

# The Hidden Tax

“A 2014 study by Cerulli Associates, a financial-services research firm, showed that 25% of investors who use financial advisers are not sure what they pay their adviser. Another 26% wrongly say they do not pay a penny.” (Housel 2015)

In April, many people are painfully aware of the taxes they pay to Uncle Sam. Compared to taxes, financial advising fees seem reasonable. However, those seemingly small fees can sometimes be just as costly. As advisors, this may sound like a strange point for us to highlight. Certainly, we believe many services are worth the fees charged. However, excessive fees for mediocre advice can do significant financial damage. For example, a 2% fee without the corresponding benefit can reduce retirement income by over 56% over a 40-year period. What is worse is that many people are not aware of the fees they pay. This article describes the effects of fees upon retirement income and the fees that never show up on statements. The next article will discuss the value of advice. The key is to figure out what balance of fees and advice is right for you.

Figure 1 shows how much income is reduced by fees when the Required Minimum Distribution (RMD) withdrawal method is used to take income from retirement accounts. The details of the RMD method are not discussed here, but the reduction is similar regardless of the drawdown technique. From the figure, one can see a 2% fee reduces income by almost 40%.

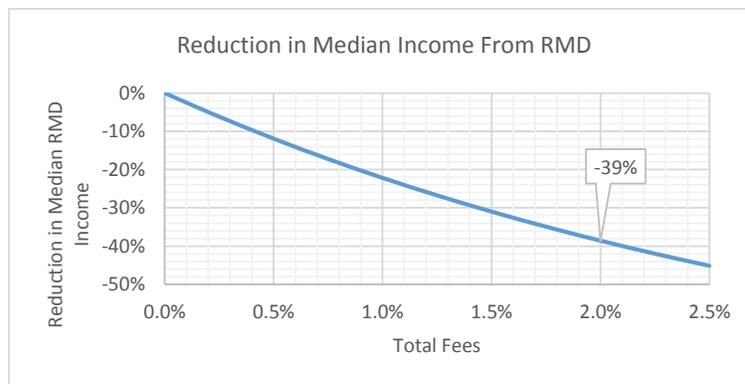


Figure 1

Determining the fees is easier than it seems, but it does take a small amount of investigating. The summary prospectus will contain a fee table like the example in Figure 2. Each column represents a different type of shares. Some shares are distributed directly to retail customers and others are sold through 401(k) or other retirement plans. The A, B, and C shares are sold to retail investors.

The top two lines of the fee table show fees that are charged one time, at either the purchase or the sale of shares in the fund. These are commonly known as “loads.” The loads that are paid on the purchase of the shares are called front-end loads, and those paid at the sale of the shares are called back-end (or deferred) loads. The deferred loads are reduced or eliminated if the shares are held for a certain period. The bottom few lines show the fees that are charged on an annual basis. Some of the fees are used for the management and administration of the fund, such as paying the manager of the fund to choose which stocks to buy and sell (Management Fee) and to pay for transaction costs and other expenses. The 12b-1 fees are paid to the planner or broker. The planner deserves to be paid for his expertise, time, and value, of course, but be aware these fund fees may be in addition to a management fee the advisor directly charges to the client.

# BlackRock Value Opportunities Fund Summary Prospectus

Shareholder Fees (fees paid directly from your investment)	Investor A Shares	Investor B Shares	Investor C Shares	Institutional Shares	Class R Shares
Maximum Sales Charge (Load) Imposed on Purchases (as percentage of offering price)	5.25%	None	None	None	None
Maximum Deferred Sales Charge (Load) (as percentage of offering price or redemption proceeds, whichever is lower)	None <sup>1</sup>	4.50% <sup>2</sup>	1.00% <sup>3</sup>	None	None
<b>Annual Fund Operating Expenses</b> (expenses that you pay each year as a percentage of the value of your investment)					
Management Fee <sup>4</sup>	0.50%	0.50%	0.50%	0.50%	0.50%
Distribution and/or Service (12b-1) Fees	0.25%	1.00%	1.00%	None	0.50%
Other Expenses	0.50%	0.87%	0.61%	0.47%	0.54%
Administration Fee	0.25%	0.25%	0.25%	0.25%	0.25%
Miscellaneous Other Expenses	0.25%	0.62%	0.36%	0.22%	0.29%
<b>Total Annual Fund Operating Expenses</b>	<b>1.25%</b>	<b>2.37%</b>	<b>2.11%</b>	<b>0.97%</b>	<b>1.54%</b>

Figure 2

Calculating the reduction in income due to fees is straightforward. The loads reduce income directly. A 5.25% front-end load reduces income by exactly 5.25%. The effect of annual fees is similarly straightforward by using Figure 1. A 1.25% fee reduces annual income by 27%. The total reduction from the two types of fees is 31%. For class B shares, the reduction is 47%. That is no mistake. The fees and loads from these shares can reduce your income by about half.

Look at a similar fund from Vanguard Small Cap Value shown in Figure 3. An investment of more than \$10,000 qualifies for the Admiral shares, which carry lower management and operating fees, and there are no loads. Using Figure 1 we see that the total annual operating expense of 0.09% will reduce income by about 2%. When compared with the BlackRock class 'A' fees at 1.25% total operating expense, one could conceivably increase retirement income by 42% by switching to the lower fee fund at Vanguard.

For example, assume that without fees the RMD produces a median income of \$100,000 per year. Fees equal to BlackRock's will reduce the income to \$69,000, whereas those equal to the Vanguard fees would reduce income to \$98,000. The \$98,000 income is 42% larger than \$69,000.

Shareholder Fees (Fees paid directly from your investment)	Investor Shares	Admiral Shares
Sales Charge (Load) Imposed on Purchases	None	None
Purchase Fee	None	None
Sales Charge (Load) Imposed on Reinvested Dividends	None	None
Redemption Fee	None	None
Account Service Fee (for certain fund account balances below \$10,000)	\$20/year	\$20/year
<b>Annual Fund Operating Expenses</b> (Expenses that you pay each year as a percentage of the value of your investment)		
Management Fees	0.21%	0.07%
12b-1 Distribution Fee	None	None
Other Expenses	0.03%	0.02%
<b>Total Annual Fund Operating Expenses<sup>1</sup></b>	<b>0.24%</b>	<b>0.09%</b>

Figure 3

In summary, seemingly small fees can have large effects on retirement income, and many of those fees are not clearly visible without some digging. It is worthwhile to take the time to understand the fees you are paying and the overall impact of those fees. The next article will discuss the benefits of financial advice.

Reference: Housel, Morgan. 2015. *Stop Deluding Yourself About Investing Expenses*. April 10. <http://www.wsj.com/articles/stop-deluding-yourself-about-investing-expenses-1428669774>.