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Hidden Costs Drag Performance

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According to a new study by the Plexus Group, a Los Angeles-based consulting firm, it has been found that a variety of sometimes hefty, often hidden transactions cost may be dragging down otherwise good performance in the mutual fund industry.

Wayne H. Wagner, chairman of Plexus, said the study tracked the trading of 140 funds during the second and third quarters of 1997. Depending on their investment styles and market capitalization, the funds incurred total trading cost of .65% to 3.11% for each share traded. Thus, funds with a 100% turnover in their holdings would drag down their return by .65% to 3.11% because of trading costs. Funds with a 200% turnover would lose twice as much, or 1.30% to 6.23% in return due to trading cost. Therefore, managers with different management styles need to overcome very different cost hurdles before their stock selections can earn returns for their shareholders. The study also explains why fund giants like Fidelity, Putnam, American Century and Vanguard are paying such close attention to trading costs these days. A summary of the Plexus findings are shown in the Mutual Fund Trading Cost schedule (Table 1).

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What are these transaction costs that Plexus tracked? First, brokerage commissions were considered, which are not included in a mutual fund's expense ratio. Brokerage commissions on trades incurred within a fund vary enormously according to the investment style and the average market capitalization of the fund's portfolio. For example, large cap growth funds have their returns reduced for commission cost by just .09% per share traded, while small cap value funds pay twice as much at .18% per share.

But commission expenses are only the most obvious of such costs. More troublesome are impact cost, which measures the effect of a fund on a stock, either up or down, when it is bought or sold. Again, the impact varies greatly among categories. On average, large cap value funds had the lowest impact costs at .07%, with small cap growth funds paying the most – some at .50% per share.

There is a more insidious expense, which Plexus calls delay or timing costs. This measures the effect of the lag between when a manager asks to buy or sell a stock and when the transaction is completed. Delay expenses can be huge, 1.83% for the average small cap growth fund, or they can be quite small, .13% for large cap value funds. Thus, with the prevalence of crossing networks that split the spread and drop commission costs to less than zero, the time it takes to cross the trade may be a mitigating circumstance in trying to eliminate commission cost.

Plexus also tracked the cost of missed trades, measuring the effect of a manager abandoning a sell or buy order before its completion because the price had moved too much. This is an opportunity cost that holds back possible returns rather than a direct loss from a fund's portfolio. Small cap funds lost twice as much from missed trades as their larger cap brethren, .62% and .53% for growth and value small cap offerings, respectively, compared to .27% and .30% for large cap growth and value funds, respectively.

Index funds, often sold on the basis of their cost-conscious style were neither the cheapest nor the most expensive, but index funds trade less often than actively managed funds. So the impact of such cost is reduced. Further, many index funds use hedge strategies which offset these transaction costs, however these hedging strategies were not part of the Plexus study.

Though individually these transactions cost may not seem to be significant, when you add them up they can be quite substantial as shown in the Mutual Fund Trading Cost schedule (Table 1). Assuming a 100% turnover in a fund's holdings, returns on studied average small cap growth mutual funds were reduced 3.11% by total implementation cost. Large cap value mutual funds weigh in with just .65% in return being lost to trading cost. Large and small cap value funds have had their returns reduced by 1.59% and 1.68%,

Table 1.
Mutual Fund Trading Cost

Type of Fund	Commission Cost	Impact Cost	Delay Cost	Missed Trade Cost	Total Implementation Cost
Large Cap Growth	0.09%	0.19%	1.04%	0.27%	1.59%
Large Cap Value	0.15%	0.17%	0.13%	0.30%	0.65%
Small Cap	0.16%	0.50%	1.03%	0.62%	3.11%
Small Cap Value	0.18%	0.36%	0.61%	0.52%	1.38%
Index Fund	0.09%	0.22%	0.80%	0.29%	1.40%

Source: Plexus Group

respectively, by their total implementation cost. Low turnover index funds, without adjustment for hedging strategies, lose 1.40% per share, if and when trades should occur.

Most of the reason for divergent trading expenses is the varying liquidity in different kinds of stocks. Small cap stocks tend to have smaller floats, making it easy to move their prices and raise trading cost. Value investors by their nature chase stocks that are not in high demand and are thus less likely to run up. Wayne Wagner observes the managers have value in their ideas, but they are not fully capturing it because their implementation costs are too high. Plexus is engaged by managers, plan sponsors and consultants to audit their trading function and recommend ways to more efficiently manage implementation cost. With the average total implementation cost now running at 1.01%, the opportunity to reduce trading cost is an increasingly popular topic. Plexus' work in quantifying implementation cost and in developing systems, process, procedures and methodologies to drive down those costs is a most significant contribution to our industry. ■

Notes

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