MarketWatch

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Oct. 18, 2009, 12:01 p.m. EDT

The cost of doing a fund's business

Commentary: Investors struggle in thicket of expenses

By Chuck Jaffe, MarketWatch

BOSTON (MarketWatch) -- You smell smoke; you expect fire. But sometimes it's just a smokescreen.

A new study suggests that mutual-fund shareholders are paying as much as $9.6 billion per year in extra or unnecessary costs that they are unaware of, and it should have started a fire in the fund industry. Instead, it fizzled, leaving only one lesson: The fund world must continue to improve its transparency so that investors aren't choking on the foul-smelling fumes of the way funds work.

Investors pay no attention to fees

Even sophisticated investors disregard fees, but WSJ Personal Finance columnist Jason Zweig says that cost control is crucial to portfolio returns. He speaks with Kelsey Hubbard.

Here's the story: The Coalition for Mutual Fund Investors, a Washington lobby organization trying to improve transparency in mutual fund operations and standards, released a study saying that there are "hidden accounts" where fund companies are siphoning off billions of dollars to pay for an additional layer of costs. The damages purportedly average almost $50 per fund account.

If true, this is the next burning fund scandal.

Alas, it doesn't seem to pass the fire test, though it's hard to see through the haze of fund accounting to know for sure. Let's put on an oxygen mask and wade in.

Omnibus is not obvious

The Coalition says the extra costs are from what it calls "hidden mutual fund accounts." In reality, these are "omnibus accounts," fund shares sold en masse to brokers, planners, retirement plans, insurers and any type of third-party financial intermediary. These services group all of their activity together into a single account, as far as the fund is concerned, and then handle the specifics of many accounts on their own, outside of the fund.

Imagine all customers from a brokerage or a retirement plan making their buys and sells in the XYZ Fund. On a day with 100 buys and 10 sells -- 110 different transactions -- XYZ officials would see just one overall transaction. The broker or plan buys or sells the shares needed to complete the day's activity, and makes investor accounts right. XYZ management not only doesn't see the 110 individual trades, it most likely doesn't even have a record of the shareholders who made those moves.

Omnibus accounting has been around for years; industry estimates suggest that there are more than 200 million individual accounts that are lumped together into these group holdings. Most consumers participate, and are never even aware of it.

Clearly, there can be issues, which is the Coalition's central theme. For example, in the rapid-trading scandals several years back, the activity was done in omnibus accounts, making it hard for the funds to know they were being played;

they couldn't necessarily see that John Shareholder was making round-trips almost every day, because his moves were offset by any other shareholder moves before the fund even knew what hit them.

Niels Holch, executive director of the Coalition, says that the mutual funds often pay the financial intermediaries a higher fee per account than they pay to their own transfer agent -- the third party who handles all investors who work directly with the fund -- for the same services. The study claims that the intermediaries for omnibus accounts get $19 to $25 to service each shareholder, where the regular transfer agent gets $10.

Making sense of the dollars

It sounds horrific -- ordinary shareholders paying more so their neighbor can get more convenience -- but industry insiders suggest it doesn't work that way. Instead, the fund negotiates a lower rate with its own transfer agents expressly because the omnibus accounts take so many transactions off the books.

In short, if those 110 daily trades were added to the fund's daily activity, shareholders would pay the freight, and the per-account service fees would rise. The party serving the omnibus accounts would, in that scenario, get less or nothing, but the total costs to the shareholder would remain the same.

"The fund's costs are lowered because it services the one customer -- the omnibus account -- rather than all of those individuals," said David Hyland, a finance professor at Xavier University in Cincinnati. "If the fund has to service all of those customers, its costs will be a lot higher. I'm all for transparency and disclosure, but ultimately investors are for total costs, and it seems to all come out the same in the wash. It doesn't look like a real problem to me, but there's no denying that it's hard to tell."

Indeed, about the only thing that is clear in this situation is that the numbers, as reported, are easily manipulated and misunderstood. There may indeed be shareholders who are paying for a service like recordkeeping twice, once at the fund level and once as part of their brokerage fees, but that's probably the cost of convenience and one-stop shopping.

It might be easier if service costs were expressed to shareholders in absolute dollar terms and removed from the expense ratio. You pay some percentage for management costs, and then three cents or a nickel per day of ownership costs. For as long as costs are lumped together, put in percentages and not expressed upfront in concrete dollars, there will always be confusion, concern and conspiracy theories over just how much shareholders pay for basic services, and who profits from those charges.