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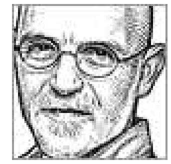
Take Off the Blinders When It Comes to Fees



By JASON ZWEIG

In the mad dash to buy bond funds -- about $200 billion so far this year -- investors are overlooking fees. Most of the new bond money is going not into dirt-cheap index funds, but into far more expensive, actively managed portfolios.

The average annual cost of owning a taxable bond fund, according to Morningstar, is 1.03% of invested assets, with a maximum of 2.98%. In a world of 3% to 4% Treasury yields, with the risk of losses if interest rates rise, those fees loom large.

In overpaying, individual investors have good company.

A study by Callan Associates, the San Francisco consulting firm, shows that even professional investors are afflicted by fee blindness, and that as the market goes up, their sensitivity to cost seems to go down.

Late this spring, Callan studied attitudes toward fees among pension plans, endowments, foundations and other institutional investors. Half had no plans in the coming year to review the fees they pay to outside money managers; many never review fees.

While 50% of these big investors think the costs they pay are justified, only 33% think their peers are paying fair fees. Callan asked a similar question of the outside managers hired by these big investors -- 83% say they deserve what they are paid -- but only 56% believe their competitors earn their keep.

That is a textbook example of "myside bias," the tendency to evaluate evidence in ways that echo our own views and put ourselves in the best possible light. Such a rationale enables even professionals to pretend that it is always someone else who is paying too much.

Prior surveys by Callan show that institutions are more likely to regard their costs as reasonable when the market has been going up. Back in the bull market of 2006, 71% thought the fees they paid were justified, versus 50% early this year.

Keith Stanovich, a psychologist at the University of Toronto and author of "What Intelligence Tests Miss: The Psychology of Rational Thought," is an expert on myside bias. A rising market, explains Prof. Stanovich, enables people to tell themselves, "I'm really good at this," automatically making the cost of investing seem more justifiable.

It is natural to pay more attention to fees when returns have been low. If the market is up 1%, a fund that charges a 0.5% annual fee will leave you with a 0.5% net profit, while another fund with expenses of 1.5% would stick you with a 0.5% net loss. That makes the threefold gap between their fees look like a canyon. If the market is up 20%, the difference between the 19.5% return on the cheaper fund and 18.5% on the costlier one looks less significant.

Fee blindness can afflict us all. In one case, only 19% of M.B.A. students at the Wharton School ended up picking the cheapest choice among four essentially identical index funds. In a survey by AARP, just 39% of investors had a strong preference for the cheaper of two funds that differed only on cost.

Mutual-fund investors can take two steps to fight fee blindness.

First, "dollarize" your expenses. You will pay much closer attention to the costs of investing when you convert them from percentages to dollars -- making them feel like what Ronald Wilcox, a marketing professor at the University of Virginia, calls "a bare-naked transaction."

Look up the annual expense ratio of your fund and multiply it by the total amount of your investment. The result: an estimate of your annual cost, in dollars, of owning the fund. That is roughly what will be deducted automatically from your account over the year. Ask yourself how you would feel if, instead, you had to write one check for that total amount and send it off to the fund company. Would it be good value for the performance you have gotten?

Second, create a "shadow portfolio." Using an online portfolio tracker, create a hypothetical basket of low-cost index funds in the same proportions as the funds you actually own. Say you have 20% of your money in a taxable bond fund that charges the industry average of 1.03% in annual expenses. In your shadow portfolio, put 20% into a choice like Vanguard Total Bond Market Index Fund, which charges only 0.22% annually. Follow along for a year, and see how your higher-cost fund compares.

Chances are, you will see that you have been paying more without actually getting more.

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