Fund fees baffle MBA students, according to study

By David Hoffman
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NEW YORK - Not even MBA students at the top business schools in the country fully understand the importance of mutual fund fees.

That is the conclusion reached in a recent study by professors at Harvard University in Cambridge, Mass., the University of Pennsylvania in Philadelphia and Yale University in New Haven, Conn. But some industry experts questioned the idea - expressed by the study's authors - that if top candidates for the master's degree in business administration don't understand fund fees, the average investor isn't well equipped to make appropriate asset allocation decisions.

Ninety-two percent of the assets in index funds are in those with an expense ratio of 0.4% or less, which is relatively low, said Brian Reid, chief economist at the Investment Company Institute in Washington. That proves that investors understand the importance of fund fees and reward the less expensive funds, he said.

Begging to differ

Other industry experts said that if that were true, the average gross expense ratio of all mutual funds - at 1.67% at the end of February, according to Morningstar Inc. of Chicago - wouldn't be so high.

The research sought to settle the issue of fees.

In the study, 250 MBA students at The Wharton School at the University of Pennsylvania and 87 college students at Harvard were told to allocate $10,000 in fictional money across four index funds that track the Standard & Poor's 500 stock index.

Because there is no real difference in how the funds are managed, the biggest differentiator, and what should have been the biggest determinant in where the students put their money, should have been fund expenses, said David Laibson, a co-author of the study and an economics professor at Harvard.

But despite ranking fees as the most important factor in their decision, the MBA students didn't allocate all their money to the cheapest index fund, a move that would have cost them $309 in expenses.

Total expenses paid by MBA students ($421) were only slightly below expenses paid by the other college students ($431), who ranked fees as the eighth-most-important factor.

One possible reason study participants didn't allocate all their money to the cheapest fund is that it is hard for anyone - even MBA students - to find expense information in fund prospectuses, Mr. Laibson said.

Study participants did allocate more money to lower-cost index funds when the study's authors made clear on a single sheet of paper all the fund expenses.

But providing the fee summary sheet didn't drive every dollar to the cheapest fund option. The MBA students ended up paying $366 in expenses, while the college students ended up paying $410.

It got worse when past performance was thrown into the mix.

When participants were given a sheet that not only included expenses but also the performance of the funds since inception, both MBA students and the other participants favored the funds with the best returns. In that scenario, MBA students paid $440 in fees, and the other college students paid $486.

Of course, looking at fund performance since inception - especially index funds that follow the same benchmark - means little, Mr. Laibson said. Differences in performance likely are the result of different inception dates, he said.

The conclusion: People just don't understand the importance of fees, Mr. Laibson said.

But the ICI wasn't alone in doubting the study's conclusions.

Even though the study used MBA students from prestigious Wharton, they are still students, said Roy Weitz, publisher of Fund-Alarm.com, an online newsletter based in Tarzana, Calif.

Students, no matter how intelligent, don't have the real-world investment expertise that investors get after being in the market a few years, he said.

But that doesn't mean Mr. Weitz agrees with the ICI's position that many investors are in low-cost funds because they realize the importance of fund fees.

If that were true, the average mutual fund expense ratio would be much lower, he said.