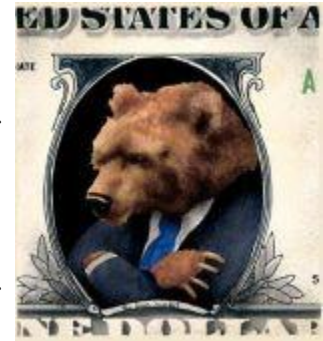


Bear Market Defense

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A friend of mine is climbing a wall of worry about her recent poor portfolio returns. She asks, "Is there anything I can do to defend myself against lower returns when the market slumps?" Happily, the answer is yes.



As the stock market goes down, expenses take a bigger cut out of return. For example, a 1.5% expense ratio from a 10% return leaves 8.5% left for the investor. But 1.5% from a lower return, say 7%, leaves only 5.5% for the same investor. Note that the expense ratio is the same, but because of the lower return in the second example, the investor puts much less in her pocket. This is because 1.5% for expenses is a bigger cut from 7% than from 10%. Precisely, a 1.5% expense ratio divided by a seven percent return is $1.5/7$ which equals 21% for expenses. On the other hand a 1.5% expense ratio divided by a ten percent return is $1.5/10$ which equals 15% for expenses, a considerably lesser number. Obviously, what you pay in expenses can make a big difference in your return, and even more so when the market is down.

This begs the question: What are you paying in expenses? More than the typical fee?

- The average managed mutual fund expense ratio is 1.3%. This does not include the cost of turnover within the fund that is also charged to the investor, although this fee is not apparent because it is taken off or added on to the sale or buy cost respectively. Nevertheless, it makes the total expense more.
- Money management fees for a private investment advisor or equivalent usually run 1% to 2%, and can be higher. Again, this does not cover any cost of turnover due to manager trading, which increases the total expense.

Are you paying any load? If you are in a managed mutual fund, did you pay a load up front, or will you be paying a load at the back end if you don't keep the fund long enough? Either of these factors increases your total monetary outlay.

What about 12b-1? If you are in a managed mutual fund, are you paying a continuing 12b-1 expense, the purpose of which is for the fund to market their product to obtain more clients? Although the yearly charge is small, often 0.25%, when it compounds over time, the debit from your return becomes substantial. Think of the 12b-1 as your involuntary charitable contribution to the fund, one that you wouldn't have to pay had you chosen a different option (one without the 12b-1 charge). Is this really something you want to do?

Compare the mutual fund and private manager examples below to the index fund (top below) that charges 0.20% expense ratio and 0.20% for turn over. Its turnover expense is less because

index funds match the market and don't try to 'beat' it by trading as does the managed mutual fund and private managers. The total cost of the index fund is 0.40%. If the return on each fund below is 7%, the money the investor puts in his pocket is 6.60% for the index instead of 4.55% from a managed mutual fund or 5.0% from a private manager, a difference of 2.05% in the first case and 1.60% in the latter. Over time, other hands dipping into investors' pockets take a substantial percentage out. It can amount to hundreds of thousands of dollars in the wallet of someone other than the investor as the account grows in size.

Example:

Index fund ER*	0.20%
Turn-over cost	0.20%
12b-1	none
Total cost	0.40%

*ER is expense ratio

Example:

Mutual fund ER	1.50%
Turn-over cost	0.70%
12 b-1	0.25%
Total cost	2.45% (If there is a load, the cost is higher)

Example:

Private Manager	1.50%
Trading costs	0.50%
Total cost	2.00%

There are sophisticated cost calculators on the Internet that can help with the expense ratio and load number crunching. One added benefit is that some calculators figure not only the dollar cost of the expense ratio, but also its foregone earnings, which would otherwise go into the investor's pocket as well.

For example, I figured the cost of the index fund and managed mutual fund on the website of the SEC using their cost calculator. Both funds were assigned the same rate of return and no load. The only difference was the expense ratio. The negative effect of turnover was not figured in, but the higher turnover in the managed mutual fund would make its numbers look even worse. The private manager results, based on the expense ratio alone, would be the same as the managed mutual fund.

I used a 10 year investment period for one hundred thousand dollars at 7% return for each example. The expense ratio was 0.20% for the index fund and 1.50% for the managed mutual fund.

Note that the total cost of the index fund was \$3,899.08 (2,927.00 for fees and 972.08 in

foregone earnings).

The total cost of the managed fund was \$27,593.15 (20563.63 for fees and 7029.51 in foregone earnings).

The total cost of the managed fund was approximately seven times the cost of the index fund.

That increased cost took its toll on the return of the managed mutual fund. Its return was \$169,121.99, compared to \$192,816.05 for the index fund. That's a difference of \$23,694.06 lost to the investor because she used a managed mutual fund instead of a comparable index fund.

The example for the private money manager would be similar.

The total cost of holding index fund would be \$3,899.08

The cost is the sum of the total fees paid plus the foregone earnings.

$\$2,927.00(\text{fees}) + \$972.08(\text{foregone earnings}) = \$3,899.08$

This result is based on the following information:

The dollar amount invested is: \$100,000.00

The annual rate of return is: 7%

The total annual operating expense is: 0.20%

The holding period in years is: 10.

At the end of the holding period, this investment will equal \$192,816.05.

The total cost of holding managed mutual fund would be \$27,593.15

The cost is the sum of the total fees paid plus the foregone earnings.

$\$20,563.63(\text{fees}) + \$7,029.51(\text{foregone earnings}) = \$27,593.15$

This result is based on the following information:

The dollar amount invested is: \$100,000.00

The annual rate of return is: 7%

The total annual operating expense is: 1.5% The holding period in years is: 10

At the end of the holding period, this investment will equal \$169,121.99.

There are other websites that determine the effect of expenses on your return as well. One is from the Financial Industry Regulatory Authority (FINRA). It offers side by side expense ratio comparisons for mutual funds and exchange traded funds (ETFs) including the effect of loads (share class designation).

Perhaps the extra expense would be alright if it was justified by better market returns, but statistics indicate this is not the case. Only 20% of managed mutual funds outperform their relevant index in any one year, and over time the results are even poorer. Is there any reason to think that private money managers do any better?

As Warren Buffet says, "Chains of habit are too light to be felt until they are too heavy to be broken." This applies to investors who ignore fees when the market is up, but can't afford to ignore them when the market is down. It is the foolish investor who doesn't pay attention to one of the few things he can control in any market—whether it is down or up.

