BOSTON — There is no shame in being cost-conscious.

Price is often the critical factor when mutual fund companies compete for business. They want to be able to tout the lowest expense ratios for their funds. That's the figure that shows how much investors pay to cover operational costs. But it isn't the only cost you should be thinking about.

There's another significant cost that's harder to quantify, isn't disclosed, and remains largely invisible: expenses from the trades that the fund manager makes.

Three university professors tried to calculate the impact of trading costs on fund performance, and their conclusion suggests that a fund's expense ratio doesn't come close to capturing the full costs that investors pay.

The study's authors found that the typical fund's trading-related expenses take a bigger bite out of investment returns than the separate fund management costs reflected in the expense ratio. They estimate trading costs shave an average 1.44 percent from returns a year. That's substantially more than the impact from funds' posted expenses, as the average expense ratio of the funds studied was 1.19 percent.

Although the study found trading costs to be more significant, good luck to any investor hoping to calculate the impact they can have on a specific fund and its returns. There's no practical way to get a decent estimate. In contrast, fund expense ratios are easy to find and precise.

"On a practical level, given the current state of affairs, trading costs really are an invisible cost," says Roger Edelen, an associate professor of finance at the University of California-Davis.

The study by Edelen and co-authors Richard Evans of the University of Virginia and Gregory Kadlec of Virginia Tech is published in the current edition of the Financial Analysts Journal.

THE COST ANALYSIS

The study analyzed portfolios and trading data from nearly 1,800 stock funds from 1995 through 2006. A cost was estimated for each trade based on three components of trading expenses.

The first two are brokerage commissions paid to execute transactions, and bid-ask spreads. The spreads are the time-sensitive gaps between a stock's asking price and its selling price. A significant mismatch can make a stock more expensive to buy and cheaper to sell, cutting into an investor's return.

MARKET IMPACT

The professors concluded the third component, price impact, is the most significant. When a fund makes a big stock purchase or sale, that trade can affect that stock's market price as the transaction is completed, typically to the detriment of the fund's performance.

When a fund buys a large number of shares, the stock's price is likely to rise as the transaction is carried out, resulting in a higher share purchase price. A stock that a manager considered a good investment at $100 a share might be purchased for an average of $101. Then, when the manager looks to sell later on, the opposite happens.

It's an especially important challenge for funds that specialize in stocks of small companies that aren't heavily traded.

"The real killer on trading costs is price impact," Edelen says. "The fund manager on average buys a little bit high, and sells a little bit low."

For example, if the market gains 10 percent in a year, a fund that bought stocks that performed that well on average may only generate a 9 percent return, after trading costs. Successful fund managers might be able to offset those costs if their portfolios outperform the market. But high trading costs make that challenge especially difficult, Edelen says.

INVISIBLE COSTS

Trading costs are subtracted from the fund's assets, but aren't reflected in the expense ratio. Both types of costs ultimately affect the investment return.
But the trading costs aren't disclosed or easily calculated. The brokerage component of a fund's trading costs is typically detailed in a disclosure known as a "statement of additional information." But few investors read them, and there's no information on costs from bid-ask spreads or price impacts.

ANOTHER VIEW

John Rekenthaler, vice president of research with Morningstar, says his company's studies also have found that trading costs can significantly reduce a fund's returns. Although he didn't make any specific criticisms of the methods used by Edelen and his co-authors, Rekenthaler said the estimate of a 1.44 percent average annual impact for a typical stock fund sounds high.

The figure probably overestimates the trading impact because funds on average don't underperform market benchmarks as much as that number would suggest, he says.

WHAT INVESTORS CAN DO

Expenses from trading vary widely among funds, and there's no standard way to calculate the costs. So most investors are stuck with considering a fund's turnover ratio as a relative gauge to indicate the potential expenses the fund may incur.

The turnover ratio shows the percentage of the stocks in the fund that have been traded within the past 12 months. Fifty percent means half of the stocks have changed hands in a year.

Edelen and his colleagues have devised an alternative that they believe better reflects a fund's trading costs, called "position-adjusted turnover," which takes into an account the relative weightings of the stocks within the fund. For now, it's best to check the traditional turnover ratio, which is widely available on fund research websites.

There's no rule about what constitutes high turnover. But generally, a ratio of 100 percent is considered a high water-mark, or 50 percent if you're especially concerned about limiting trading costs.

If a fund's turnover exceeds those levels, you may want to steer clear, unless the fund's investing style justifies frequent trading.

Questions? E-mail investorinsight(at)ap.org

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