ROCHESTER BUSINESS JOURNAL
RBJ
VOLUME 30, NUMBER 2 WWW.RBJDAILY.COM APRIL 11, 2014

High fees, expenses and taxes can drain long-term returns

VIEWPOINT
Mark Armbruster

With winter finally winding down and the holidays squarely behind us, I'd like to say something very Grinchy: It is actually better to receive than to give. This may sound like blasphemy, particularly in Rochester, a city renowned for its philanthropy. But I'm not talking about charitable giving. I'm talking about your investment portfolio.

Too often, investors make decisions about their money without regard to expected return and the costs involved in earning that return. It is important to focus on earning the best possible return, but it is equally important to focus on keeping that return. Unfortunately, it is rare for investors or even investment professionals to take that additional step. The costs inherent in the investment process can be steep, in some cases confiscating the majority of your return.

For example, several years ago I did a trade for a client who required that I use his broker, who was a friend of his. It was a large trade, but very simple. I sold $1 million worth of an exchange-traded fund and immediately purchased $1 million of another, similar fund. The brokerage commission for these two trades was $10,000. The same trades, executed at a discount brokerage firm, would have cost less than $20. That friendship cost the client a bundle.

Unfortunately, this is not a rare occurrence. Recently I spoke with an investor who has an investment portfolio worth about $2.5 million. He is paying investment management fees of 2 percent annually. I pointed out that his fees seemed quite high for a portfolio of that size and showed him how he could cut his fees by half. Ultimately, he decided not to make any changes because his adviser belonged to the same country club and it might have created an awkward social situation. Using a very modest return assumption, I calculated that paying the higher fee level will cost the investor more than $1 million in lost earnings over the next 20 years.

Clearly, the impact of high fees can be significant. A study published in the most recent *Financial Analysts Journal* found that investors in traditional, actively managed portfolios are likely overpaying by 2.2 percent annually. Compounded over many years, the potential impact of this on your long-term wealth is astounding.

As insidious as investment fees and expenses can be, the bite from taxes can be even worse. In fact, a portfolio managed without regard to the impact of taxes could give up 40 percent or more of its annual return. Aggressive trading, not properly using retirement accounts and forgetting to harvest tax losses can all result in significant after-tax performance lags.

Consider the following: The average annual return of the stock market since 1926 has been 10.5 percent. If you subtract 2 percent for total investment costs, 2.5 percent for taxes (assuming a 30 percent tax rate), and 3 percent for the impact of inflation, you are left with only a 3 percent real return. That means that while you took all the risk to earn a double-digit return, you net only 30 percent of it. The majority of the return goes to financial intermediaries, the government and a loss of purchasing power. That doesn't seem fair.

There are, of course, ways to reduce fees and taxes. The first is to recognize the myriad fees involved in the investment process. If you work with a full-service broker or an investment adviser, you are surely paying a fee for their services. If you are using mutual funds in your portfolio, they also levy management fees, which are deducted from your returns. Trades executed in your account may incur commissions that accrue to the custodial firm that holds your account. These can be significant, as we saw in the example above. Finally, there are implicit costs in the investment process, such as the bid/ask spread when doing trades, the "market impact costs" those trades incur, and also cash drag, or the opportunity cost of not having your funds fully invested.

Some of these costs are easy to identify, but others are more difficult and must be estimated. However, knowing what the fees are might allow you to negotiate a better deal with your adviser, invest in funds with lower costs, and perhaps trade less frequently to reduce trading-related costs. The adage that you get what you pay for does not hold in investing. In fact, it is the opposite. Anything you pay out in costs will reduce the return you earn. Costs at all levels must be carefully managed.

The same is true of taxes. There are two primary sources of tax liability in the investment process: income from bond interest and stock dividends, and capital gains. It may not be desirable to reduce the income your portfolio generates, but you can be smart about where you generate it. Income is generally taxed at ordinary income tax rates, which can be quite high. So, if possible, hold income-producing investments, like bonds and REITs, in your retirement accounts. That way the income is shielded from tax until you start to draw funds from the portfolio, after you retire.

Capital gains taxes generally are much easier to control, because you have discretion over when you sell an investment and thus incur tax. At a minimum, investments should be held for more than 12 months to take advantage of the generally more favorable long-term capital gains tax rate. However, reducing your portfolio turnover dramatically is an even better idea. High levels of trading have been shown to reduce your returns, largely because of the fees and taxes involved. Holding a broadly diversified portfolio for the long run is generally the best course of action.

The investment industry is one of the most profitable and richly compensated. CEOs of large investment banks routinely earn salaries in excess of $20 million. Successful analysts, portfolio managers and salespeople can earn well into the seven figures. These people are not needy and not worthy of your charity. So while it may be better to give than to receive, this philosophy is best reserved for your philanthropic interests and kept out of your investment plan.

Mark Armbruster is president of Armbruster Capital Management Inc.