can be temporary, they can be long-term as well.

- **Bid-Ask Spread Costs** — When a security is traded, the trader (known as a fund specialist) sets the bid (buy) and ask (sell) prices for a security. The difference between the two prices is a cost that is retained by the fund specialist for the service provided.

Trading costs are generally higher for actively managed funds than for indexed funds, in particular, for actively managed funds with high turnover rates of their portfolio of securities (which, unlike trading costs, are required to be disclosed). This is due to the increase in commissions associated with turnover (since the securities turn over more, there is more trading). And, as noted above, trading costs are generally higher with smaller-capitalization funds (funds that invest in smaller companies) than with larger ones. It would be preferable if there was a correlation between higher portfolio turnover (i.e., higher trading costs) and investment performance, since an investor would essentially receive more "bang for the buck," however, the relevant studies do not link the two.

In fact, in terms of overall fund expenses, the evidence points to the opposite conclusion: the lower the fund cost, the better the performance. Cost is one of few reliable indicators of future fund performance. Of course, there are exceptions to the rule, but in general, it does not appear that more expensive fund managers justify their expense in terms of higher investment returns.

Why are these trading cost expenses not disclosed? According to a Wall Street Journal article, the SEC has historically cited difficulty in quantifying non-commission elements of trading costs, such as bid-ask spreads, market impact costs, and opportunity costs as a rationale for not requiring disclosure[3]. However, this fee is quite real, and, if sufficiently large, can be a major drag on investment returns (which, by the way, are reported net of all expenses, including trading costs).

Surprisingly, little has been reported in the media about the existence of these mutual fund costs. A Google search reveals only a handful of articles on the subject published in the last decade. Despite the lack of disclosure and publicity, plan sponsors need not be left in the dark about trading costs. Fund families can, and will, provide commission costs and even estimates of total trading costs to plan sponsors upon request.

Hopefully participants will someday know the true cost of the mutual funds in which they invest!

[1] Wall Street Journal: The Hidden Cost of Mutual Funds, March 1, 2010
[2] U.S. News and World Report: How Mutual Fund Trading Costs Hurt Your Bottom Line, March 4, 2013
[3] Wall Street Journal: The Hidden Cost of Mutual Funds, March 1, 2010

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