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Why Fees Matter So Much

Half a percent per year…one percent per year… investment advisory fees such as these may seem small but they are significant factors in investors' long term returns. Fees destroy value over time because of the effect of compounding. To illustrate, let's make the following assumptions:

- An investor starts investing with $100,000 with the intent to hold on for 30 years, looking for a traditional allocation between US and international stock market, along with fixed income assets.
- There are two different advisory options, an investment advisor who charges 1.5% per year in fees and another who charges 0.25%.
- Both advisors construct a portfolio that approximates the overall return of a blended US/international/fixed income portfolio. We assume that overall return is 8% per year.

	Option 1 **1.50% Fee**	Option 2 **0.25% Fee**
Initial Investment	$100,000	$100,000
	Compound for 30 years at 6.5% net return per year (8% market return minus 1.5% fee)	**Compound at 30 years at 7.75% net return per year (8% market return minus 0.25% fee)**
Final value (before capital gains taxes)	**$661,437**	**$938,682**

With the 1.5% fee you would have $661,437 after 30 years. With a 0.25% fee, you'd end up with $938,682. That $277,246 difference means paying for your own child to go college rather than paying for your advisor's.

But is a higher fee advisor actually worth it?

- The academic literature and actual performance data from active managers bear out what common sense would dictate: The odds of a high-fee advisor outperforming the market averages over a 30-year period are practically zero.
- When you factor in fees, transaction costs, and the chance that a high-fee advisor picks bad stocks, the underperformance worsens.
- Expertise in managing ultra-complex financial situations, estate planning and trust services, etc. can be valuable and deserve a higher fee. When you consider a high-fee advisor versus a low-fee approach, you can quantify the two and determine for yourself whether it's worth it for your situation.

Beware hidden fees

- If advisors allocate their clients to mutual funds, the mutual fund management fee is not explicitly stated on the monthly statements.
- Also, actively managed portfolios incur transaction costs from turning over the portfolio. Markups and bid-ask spreads are not reported on monthly statements.
- Advisors who keep idle cash balances for their clients may be paying a below-market interest rate and profiting from the spread.