



Fees Matter

How investment costs drive bottom line results

Americans have an eye for value. We take pride in finding a clear, logical connection between what we pay for a product or service and what we receive in return. When we don't see that connection, we look elsewhere.

In many cases these value calculations and judgments are easy to make. It either adds up or it doesn't. Fifty dollars is far too much for a flimsy tee shirt, but about right for a beautifully prepared steak dinner in a warm and inviting restaurant. We buy or we don't buy, based on these fairly simple mental calculations.

In some cases, however, it is difficult to assess whether the value received justifies the price paid. This is especially true in the investment world. Consider this example:

On January 1, Richard entrusts ten million dollars to his financial advisor at one of the major national broker-dealers. At year-end, Richard's statement shows his balance has grown to \$10.5 million, a five percent increase. Richard wonders if he got a good value for what he paid in fees.

Good question. Let's take a look.

Some costs are clear

Richard's first step would be to examine the fees that appear on his statement, typically a management fee charged by the advisor for his or her work in managing Richard's portfolio. Generally expressed in basis points, management fees are based on portfolio size. Eighty basis points, for instance, would amount to \$80,000 on Richard's ten million dollar portfolio.

So Richard paid his advisor \$80,000 to generate \$500,000 in portfolio growth. If this was all there was to it, Richard could make a rational value judgment about what he paid for what he got. But it is far from that simple. Richard paid other fees that do not appear on his statement.



Some costs are invisible

The advisor's statement lists only fees and charges levied by the broker-dealer directly to Richard. But these are not all of the costs. Other expenses incurred to invest Richard's assets are deducted from the performance of his investments. The costs are paid with his money, but he never sees them. Here are some examples:

- **Commissions:** When a money manager buys or sells stocks, the trades are routed back through the broker-dealer where Richard opened his account. The broker charges the money manager commissions on the trades, which the manager pays with Richard's money.
- **Manager fees:** Money managers also charge quarterly fees based on portfolio size. Again, these fees are deducted from performance, not itemized on the statement. Index fees cost less and active manager fees cost more.
- **Soft dollars:** In exchange for commissions, the broker-dealer may reward the manager with (perfectly legal) "soft dollars" to pay for research and technology services. Either way, it's Richard's money being used as compensation from the broker-dealer to his money manager, with no apparent benefit for Richard.
- **Markups:** When municipal bonds are purchased, they are deposited in Richard's account at a higher cost than the actual transaction cost. The broker keeps the markup. The same happens when the bonds are sold – the proceeds that Richard's account receives are less than the actual transaction price. The broker keeps the markdown.
- **Sales charges:** When the advisor directs assets to money managers for so-called "hot" investment products, such as private equity or hedge fund opportunities, a sales charge is often applied. Like a cover charge at a nightclub, these fees – which only earn the payer the "right" to invest – reduce Richard's return but do not appear on the statement he ultimately receives.

Commissions, sales charges, manager fees, soft dollars and markups, although they are not likely to appear on any statement that reaches the investor, are nonetheless just as real as any management fee or other charge that investor does see. They reduce gains and accentuate losses.

These charges can easily add up to 50 to 100 basis points, reducing the investor's account value by .5 to 1 percent each year. What's this mean for Richard? There are two ways to look at it. First, the \$80,000 in fees shown on



his statement understates his true expenses by \$50,000 to 100,000. Or second, the \$500,000 return on his portfolio would have been \$50,000 to 100,000 higher without these hidden fees. Either way, Richard’s end-of-year balance was reduced by tens of thousands of dollars through fees and charges he had no idea he was paying. Not knowing these fees, he’s unable to make a valid judgment regarding the value he received.

Because these hidden charges are, well, hidden, due diligence is essential. Fee policies vary widely, so all investors should ask about commissions, markups, soft dollars and other fees they may be paying. For the most part, these are discretionary and unnecessary charges. Meant primarily to support the high overhead expenses of large brokerages and sales forces, these costs produces little if any value for the investor. Investors deserve to know how their assets will be invested and spent; asking questions is critical.

The fiduciary standard

When asking these questions, the answers of Registered Investment Advisors (RIAs) are likely to be quite different than those of large brokerages. RIAs are fee-only advisors, meaning the only income they derive is through fees paid directly by the client. RIAs are held to a fiduciary requirement, which means that the advisor is *legally bound* to make investment decisions that are in the best interest of their clients. A Registered Investment Advisor must disclose any real or potential conflicts of interest. Brokerages, not bound to a fiduciary standard, are free to put their own interests ahead of clients’.

	Osbon Capital Management	Other advisors
Sources of income	Management fee only	?
Management fee	80-60-40 basis points, based on portfolio size	?
Trading costs / commissions	none	?
Markups on bond trades	none	?
Soft dollars	never	?
External managers’ fees	fully disclosed	?

RIA fee structures are generally more investor-friendly than found at large brokerages. For instance, RIAs do not charge markups on muni bonds. Nonetheless, many RIAs do pay commissions and pass them on to investors. Many participate in soft dollar compensation (paid from investors accounts).



By avoiding several layers of costs and overhead, some RIAs improve bottom line investor returns, all other things being equal. (This framework also aligns investor and advisor interests – when the investor’s account grows, so do the fees paid to the advisor.) Still, it is just as important to query RIAs on fee policies as any other financial services provider. This is definitely an area where knowledge is not just power; knowledge translates into less waste and higher account balances.

The OCM difference

Osbon Capital Management is a Registered Investment Advisor operating as a multi-family office. Cost control and transparency are high priorities for our business model and our clients. We know that by reducing costs, we increase total return for our clients.

We welcome a thorough and open discussion of this critical topic.

Investors have many choices in how and where their assets are invested. No single choice is ideal for all investors. But a clear understanding of the costs of investing, how they are paid, and who receives them is essential for any investor seeking to optimize returns.

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