Morningstar Study Says High Fees Are Bad for Investment Performance

What investors pay for mutual funds makes a difference in how well they perform

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Morningstar has just released a study of the impact of mutual fund expenses on fund performance. It turns out that lower-expense funds outperform higher-expense funds—and expenses are a better predictor of future returns than Morningstar's own star rating.

In fact, Morningstar's director of mutual fund research, Russel Kinnel, reports in an August 9 article on Morningstar.com, How Expense Ratios and Star Ratings Predict Success: "In every single time period and data point tested, low-cost funds beat high-cost funds."

It isn't that the star ratings are not useful—but that the expense ratios worked every time. Kinnel explains further in the article that expense ratios are "strong predictors" of performance. "In every asset class over every time period, the cheapest quintile produced higher total returns than the most expensive quintile," he says.

For the study, Morningstar looked at: funds in the highest and lowest quintiles of expenses, categorized them and compared total returns; "success ratio"—the percentage of funds that "survived and outperformed" rather than got merged or closed; and star ratings.

The thinking that "past performance has zero predictive power—went too far," said John Rekenthaler, vice president for research at Morningstar. As part of the smackdown between passive and actively managed investing, fees have become important, but "there is still value to" manager skill, he said.

Rekenthaler cited a Department of Labor (DOL) proposal to use computer models to direct investment in 401(k) plans, telling *WealthManagerWeb.com* that they "only apply investment style and cost, they don't consider past performance." That model misses whatever predictive power manager skill would have, he said, and would seem to favor a low-cost index type of fund—which of course gets investors beta, but no alpha.

The DOL cautions 401(k) investors about the severe erosion higher fund or account fees cause to their accounts. Each 1% in additional fees eats up 28% of the ending value of an account over a 35-year span—not an unusually long span for a career.

Here's the DOL example:

"Assume that you are an employee with 35 years until retirement and a current 401(k) account balance of $25,000. If returns on investments in your account over the next 35 years average 7% and fees and expenses reduce your average returns by 0.5%, your account balance will grow to $227,000 at retirement, even if there are no further contributions to your account. If fees and expenses are 1.5%, however, your account balance will grow to only $163,000. The 1% difference in fees and expenses would reduce your account balance at retirement by 28%."

This is a stunning example, and it demonstrates from a different angle why this is so critically important that Kinnel recommends that fund expenses be factored into fund selection as a "primary test." The answer is, he says in the article, that "they worked every time—because costs always are deducted from returns regardless of the market environment." Begin, Kinnel advises, by focusing on funds in the cheapest or two cheapest Morningstar fund expense quintiles, and you'll be on the path to success.