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## Is Your Clients' Financial Toolkit Complete?

Why passive funds cost less, yet continue to perform better.

by *Neal Frankle, CFP*

*DISCLOSURE: Readers should assume that all funds mentioned in this column are owned by the author and/or his firm unless otherwise noted.*



**Neal Frankle**

When I was very young, maybe eight or nine years old, my father used to have me help him work on the family car. I used to love it when we had to install brakes, because I got to crawl under the car and help "bleed" the air from the brake system. Before we crawled under the car, we carefully chose the tools we'd need. I learned the hard way that it would take much longer to get the job done if we didn't have the right parts and the right tools at the ready. I was lucky to learn the value of having the right "tools" as a young boy and I applied that lesson to many life challenges — among them, investing.

Today, few people work on their own cars. Maybe that explains why so few understand the need to have the right "tools" when it comes to investing. For example, few investors understand the different "tools" available in the mutual fund "tool box" and as a result lose out.

Let me explain.

There are two broad classes of mutual funds; actively managed funds and passively managed funds.

If your clients' investment advice comes from a large brokerage firm or bank, they are probably most familiar with actively managed funds. Actively managed funds have a manager or management team and they usually have an expensive research team to help the managers decide what to buy and sell. In fact, managers of actively managed funds usually do lots of buying and selling and that costs your clients a pretty penny as you'll see in a moment. If your clients' financial toolkit is full of actively managed funds, their financial car might only be operating on three cylinders. What are the challenges with these types of funds? Plenty.

According to John Bogle, the former chairman of Vanguard Mutual Funds, the average expense associated with actively managed funds exceeds 1.5 percent. That means, if your client invests \$100,000, the fund manager takes \$1,500 every year for the privilege of investing your money. The fund collects management expenses even if it's a no-load fund. Your clients can call their fund company and ask them what the management expense is for their funds. But don't let them stop there.

Have the client ask what the turnover of the fund is while they are at it. The turnover is the number of times stocks in the portfolio

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are bought and sold. Now you'd think a big fund could buy and sell stocks cheaper than an individual, but believe it or not, they can't. Actually, it costs them more money to buy and sell than it costs you or anyone else. Why is that? Let me demonstrate. Assume XYZ stock is trading at \$65 per share. When you buy 100 shares of XYZ, you can buy those shares without moving the price. One hundred shares isn't even a blip on the radar screen and you'll get your shares at \$65 most likely. But when your fund buys XYZ, they don't just buy 100 shares. An average size fund might need to buy 100,000 shares. And what happens when your fund buys 100,000 shares of XYZ stock? They force the price up. They get the first shares at \$65 but they have to bid more to get the large number of shares they need. By the time they are done buying, the average price might go up to \$67 or higher. Why should you care about that? Only because this trading costs investors a fortune. Remember, turnover is just jargon for the number of times stocks are bought and sold in the fund. Bogle says the average fund turnover is 100 percent and that adds another 0.6 percent to the cost. So, in our example, if you have \$100,000 in your fund and the turnover is 100 percent, this costs you an additional \$600 per year. Let's look under the hood for a minute.

That's \$1,500 for "management" and \$600 for turnover — buying and selling costs. The total cost to own that fund are \$2,100 every year and that's before they made you a nickel in profit.

So if actively managed funds occupy a lot of space in your clients' toolbox, I hope I've convinced you its time for them to get some new tools. Specifically, I hope they'll consider passively managed funds.

These funds are commonly referred to as index funds. They are mutual funds that buy the stocks that make up a particular index. If the index is the S&P 500, the index fund will buy all 500 stocks that make up that index. If the index is the NASDAQ 100, can you guess what stocks the index funds buys? You are right! The 100 stocks that make that index. Another type of passive index fund is the exchange traded fund (ETF). These are almost identical to the index funds exceed their costs are even lower than index mutual funds. Also, the ETF trades like a stock so it can be bought and sold real time during the day.

Passive funds (or ETFs) don't have fancy expensive managers or research teams. They don't need them because all they do is hold the stocks that make up that index. Almost no buying and selling is involved. As a result, the expenses associated with index funds and ETFs are a fraction of the actively-managed fund expenses. On average, the passive fund or ETF has a total of 0.25 percent for all their expenses. In other words, \$100,000 in a passive fund might cost you \$250 whereas the typical actively-managed fund will charge you \$2,100 yearly.

And to put the screw in the driver, most actively-managed funds fail to outperform the average index fund or ETF. Let me say that again. **On average, actively-managed funds (the expensive ones) fail to outperform the passive funds (the least cost alternative).**

So, if we add this up, we find that the passive funds cost less and perform better. Why don't the brokerage houses and banks tell you this? Because they are the ones raking in the management fees, that's why. They can't afford to tell you. But too bad for them because now you know about them and hopefully, you'll tell all your clients.

My suggestion is that you investigate index funds and ETFs as low cost alternatives to expensive actively-managed funds if you want to save money and help your clients have better potential investment performance.

*[Neal Frankle](#) is the author of Why Smart People Lose a Fortune: 5 Steps to Restoring Your Wealth and Sanity. He helps affluent clients establish and implement a safety-net strategy to protect their wealth. He also helps other professionals, such as CPAs, do the same for their clients.*