Your Returns Are Not as High as You Think: The Hidden Cost of Fees

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The following is adapted from Navigate the Investment Jungle.

A hobby investor once bragged to me that he was getting 100 percent returns by investing in tech mutual funds. So I offered him a challenge: “Prove to me that your investment dollar grew by 100 percent and I’ll buy you lunch anywhere in town, no strings attached.”

Spoiler alert: I never bought him lunch.

While his earnings *were* good, he was paying almost 6 percent in fees per year, eating significantly into his profits. He’d fallen into the same trap that so many people do: failing to fully and carefully investigate fees.

On paper, fees may not seem like a big deal, but this hidden cost can quickly add up, costing you as much as 30 or 40 percent of your investment returns. If you aren't paying attention to your fees, you could be leaving a lot of money on the table.

It's not enough to simply know your fee percentages. A percentage is too abstract—for instance, 6 percent may not seem like a big deal. To fully understand the hidden cost of fees, you need to put them into context. There are two good ways to do this: calculating the compounding cost over time and translating percentages to dollars.

The Compounding Cost of Fees

Fees compound, just as returns do. What seems like a small percentage can, over time, become a huge problem.

To illustrate how much difference fees can make, let's compare three hypothetical investors: Shirley, Barbara, and Jane. They're all the same age and, when they reach thirty-five, each one invests $100,000 in a mutual fund that delivers consistent annual returns of 7 percent. The only difference in their investments is how much they pay in fees. Shirley pays 3 percent, Barbara pays 2 percent, and Jane pays 1 percent.

Thirty years after their original investments, Shirley, Barbara, and Jane cash in their mutual funds. Shirley's $100,000, growing at 7 percent minus 3 percent in annual fees, has grown to $324,340. Barbara's $100,000, at the same rate of return minus 2 percent in annual fees, is now worth $432,194. Jane's $100,000, with her 1 percent fees, is up to $574,349.

All three women invested the same amount of money and achieved the same returns, yet over thirty years, fees cost Shirley $250,000 more than Jane.

A 2 percent difference in fees doesn't sound so small anymore, does it!

There are a lot of great fee calculators available online, including one from the SEC. Simply Google "mutual fund fee calculator" or "investment fee calculator," and see for yourself the kind of impact a change in fees could have on your investments.

Dollars vs. Percents

In addition to looking at the long-term accumulation of fees, it's important to translate fees from percents to dollars, so that you understand the true cost. You might be surprised at what you find.

One of the worst nightmare fee scenarios I've witnessed was with a man named Todd, who had put $1.2 million into a variable annuity. He'd been told that the variable annuity would guarantee him $100,000 a year for the rest of his life, which sounded pretty good to him.

Todd thought he was paying just 1.2 percent in fees, but in reviewing the prospectus for the annuity, I discovered the number was closer to 4.5 percent. Even after learning the true percentage of his fees, Todd wasn't too worried. 4.5 percent seemed a small price to pay for $100,000 a year.

Todd had a shock coming. By the time he sought out my advice, a few years after he signed his contract, his account had grown to almost $2 million. 4.5 percent of almost $2 million is a sizable chunk of money. When I saw him, his $100,000 a year was costing him *$80,000* per year in fees. As his money continued to grow, so did his fees. Eventually, his money grew so much that he was paying more in fees than the guaranteed $100,000 he was receiving.

Until I laid it out for him, Todd had no idea how much he paid in fees. Worse, he had signed a nine-year contract which imposed stiff penalties, known as surrender fees, if he canceled. Although Todd was paying excessive fees, I couldn't recommend that he cancel his agreement, as it would have incurred even greater costs.

The harsh and painful lesson he learned was that you can't ignore fees and that even if a percentage doesn't sound too bad, you have to calculate the dollar value for context.

Take Control of Your Fees

Fees can rack up quickly and eat into your returns. To protect your investment, you need to take back control of your fees. That starts with calculating your fees, compounded over time and translated into dollars, so that you can shed light on this normally hidden cost.

Additionally, if you choose to hire someone to help manage your wealth, search for someone with a clear fee structure. If someone's not upfront about fees, they're probably hiding something. As an example of the kind of fees you should expect, my firm charges a yearly management fee that, on average, breaks down to 1 percent of assets under management, paid in four quarterly installments. There are no extra fees, no transaction costs, and no other hidden charges.

It's your money: your returns should be going to you, not to excessive fees. So take a closer look at what fees you're paying, and take back control.

For more advice on managing fees, you can find [Navigate the Investment Jungle] on Amazon.

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