Investors may be paying excessive and unnecessary costs to invest in high-fee funds when markedly lower-fee versions are available, says WSJ Wealth Expert Micah Hauptman of the Consumer Federation of America. PHOTO: GETTY IMAGES/ISTOCKPHOTO

By MICAH HAUPTMAN
Dec 4, 2016 10:02 pm ET

Micah Hauptman (@MicahHauptman) is the financial services counsel for the Consumer Federation of America.

Are you paying more than you should be for your mutual funds? Could you purchase essentially identical alternatives for much less money?

The answer to both questions appears to be yes. Newly released academic research provides compelling evidence that many investors are, in fact, paying excessive and unnecessary costs to invest in high-fee funds when markedly lower-fee versions are available.

Typically in competitive markets, close-to-identical products have similar prices. However, in the mutual-fund industry, there are often significant price differences for similar if not identical products. This mutual-fund fee dispersion phenomenon previously has been documented in several academic and empirical studies for S&P 500 index funds and money-market funds. The excess costs that an investor pays for these essentially identical funds doesn’t lead to better performance; in fact, it’s just the opposite. The excess costs
only serve to reduce the investor’s returns and pad the fund manager’s and fund company’s pockets.

Newly released academic research provides further evidence of fee dispersion in the mutual-fund industry. The authors first update the existing research regarding S&P 500 index funds and find economically significant and persistent fee dispersion for these funds during the past 15 years. For example, the authors find an average reported spread in costs between the lowest- and highest- (10th and 90th percentile) cost S&P 500 index funds to be 1.16 percentage points annually since 1999.

In other words, an investor who made the “wrong” choice would end up paying more than one percentage point extra annually for the “privilege” of seeing her performance reduced by an equivalent amount, as compared with investing in one of the lowest-cost versions. The authors describe these cost differences as “stunningly large.”

Perhaps more significantly, the authors find that economically large fee dispersion is not limited to S&P 500 index funds. Rather, this fee dispersion phenomenon extends across the entire U.S. equity-fund industry, including the largest funds representing almost 85% of the market value of the fund universe. Furthermore, fee dispersion has increased notably over the past 20 years.

When the authors compared costs based on different funds’ shared characteristics, including performance, risk and other features investors are likely to care about, they found the average annual spread in excess costs between the lowest and highest cost U.S. equity funds was 1.25% since 1990. The authors found qualitatively very similar results when they compared costs based on different funds’
overlapping holdings, reflecting their shared exposure to the same underlying assets.

Thus, just as with S&P 500 index funds, an investor could end up paying more than 1% extra annually and get nothing in return for that added cost. In fact, she would see her net-of-fee performance reduced by that amount.

At first blush, a cost difference of 1% may seem insignificant, but small differences in investment costs can add up over time. According to the authors, for example, a hypothetical investor who purchased the lowest cost version of funds would have earned more than 70% higher returns net of fees than an investor who purchased the most expensive version of funds over their 49-year sample period, from 1966 to 2014. Put simply, an investor who purchased the highest cost version of funds would be handing over those higher returns to the fund manager and fund company.

According to the authors’ back-of-the-envelope calculations, the largest funds in the industry stripped an average of $2.1 billion per year from investors in excess revenue over the sample period. And in 2014 alone, the largest funds took nearly $7 billion in excess revenue from investors.

Despite the fact that many investors are increasingly sensitive to fees, the current approach to mutual-fund cost disclosure is clearly insufficient to encourage all investors to make the most cost-conscious decisions. New approaches to mutual-fund cost disclosures must therefore be a top priority for the Securities and Exchange Commission in the next administration.

Putting in place a 21st Century approach to mutual-fund disclosures will help investors more easily and effectively compare funds’ costs, enable investors to better understand how the different costs of comparable products can make meaningful differences in their overall returns, and aid them in making better choices when purchasing products. It will also encourage market competition that ultimately reduces fee dispersion and lowers investors’ costs.

Read the latest Investing in Funds & ETFs Report.