Do You Really Know the <u>True</u> Cost of Your Advisor?

Many advisors fail to reveal the total costs to clients.

By Ric Edelman

Diversification. Asset allocation. Portfolio optimization. Sharpe ratios. Modern Portfolio Theory. The efficient frontier. The Fama-French Three Factor Model.

When it comes to making investment decisions, many consumers know they are ill prepared to do it themselves. That's why you're smart to turn to a financial advisor for help. A talented, dedicated advisor can help you develop a portfolio that's suitable and appropriate for your situation, one that's designed to meet your goals and can generate higher returns at lower risks — and with less work — than you are likely to obtain on your own.

But how much does it cost to work with a financial advisor? This article will tell you.

As I explained in *The Truth About Money,* you should always ask how advisors are compensated. Unfortunately, if that's *all* you ask, you might not be told the whole story. That's because there's often a big difference between *what they earn* and *what you pay.* Therefore, instead of asking, "What is your compensation?" you should ask, "What are the <u>total costs</u> I will incur by working with you?"

You see, when your financial advisor provides you with a portfolio of funds, you'll incur not one cost, but three. So it's vital that you receive full disclosure — otherwise, you might end up paying far more than you should, and far more than you realize.

First, of course, is the advisor's fee. Known as an *asset management fee,* it is generally expressed as a percentage of assets. At some firms, the asset management fee is as high as 3% per year (the maximum fee for the Edelman Managed Asset Program is 2%, and larger accounts pay a lower fee). Usually, one-fourth of the fee is debited from your account each quarter. Most firms assess the fee in advance, which means your account is debited January 1 for the services you'll receive from January 1 through March 31. (By charging you in advance, less of your money is invested, reducing your profit potential. That's why the EMAP fee is collected at the end of the quarter, after you have received services for the quarter.) Financial advisors provide complete details on their fees in Form ADV (Part II & Schedule F), a federal disclosure document that each advisor is required to provide to you.

But the asset management fee is not the only cost you'll incur. In addition to paying for your advisor, you must also pay for the funds your advisor has recommended, and this is where you'll find two other costs: fixed expenses and variable expenses.

Fixed expenses are included in something called the *Annual Expense Ratio.* Every mutual fund and exchange-traded fund charges this fee — even so-called "no-load" funds. ("No-load" means there are no commissions when you buy or sell shares; it does not mean "no fee.") The expense ratio pays for the fund's recurring operating costs, from the manager's salary to the toll-free phone number investors call to talk to customer service representatives. According to Morningstar, the average expense ratio is 1.56% per year, although many are more than 2%. The highest in the industry is a staggering 15%!

Although the expense ratio is expressed as an annual figure, it's actually debited on a daily basis. But fund investors never notice it, because the charge does not appear on monthly statements. To find it, you must look in the fund's prospectus, where the expense ratio is expressed as a percentage.

Many investors — and, astonishingly, even many

over

investment advisors — think the annual expense ratio covers all fund expenses. But it doesn't. The expense ratio covers only perennial fixed costs — salaries, marketing, overhead and the like. But there are many variable costs to operating a fund, and these are excluded from the expense ratio.

The biggest variable costs are brokerage commissions and trading expenses. Whenever the fund manager buys or sells a security, he pays brokerage commissions — just like you would, if you were to buy or sell a stock or bond. Of course, funds pay lower commission rates than you would pay. Even so, considering that funds trade millions of shares representing billions of dollars, their trading costs are huge — and the more the fund trades, the more it spends on brokerage commissions. Typically, funds spend tens of millions of dollars in trading costs per year, *and these expenses are not included in the Annual Expense Ratio or even disclosed in the prospectus*. To find these and other expenses, you must look in the fund's Statement of Additional Information.

Good luck getting a copy from your advisor. Unlike the prospectus, advisors are not required to provide this statement to you. As a result, clients virtually never see one. In fact, from my years of training financial advisors across the country, I can tell you that most advisors themselves have never even heard of the SAI. Yet the fees it discloses can equal or even *exceed* the Annual Expense Ratio. Until recently, you had to ask fund companies to mail you their SAIs. But thanks to the Internet, you can now find these documents at most fund company Web sites.

SAI expenses are difficult to determine, but a 2007 analysis by Virginia Tech, the University of Virginia and Boston College revealed that the average SAI charge is 1.44% per year. This is in addition to the 1.56% charged by the average Annual Expense Ratio. In other words, the total charge of the average mutual fund is 3.00% per year.

By adding this to the advisor's fee, you can see that ordinary investors often incur total annual costs of 4% per year.

So be careful when asking an advisor what he charges. If he says, "My fee is 1 percent," he might be technically correct — although the claim would be omitting the Annual Expense Ratio and SAI charges that you'll also incur. So when you are interviewing potential advisors, make sure they tell you the *total* costs you'll pay to work with them.

The Costs of Working with a Financial Advisor

This chart shows you the annual costs, assuming a $250,000 account.
You can compare the Edelman Managed Asset Program with other advisors.

	Industry Average	EMAP
Advisor Fee for $250,000 Account	1.39%	1.86%
Annual Expense Ratio	1.56%	0.33%
SAI Charges	1.44%	0.07%
Total	**4.39%**	**2.26%**

Sources: Virginia Tech, University of Virginia and Boston College; Morningstar; Tiburon Strategic Advisors; Edelman Financial

Note: This chart and the accompanying article refer to advisors who recommend mutual funds and exchange-traded funds to their clients. If your advisor recommends individual securities such as stocks and bonds, a private money manager or a separately managed account containing individual securities, you must be careful that you are being told the total costs of such arrangements, which can include management fees, brokerage commissions, trading expenses and other fees.