



Letter to the Editor

June 17, 2008

The following letter is in response to our [interview](#) with Ken French regarding his study on *The Cost of Active Investing*, in which he argues that the cost of active investing, relative to passive investing, is approximately 67 basis points annually.

Dear Editor:

How did Ken get such a low cost for active management? I believe the cost is actually much higher than 1%, possibly as high as 3 to 5%, when you include taxes, management fees, 12-b1 fees, and trading costs.

Expenses vary by share class. A shares have up front commissions (3% – 5.75%), B shares have hidden 12-b1 fees with typically a 7 year hold to avoid CDSC charges, and they pay 4.5% up front to brokers, and C shares have a 100 basis point trail. At the end of the day, the average cost of a retail mutual fund has to be a lot higher than 1.00% when share class is taken into account.

I am a big fan of ETF's and a combination of active and passive management. I find the data interesting. I also understand that Ken was being conservative in his estimate of total costs. The data I have seen and have on file suggests that he is being *very* conservative.

Looking again at the data that was used in the study, it looks like active and passive funds are blended together - such as active managers and index mutual funds, which of course would skew the number to the downside. In order to really get an idea of costs only actively managed funds and their expenses should be in the data. Then a more accurate picture could be painted on the cost of active management.

Anonymous

Ken looks at all the data on a pre-tax basis, so taxes are not included. All the other fees you mention are included.

The study looks at three types of active investing: mutual funds, institutional funds, and hedge funds (including funds of hedge funds). The costs of each vary greatly. The average cost for mutual funds was 0.95% in 2006. The average cost for institutional funds was only 0.34%. Hedge funds fees are high (4.26% or



6.52% in a fund of funds). But hedge funds represent a relatively small slice of US equities. The cost of trading was about 0.21%. When you average this together, based on the amount of money in each bucket, it is 0.67%.

For mutual funds, he uses annuitized load data provided by the ICI. The average annuitized load in 2006 was only 0.15%, because of a shift to no-load funds. (This is the cost of loads spread across all open ended funds.) Also, B and C shares have lost popularity over the last five or so years.

Ken's methodology involves calculating the total cost of active management, exclusive of passive management (index funds, ETFs, and ETNs). He also determines the percentage of assets that are invested passively (which, for mutual funds in 2006, was about 12%). He then calculates the cost of management if all US equities were managed passively, based on an estimate of the cost of passive management. The difference between this number and the total cost of active management is the excess that is paid for active management.

He would agree that his numbers are low, and the true number is higher, but he wanted to be conservative in his analysis.

Editor

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