



## **The Expense Paradox**

By John F. Doyle

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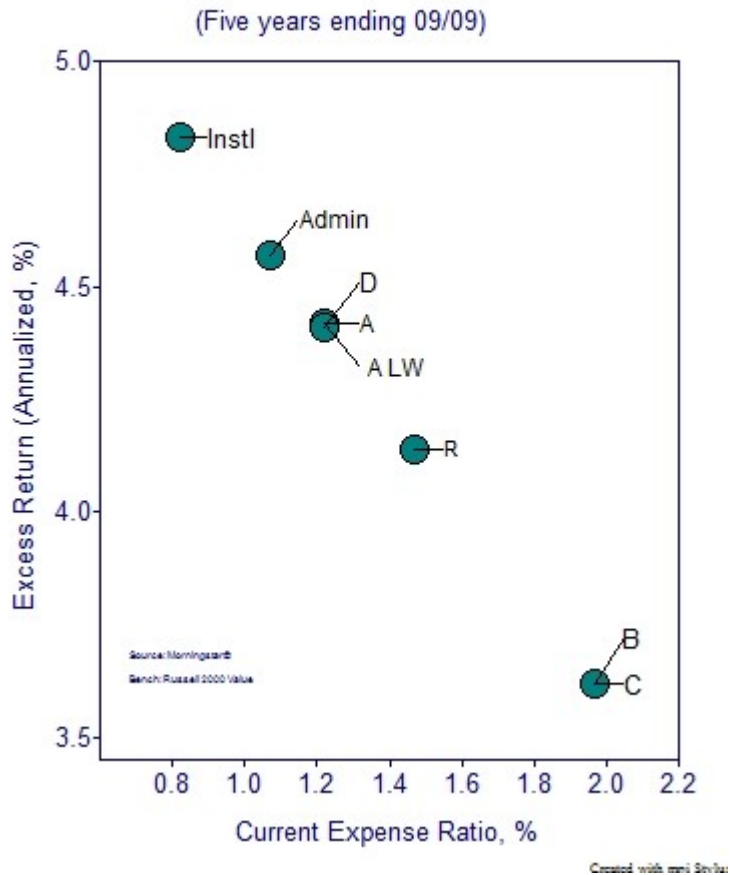
A convenient reason to eliminate a fund from consideration is high expenses. While that criterion alone is often a good guideline, blindly relying on it can cause you to overlook otherwise attractive funds.

Therein lies the expense paradox – sometimes you have to pay higher fees for superior management.

Advisors have come under pressure from a number of quarters – peers, professional organizations, regulatory bodies, and clients – to assign primacy to expenses in the fund selection process. Retail investors hear, especially from the media, that they must avoid “expensive” funds because those high expenses will depress future returns. Fiduciaries are counseled to avoid funds (and share classes) that have “above-average” expense structures. If any of this deserves credence, we should be able to find a clear relationship between fund expenses and returns.

It’s easy to construct a case to show that the admonitions make sense. We can do so by comparing the returns (excess over bench in this example) of all of the share classes of the same fund, as shown below for the Allianz NFJ Small Cap Value, and by relating them to associated expenses. (Keep in mind that mutual fund returns are reported *net* of expenses.)

## Allianz NFJ Small Cap Value: All Shares

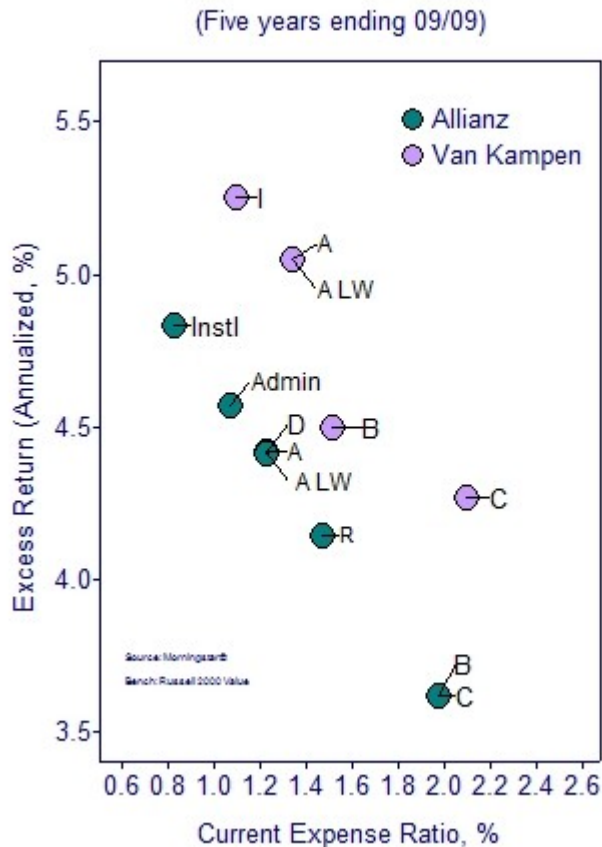


A clear indirect adverse relationship between expenses and returns emerges. But this connection is not surprising; the underlying portfolio return of each of the fund's share classes is the same, so return differences among the share classes may correctly be attributed to their respective expense structures. (Let's consider loads to be trade commissions and exclude them from this discussion.)

Assuming that you have decided to invest in the Allianz fund, and that you have complete freedom to choose one share class from the array of options, common sense seems to dictate buying the institutional (Instl) share class. It has the highest return, which necessarily means that it has the lowest expense ratio.

It's reasonable to expect to see essentially the same return/expense pattern when examining other multi-share class fund products. So let's broaden our focus by including another fund, Van Kampen Small Cap Value.

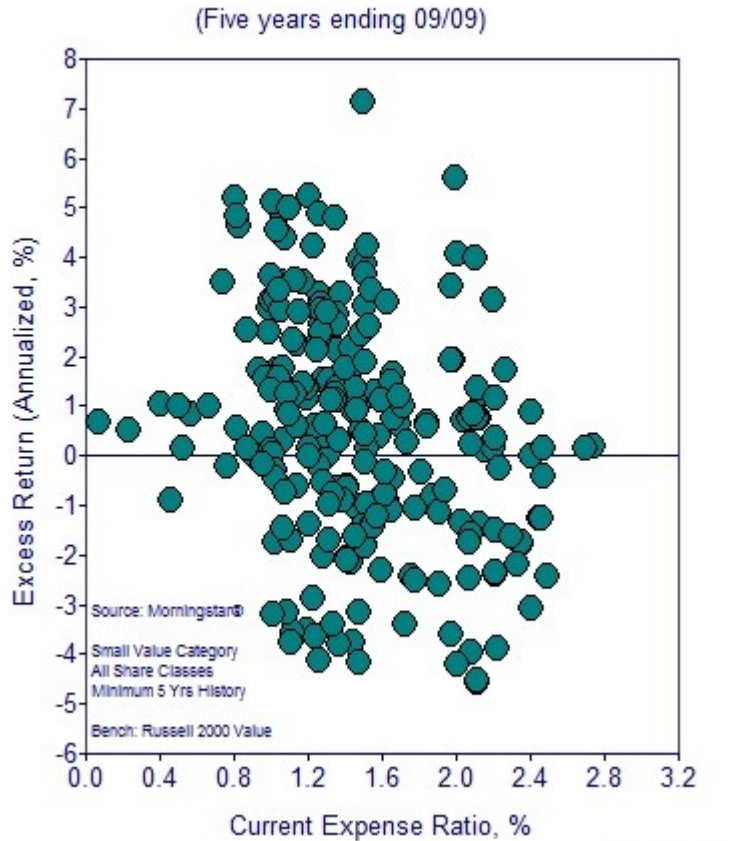
**Allianz NFJ, VKF Small Cap Value: All Shares**



The return/expense pattern for the Van Kampen fund is also as one might expect. With the exception of the B shares, all of its share classes have both a higher return and a higher expense ratio than the competing Allianz share class. All other factors being equal (of course they are not), wouldn't it be prudent to favor the Van Kampen fund, even if doing so means accepting higher expenses? The answer clearly is yes – before considering other important factors, such as risk-adjusted return, that is.

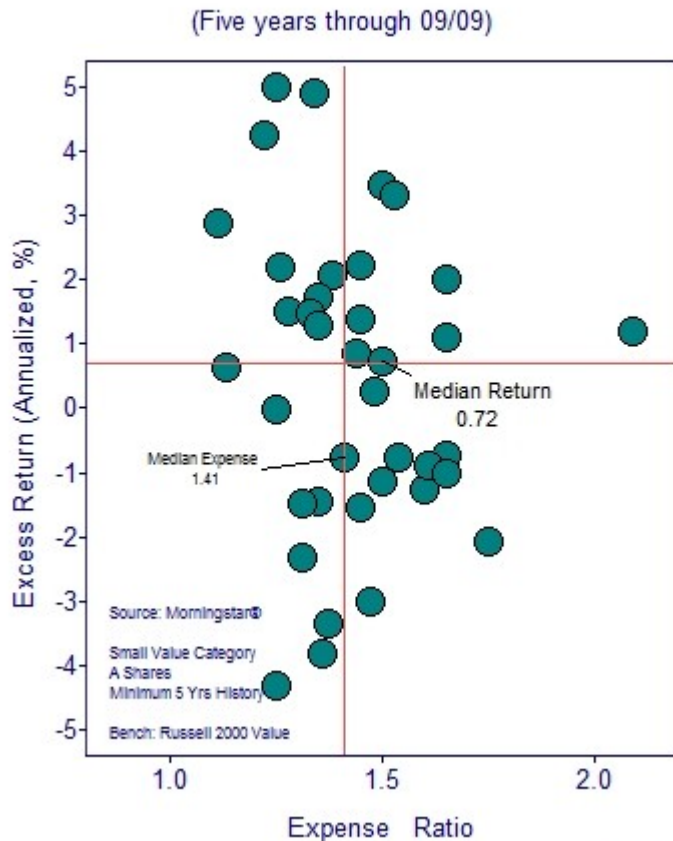
When faced with the need to evaluate a large number of competing products, the task gets messy. The next chart displays all share classes of all small cap value funds. Right off it's apparent that we are looking at data, not information. At a glance it's impossible to discern a clear relationship between expense and return, and even statistical analysis doesn't make one evident.

## Small Cap Value: All Share Classes



What if the focus is narrowed to a single share class, to remove the influence of the multi-share class expense structure, as shown in the next visual? Will it help to clarify our perception of the relationship between return and expense?

## Small Cap Value Funds: A Shares



We certainly do get a reduction in “noise,” and the funds appearing in the upper left quadrant of the plot catch our eye. But do you see a meaningful relationship between expense and return?

When examining other share classes of the two funds, the result is the same, as is the case when inquiring into most other sectors of the market. As you might expect, however, the returns of index funds tracking the same benchmark are clearly affected by the level of expenses. The same holds for certain bond fund categories, where gross excess return is so small that expenses have a prominent negative effect on them.

What can we take away from this brief exposition? First, it may be unwise when evaluating funds to place undue emphasis on a single factor, such as the expense ratio. Second, advisors ought to arm themselves with the information they need to counter misdirection by the media and by some marketers of “low cost” funds on the subject of expenses. It might be useful to have on hand visuals like the ones shown above. A comparison of risk-adjusted return versus expenses could be very effective. And finally,



while most vendors of mutual funds do not seem to feel that they can charge higher fees for superior results, many vendors of poorer-performing funds have no such reluctance. Why allow this practice to continue?

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