

## Funds That Charged Less Offered More: Study

**As Washington wrestles** with new rules over how much a mutual fund can charge, new research shows the funds that have been charging the least have offered some of the best returns.

Lower costs were a better predictor of good fund performance over a five-year period than a star-rating based on the fund's actual returns and volatility, according to a recent study by industry firm Morningstar.

The analysis pitted Morningstar's own star rating system against expense ratios. The study concluded the star system can be helpful in identifying funds that might be merged out of existence but that "investors should make expense ratios a primary test in fund selection." The ratios "are still the most dependable predictor of performance," writes Morningstar's director of mutual fund research Russel Kinnel.

Morningstar tracked funds during different periods between 2005 and 2010 and found that in every asset class over every time period, the least expensive quintile – the bottom 20% -- produced higher total returns than the most expensive 20%. Domestic equity funds in the lowest 20% by cost in 2005 returned an annualized 3.35% over the next five years, compared with a 2.02% return for funds in the most expensive quintile.

"If there's anything in the whole world of mutual funds that you can take to the bank, it's that expense ratios help you make a better decision," concluded Kinnel. "In every single time period and data point tested, low-cost funds beat high-cost funds."

Industry firm Financial Research Corporation declined to comment on the results of the study.

The debate over whether cheaper funds make more money is decades old, yet the study honed in on a particularly volatile period for the market.

The five-year period used by Morningstar was fairly representative because it included a variety of market conditions, says John Rekenhale, vice president of research at Morningstar. Still, the firm plans to perform a similar analysis over multiple time periods with multiple ending dates, he says. (The research published this week included various periods but only one ending date.)

Bill Houck, a financial advisor and certified financial planner at Modera Wealth Management, says the last five years have been particularly tough on equity funds, and those that maintained lower costs produced a higher compounded return over time, leading to more wealth in the person's pocket.

Houck added that the study's results should not be considered unique to that time period. "The data I've always seen have shown that lower costs in mutual funds make a difference in performance over time," he says, adding that "costs are certainly a very important component."

### What do the higher costs buy?

For financial advisors, the question of price vs. performance speaks to a larger debate: index funds, which tend to be cheaper, vs. actively managed funds, which are typically more expensive.

Some advisors say index funds will always hold the edge. "Study after study has shown that most managers can't justify the cost of the fund over time," says Houck, who stays away from funds with an expense ratio greater than 0.5%.

The study didn't look at actively managed funds vs. indexed funds, says Morningstar's Rekenhale. It just offers support to lower cost funds. "The advantage of an index fund is that it's low cost," he says. "But if you're comparing a low cost index to a low cost active, it's a matter of preference."

Others advisors maintain actively managed funds can offer value. The argument for lower cost index funds is essentially that no one is smart enough to beat the market, says Keith Amburgey, an advisor with Rutherford Asset Planning. Amburgey doesn't buy that argument. He tends to steer clients toward funds that average expenses of less than 1.0%, but he says investors "can find good managers in the 0.75% to 1.25% range."

Take **Van Eck Global Hard Assets (GHAAX<sup>1</sup>)**, with a ratio of 1.46%, the most expensive fund offered through Rutherford Asset Planning. It's ranked second in its category for the last five-year period and has ranked in the top 30 for the past 15 years. The fund specializes in natural resources, and a portion of its expenses goes to an expert team that includes a geologist, he says.

Houck says some actively managed funds maintain low expense ratios, as well.

### How to evaluate a fund.

For investors looking to assess funds on their own, Morningstar's Kinnel says to hone in on the cheapest 20% to 40% of funds.

However, he adds that sizing up cost is only the first step. Kinnel urges investors to study a fund's other fundamentals. "Don't look for the 10-second answer," he says. "You should understand management, strategy, and stewardship, too, before you send in your check."

For investors set on a pricier fund, like the Van Eck Global Hard Assets fund, Amburgey offers three tips:

- (1) Look at different time periods and markets. For instance, compare 2008 to 2009 because they represent drastically different environments.
- (2) Try to weed out luck from skill. If a fund's success came by heavily investing in one sector, consider whether gain came after a change in strategy or whether the fund was merely in the right place at the right time.
- (3) Get personal. "You have to get to know the fund managers themselves," he says. "It can be worth it if you find someone you believe is truly talented and has a good team."

## Same fund. Different expenses.

Some investors take share classes for granted when considering price and performance, advisors say. The same mutual fund will come with a different price tag and net return, depending on which share class an investor buys. For example, C-shares come with added expenses.

Amburgey says his firm occasionally buys the institutional class of shares – which has a lower expense ratio and is sold in larger amounts – when the transaction can service multiple clients.

A fund's fees are also affected by how an investor buys it. Whether the investors used a broker – and whether that broker works on a fee-only or commission basis – can affect the fund's net cost.

Morningstar's Rekenhale said the study took into account different fees for different share classes, but he said the firm couldn't account for indirect fees, which impact an investors' return.

"Whether investors know what they are paying is a different issue," he says. "We can only see the official costs, those associated directly with the fund."

<sup>1</sup><http://www.smartmoney.com/quote/GHAAX/>

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