Double Dipping *By Shirley M. Mueller, MD*

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"You'd have to be stupid to invest in this. I don't know anyone that stupid."

When I was starting out in the investment industry in the late 1990s, I had an ethical dilemma regarding a product that my company sold. It was a fund composed of underlying mutual funds, a fund of funds. I suspected it was a "double dip"—meaning that the clients are charged twice. The first cost was the management expense for choosing and putting the mutual funds together. The second was the internal expense of each separate mutual fund.

Costly Advice

In order to sell this product, I had to confront my worst fears about it, that it was "double dipping." I asked my mentor at the company, "Do the clients pay the internal expense ratio and other charges that are inherent in these funds as well as our management fee?" "Of course," he said, "Why wouldn't they?"

I hesitated before pushing my point. It was important for me not to offend my teacher. I timidly replied, "Then the expenses are really high for this product since the client is charged not only our management expense of 1.5%, but also the internal expense of each selected mutual fund running at least 1.3%. The total expense would be somewhere around 2.8% taken out of an investment return. That's a chunk of money." The response of my mentor (who incidentally had spent some time at Harvard in their business school) was: "Well, look what they get for their money."

What did they get for their money? Well, almost certainly not what they had hoped. For the convenience of buying this bundled fund that they were told was poised to outperform the market, the investors were charged a 2.8% expense ratio. With the turnover of the managed funds and the taxes that it generated, they were paying even more. So, the managers had to outperform the market by 2.8% plus for our clients to make money. The problem is that there is an inverse relationship between expense and return. Research shows that in general, the higher the expense, the lower the return.

This was my first introduction to the world of 'double dipping,' or multiple charges for a bundled product. My nonverbal response was only in my head because I didn't want to offend my mentor. It was, "You'd have to be stupid to invest in this. I don't know anyone that stupid."

The truth of the matter was that my colleague didn't either. The difference between the two of us was that when he explained the product to clients, he just didn't mention the internal charge of each fund in addition to the management fee. In that way, the client didn't really know what they

were paying in expenses. And, in the collective psyche of the investment industry, the client's perception is reality, which is something like, "What the client doesn't know won't hurt him."

In reality, investors aren't stupid when presented with accurate information. Instead, they respond wisely and in their own best interests, just as they should. There is concrete evidence for this in my recent blog at Physician's Financial News, *Vote with Your Feet*.

Do Some Digging

Are you invested in bundled funds and paying high expenses for that convenience? This is how to find out. First decide if any of your funds are bundled. You can determine this by looking at the fund's holdings. If it contains underlying mutual funds, you have a bundled fund. Then, try to assess what you are paying for it.

If you are charged more than the weighted average* of all the underlying funds, you are paying two expenses, the second for overall management. Your fund is double dipping. Another approach to this problem is to call your broker or investment manager and ask direct questions about any management fee of bundled funds you own, as well as separate mutual fund expense ratios assessed to you.

A way to avoid this situation altogether is to invest in low-cost index funds that don't 'double dip', even when they are bundled. Take for example, the Vanguard Life Cycle funds that I discussed last week in *Investment Ideas for Time Starved Doctors*. I was assured by two different Vanguard representatives that the management expense ratio for the life cycle funds is the only cost and that a further underlying internal charge for each fund is not assessed. In the words of Dan Emmons, one of the Vanguard representatives, "The expense is only the weighted average of the underlying funds." He is right. I figured the numbers and they do add up. Fidelity and T.Rowe Price also have low-cost funds, though generally they are more expensive than Vanguard.

As Benjamin Franklin said, "An investment in knowledge pays the best interest." Understanding why higher cost bundled funds are best to avoid must surely fall in this category.

*Weighted average: The item (in this case expense ratio) multiplied by its weight (in this case % of underlying fund to total) and then added to the other similarly figured items. The total is divided by the weights (usually 100) to yield the weighted average.