Dollars & Sense

Size Does Matter … For Your Expense Ratio

Joel M. Schofer, MD MBA CPE FAAEM
Commander, Medical Corps, U.S. Navy

I published this article three years ago in Common Sense*, but this is such a critical concept that it bears repeating every few years. In addition, the recent price war among investment firms has made it even easier to lower your investment costs.*[1] *There has never been a better time to take a solid look at the investment costs you are paying.*

Whether you are managing your investments by yourself or getting help, you need to understand one critical concept, the expense ratio of your investments. Every mutual fund and exchange-traded fund (ETF) has an expense ratio and keeping it as small as possible is key to your long-term financial success. Size does matter.

What is an Expense Ratio?

An expense ratio is the percentage of a fund's assets that is used for expenses. In other words, if you invest in a mutual fund with a 1% expense ratio and that fund makes 10%, you'll only get a 9% return on your investment because 1% goes to pay expenses. The less of your return you use to pay expenses, the more you get to keep.

What is an average expense ratio? An average stock mutual fund has an expense ratio of about 1%, but the expense ratios for mutual funds that are similar in their composition can vary wildly. For example, if you look at a list of Standard & Poor 500 index funds offered by investment companies, you'd find expense ratios as low as 0.032% for the Thrift Savings Plan (TSP) C Fund (a military only retirement investment) and as high as 1.36% (State Farm S&P 500 Index B, SNPBX).[2,3] While 1.33% does not seem like that large of a difference, keep in mind that costs last forever and that small differences compounded over years will cost you a lot of money. Incidentally, that is one of the major benefits of the military retirement plan – its industry leading low cost.[4]

Love Your Grandparents

Let's pretend that when you were 25 years old your grandparents gave you $10,000 to invest in an S&P 500 index fund for 50 years, during which you earn a 9.5% return. If you invested in the State Farm index fund with the 1.36% expense ratio, you would have $500,000. That sounds pretty good! However, if you invested in the TSP C Fund with the 0.032% expense ratio, you would have $921,000.

That 1.33% difference in the expense ratios cost you $421,000!

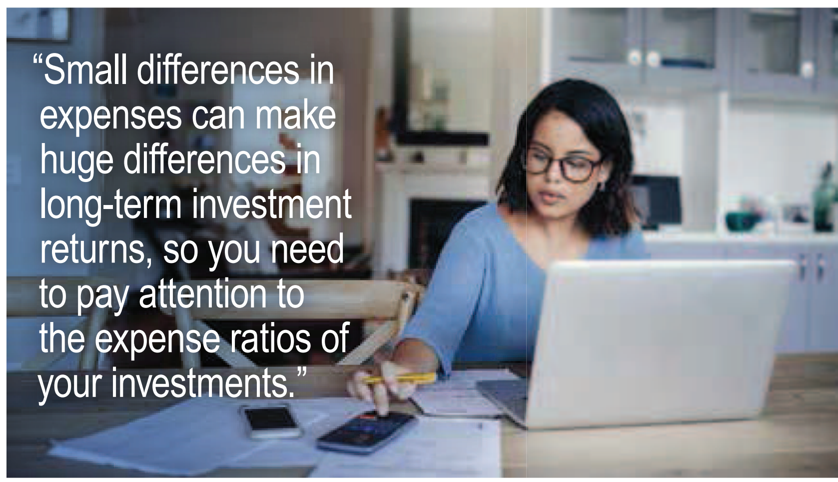
Small differences in expenses can make huge differences in long-term investment returns, so you need to pay attention to the expense ratios of your investments.

This difference is even more dramatic when you compare actively managed funds to passively managed index funds. Because actively managed funds have higher expense ratios than index funds, it is very difficult for an active manager to beat his/her comparative index over the long-term. This is why I invest 100% in index funds.

Shop Around

When you are picking your investments, keep in mind that you can't control what happens to the market, but you can control which investments you choose and the expenses that they charge. Any time you are looking to invest in a mutual fund or ETF, you should search for similar funds and compare expense ratios, which you should try to keep below 0.5% (or even 0.25% if possible). You can find the expense ratio easily by looking up the fund you're considering on Morningstar.com.

Make sure that at a minimum you take a look at the Vanguard version of the investment you are considering since their expense ratios are consistently among the lowest in the industry and they never charge extraneous fees, like loads.



There is no reason to pay more expenses for what is the same investment product. The size of your expense ratio matters. It could cost you A TON of money over the long-term.

If you'd like to contact me, please email me at jschofer@gmail.com or check out the two blogs I write for, MCCareer.org and MilitaryMillions.com.

The views expressed in this article are those of the author and do not necessarily reflect the official policy or position of the Department of the Navy, Department of Defense or the United States Government. ●

References

1. The Investment Company Price War and the Thrift Savings Plan http://www.militarymillions.com/2017/09/06/the-investment-company-price-war-and-the-thrift-savings-plan/
2. C Fund: Common Stock Index Investment Fund https://www.tsp.gov/InvestmentFunds/FundOptions/fundPerformance_C.html
3. State Farm S&P 500 Index B SNPBX https://www.morningstar.com/funds/XNAS/SNPBX/quote.html
4. Why are the TSP Investment Expenses So Low? http://www.militarymillions.com/2018/02/20/why-are-the-tsp-investment-expenses-so-low/