

# FINANCE & BANKING

## Is Your Financial Tool Kit Complete?

By Neal Frankle, CFP®

When I was young, maybe eight or nine years old, my father started having me help him work on the family car. I used to love it when we'd install brakes because I got to crawl under and help "bleed" the air from the brake system.

In addition to being first-rate boyhood fun, working with my father on the car taught me this life lesson: always get your tools in order first. Before we shimmied under the chassis, we always carefully chose what we'd need and pushed the tools into place or carried them under on our bellies. It was a lot of prep work, but it would take much longer and get much dirtier if we had to keep scooting around on the ground and scrounging for the right tools while we were in the middle of the job.

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 what's available in the mutual fund "tool box"-and lose out as a result.

Let me explain. *There are two broad classes of mutual funds: actively managed and passively managed.* If you get your investment advice from a large brokerage firm or bank, you 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 you a pretty penny, as you'll see in a moment. If you have only actively managed funds, your financial life may need a tune-up.

What are the problems with these funds? Plenty.

First, 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 you invest \$100,000, the fund manager takes \$1,500 every year for the privilege of investing your money. Your fund collects management expenses even if it's a no-load fund. You can call your fund company right now and ask them what the management expense is for your fund and they'll tell you. But don't stop there.

While you're at it, ask them what the turnover is. The turnover is the number of times stocks in the portfolio are bought and sold. You'd think a big fund could buy and sell stocks cheaper than you could buy and sell stocks, but believe it or not, they can't. Actually, it costs them more money to buy and sell than it costs you.

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. A 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 buy just 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 and 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. This is known as slippage.

Why should you care about that? Only because this trading (slippage) costs you a fortune. Remember, turnover is just jargon for the number of times stocks are bought and sold in the fund. According to Bogle of Vanguard, 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.

Take a look under the hood: That's \$1,500 for "management" and \$600 for turnover, or buying and selling costs. The total cost to own that fund is \$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 tool box, I hope I've convinced you its time to get some new tools. Specifically, I hope you'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.



Passive funds don't have expensive managers or fancy research teams. They don't need them, because all the index fund does is hold the stocks that make up that index. Almost no buying and selling. As a result, the expenses associated with index funds are a fraction of the actively managed fund expenses. On average, the passive fund 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. Read 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. And you didn't even have to get dirty to find out.

*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. To receive a free report on how to find the best funds, email him at [Neal@WealthResourcesGroup.com](mailto:Neal@WealthResourcesGroup.com).*