

The *Real* Cost of
Your Advisor

**Instead of asking,
“What is your fee?”
you should ask,
“What are the total
costs I will incur by
using your services?”**



WHAT EVERY INVESTOR SHOULD KNOW: THE REAL COST OF YOUR ADVISOR

By Karl N. Huish, Esq., CFP®

We see a doctor when we are seriously ill, or a lawyer when we need an important legal document drafted. Likewise, most investors turn to professional financial advisors to develop, implement and maintain a suitable investment portfolio. The right advisor can help you invest in a portfolio that’s appropriate for your situation, is designed to meet your goals, and can generate higher returns at lower risks than you are likely to obtain on your own.

Advisors can add value: A Charles Schwab study indicates that investors who work with professional investment advisors had returns anywhere from 2% to 4% more per year, when compared to other similarly situated investors.¹

Investors frequently ask prospective advisors how much they charge for investment advice.² Unfortunately, this is the wrong question. Instead of asking, “What is your fee?” you should ask, “What are the total costs I will incur by using your services?” Let me explain.

It will surprise you to learn that the investment advisor’s fee may be only the *fourth* largest expense you will incur. While it is important that your investment advisor’s fees are reasonable, what matters most are the *total* expenses associated with your investments.

Most investment firms purposely want clients to be in the dark about total fees and expenses. On the other hand, Tribeca clients are knowledgeable about such matters, and choose a Tribeca advisor in part because of it. Let’s review the different fees, expenses and costs.

First is the advisor’s fee which is generally expressed as a percentage of assets. At some firms, the advisory fee is as high as 3% per year, but typical fees are 1-1.5% per year, depending on the size of the account and the services rendered. Usually, one-fourth of the fee is debited from your account each quarter.

In some cases the investment advisor hires a third party to manage a portfolio, while the advisor provides wealth management services for the client. In these cases there is an additional portfolio management fee or subadvisory fee that is charged.

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An investment portfolio is like soap. The more you touch it, the smaller it gets.



Mutual Fund Costs – What is Included?

Your advisor will generally recommend mutual funds,³ which will cause you to incur three other expenses: fixed, variable, and taxes.

The mutual fund's Annual Expense Ratio is the fixed fee charged by every mutual fund and ETF.⁴ The expense ratio pays for the fund's recurring operating costs, from the manager's salary to the help desk, to the glossy marketing materials and expensive magazine advertisements. According to Unified Trust Company, the average expense ratio is 1.62% per year, although many are more than 2%.⁵

Unless you know what this fee is, you will never see it, because it is debited on a daily basis, and does not appear on your monthly custodial statements. To find it, you must look in the fund's prospectus.

Many investors (and even some investment advisors) think the annual expense ratio covers all fund expenses. Nope. The expense ratio covers only fixed costs — salaries, marketing, and overhead. But there are also variable costs to operating a fund, which are not included in the expense ratio.

The biggest variable costs are brokerage commissions and trading expenses. Whenever the fund manager buys or sells a security, he pays a brokerage commission — just like you would if you were to buy or sell a stock. Because of volume, funds pay lower commission rates than individuals would pay, but the trading costs are still huge, and the more the fund trades, the more it spends on brokerage commissions. These trading expenses (which can easily amount to tens of millions of dollars per year) 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 ("SAI").

Now, most advisors have never heard of the SAI. Why? Advisor's education about mutual funds is typically provided by...Wall Street mutual fund companies! (This is similar to doctors getting their education about drugs solely from drug companies.) Mutual fund companies generally don't want to point out these additional costs, and advisors are not required to provide this statement to you. As a result, clients virtually never see one. Yet the fees it discloses can equal or even exceed the Annual Expense Ratio. You can now find the SAI document at most fund company websites.

SAI expenses are difficult to determine, but a 2007 analysis by Unified Trust Company revealed that the average SAI charge is 1.47% per year.⁶ This is in addition to the 1.62% charged by the average Annual Expense Ratio. In other words, the total charge of the average mutual fund is above 3% per year. By adding this to the advisor's fee, you can see that ordinary investors often incur total annual costs of 4%-5% per year.

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What kind of impact will a 2% excess fee have on your investments? A loss of nearly half of your total portfolio!



The Real Cost of Working with a Financial Advisor

This chart shows you the annual costs, assuming a \$250,000 account.

You can compare the Tribeca program with other advisors.⁷

	Industry Average	Tribeca
Advisor Fee for \$250,000 Account	1.39%	1.20% ⁸
Portfolio Management	--	0.35%
Mutual Fund Expense Ratio	1.62% ¹¹	0.37% ⁹
Mutual Fund Trading Charges (SAI)	1.47% ¹²	0.07% ¹⁰
TOTAL	4.48%	1.99%

For tax-deferred accounts, our analysis is now complete, and we can look at the typical total cost of an advisor, compared to the cost of using a Tribeca advisor. Because Tribeca uses institutional-class funds, the mutual fund costs and SAI charges are both very low. For tax-deferred accounts, the total difference between Tribeca and a typical advisor is about 2% per year.

What kind of impact will a 2% excess fee have on your investments? On \$100,000 invested over 30 years with an assumed rate of return of 6.5%, an additional 2% fee would reduce final retirement income from \$498,395 to \$280,679, a reduction of 44% — that’s nearly half of your portfolio lost to excessive fees.

In March 2007 testimony to Congress, two 401(k) plans were compared where workers invested \$3,000 annually.¹³ Plan 1 earned 7.5% annually, while Plan 2 had extra fees of 1.5%, and so earned 6% annually. Plan 1 had \$1,244,260 after 47 years of working compared to \$766,694 in Plan 2, a difference of \$477,566.

Years	Plan #1 - Fiduciary 401(k) Earning 7.5%	Plan #2 – Hidden Fee 401(k) Earning 6%
10	\$45,624	\$41,915
20	\$139,658	\$116,978
30	\$333,463	\$251,405
40	\$732,902	\$492,143
47	\$1,244,260	\$766,694



\$477,566

Difference due to excess fees!

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These excess fees also delay retirement. A 2% excess fee would require an additional 64 months of work in order to receive the same monthly retirement income.

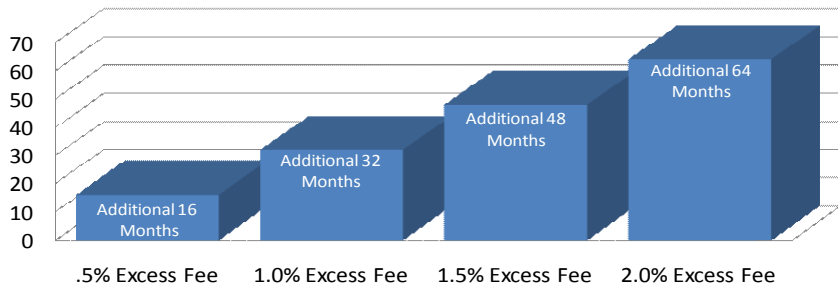
Uncle Sam likes active mutual fund investors — they pay more taxes!



That is nearly \$500,000 in lost retirement savings. Who is going to make up this difference? Even an excessive fee of “only 1%” can reduce retirement savings by 15-25% over the lifetime of the 401(k) account.

These excess fees also delay retirement. A 2% excess fee would require an additional 64 months of work to receive the same monthly retirement income. This is over five years — probably the best years of retirement — absolutely lost because of excess fees.

Additional Months Required to Work in Order to Receive the Same Monthly Retirement Income



Taxes: The Most Hidden Expense

We are all painfully aware of how much we pay in total taxes, yet few investors understand the investment portfolio’s contribution to their tax bill. Once a year, our CPA tells us to write a check for such and such amount, and that’s it — we don’t see a detailed breakout of our tax bill. Yet for most investors, taxes are the single largest expense associated with their portfolio.

Here again, there is a tremendous difference between regular active mutual funds, and the funds used by Tribeca. Most mutual funds trade frequently, incurring short-term capital gains, which are taxed at ordinary income rates.¹⁴ Figuring out the tax impact of mutual funds can be tricky because each fund has a different turnover rate (which can vary by year), and investors face different federal marginal tax rates and state tax rates. Yet some important conclusions can be drawn.

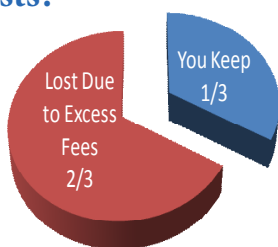
In a 15-year study looking at thousands of active mutual funds, the tax cost was gauged to be 2.7% per year.¹⁵ That dwarfs every other expense of the average active fund. On the other hand, passive investments which trade infrequently had an average tax impact of 0.9% per year, according to the study. This is a difference of 1.8% per year.

At Tribeca, we do not use typical index funds (which themselves have low tax impact), but for taxable accounts, use highly tax-efficient funds from DFA. These will reduce the tax impact down to an average of about 0.4% per year.¹⁶

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The tax impact of active funds averages 2.7% per year. That dwarfs every other expense.

Could you lose two-thirds of your total return to unnecessary costs?



Investor's Total Return

With this information in hand, we can now estimate the real cost of the typical investment advisor — including taxes — and compare that to what it would be with a Tribeca advisor.

The *Real* Costs of Working with a Financial Advisor— Including Taxes

This chart shows you the annual costs, assuming a \$250,000 account.

	Industry Average	Tribeca
Advisor Fee for \$250,000 Account	1.39%	1.20%
Portfolio Management	--	0.35%
Mutual Fund Expense Ratio	1.62%	0.37%
Mutual Fund Trading Charges (SAI)	1.47%	0.07%
Taxes	2.70%	0.40%
TOTAL	7.18%	2.39%

Did your advisor ever tell you that the total cost impact of your investments was over 7% per year? My guess is no, yet that is about the industry average.

You don't need a Nobel Prize in Economics to know that excess expenses of over 4% per year (take 7.18% less Tribeca's total impact of 2.39%) will significantly reduce your investment portfolio. Assume an initial investment of \$100,000. If invested at 9% average annual compound rate of return for 30 years, it grows to \$1,487,471; but reduce that by 4% per year (the typical excess expense amount), and it only increases to \$448,122. That is losing over two-thirds of your total return (over \$1 million in this example) to unnecessary costs! What if you could eliminate this dead weight?

Are these Hidden Fees Worth It?

You might argue that these additional fees are worth it if the chosen active mutual fund significantly outperforms the market. What does the data say? A comprehensive study published in 2008 reviewed active mutual fund performance over 32 years (1975 – 2006).¹⁷ Professors Laurent Barras, Olivier Scaillet, and Russ Wermers used the most advanced statistical testing in science to drill down into fund performance. The researchers found that, after taking expenses (other than taxes) into account, only 0.6% of fund managers actually outperformed the broad stock market averages. That's only one in 160. This extremely low number "can't eliminate the possibility that the few [funds] that did were merely false positives" – just lucky, in other words, according to Professor Wermers.

And by the way, this study didn't take into account taxes. If taxes were included, for the active mutual funds would have performed even worse.

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If you were purchasing a home, you wouldn't only ask about the cost of the kitchen and skip over the big question: what does the entire home cost? Yet with investing, many investors do just that.



Ask the Right Questions

Of course, high fees and hidden fees are a big reason that very few mutual funds outperform the market averages. As the investor, be sure to ask the right questions. If you were purchasing a home, you wouldn't only ask about the cost of the kitchen and skip over the big question: what does the entire home cost? Yet with investing, many investors essentially do just that. When you are interviewing potential advisors, make sure they tell you the total costs you'll pay to work with them. Here's a hint: most advisors don't know *themselves*. 📌

1. “New Schwab Data indicates Use of Advice and Professionally-Managed Portfolios Results in Higher Rate of Return for 401(k) Participants” Charles Schwab Study (November 28, 2007).
2. This article assumes your advisor receives no compensation other than the disclosed advisor fee. If your advisor is paid a commission for selling you products, you have a set of additional problems not contemplated by this article. Let’s state the obvious: How an advisor is compensated will affect the investment advice given. Despite this, many affluent clients—even those investing millions of dollars—are still receiving advice from commissioned salespeople. Question: how can a person receiving a commission from a Wall Street company possibly give objective advice about investments? Answer: he simply cannot. If an advisor is paid by Wall Street, his ultimate allegiance is to Wall Street. If an advisor is paid by his clients, that’s where his loyalty lies. It is contrary to human nature for someone to be paid by one party (Wall Street) and yet give unfettered loyalty to a separate party (the client).
3. This article refers 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, principal markups, and other fees. We have seen examples where the client was told that the costs were “zero” and the actual hidden markup cost was 7%.
4. “No load” funds have this expense as well. “No-load” means there are no commissions when you buy or sell shares; it does not mean “no fee.”
5. Beyond this discussion are the obscene fees charged by hedge funds. See “The Sleaziest Show on Earth: How Hedge Funds are Robbing Investors,” *Forbes*, May 24, 2004 (cover story)
6. In reality, the costs are much higher than disclosed in the SAI, because of the “bid-ask spread” involved in the buying and selling of securities. Such topic is beyond the scope of this article.
7. Sources: Morningstar; Tiburon Strategic Advisors; Tribeca Advisors, LLC; DFA.
8. This is an assumed Tribeca advisory fee for this account size. Some advisors may be higher or lower, based on the particular services rendered by such advisor. Each advisor sets his own fees.
9. Each Tribeca portfolio has a different mix of mutual funds and thus a slightly different weighted average of fees. This amount represents the average portfolio.
10. Source: Tribeca Advisor’s internal review of DFA’s SAI documents.
11. Kasten, Gregory W., “High transaction costs from portfolio turnover negatively affect 401(k) participants and increase plan sponsor fiduciary liability,” *The Journal of Pension Benefits*, 2008. (Mr. Kasten is the President of Unified Trust Company.)
12. *Ibid.*
13. Written testimony of Matthew D. Hutcheson, Independent Pension Fiduciary, presented to the Committee on Education and Labor, U.S. House of Representatives, March 6, 2007.
14. Tax law review: Investors pay short-term and long-term capital gains taxes on their investments. Short-term gains (generally gains where the holding period is one year or less) are taxed at the highest marginal ordinary income tax rate (which can approach 50% for some investors). Long-term capital gains are taxed at lower rates. Active mutual funds trade frequently—after all, the investor is paying for the mutual fund manager to dart in and out of the market in search of performance—and so are very tax inefficient. With passive investments, such as the funds used by Tribeca, most of the gains are in the form of unrealized capital gains. These are profits that have not yet been realized for tax purposes; taxes need not be paid on these gains currently. Unrealized capital gains remain a growing part of the net asset value of a fund’s share rather than being distributed to the investor. Passive investments minimize portfolio turnover, and so maximize unrealized capital gain.
15. Vanguard Financial Markets Research Center. Percentages rounded.
16. This represents an approximate average of DFA tax-managed and tax-aware funds (which are typically used for taxable accounts), from years 2000-2007, using data from Russell Investment Group and DFA.
17. Barras, Laurent, Scaillet, Wermers, and Russ, “False Discoveries in Mutual Fund Performance: Measuring Luck in Estimated Alphas” (May 2008). Robert H. Smith School Research Paper No. RHS 06-043 Available at SSRN: <http://ssrn.com/abstract=869748>



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