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Opinion: Improve Disclosure of Portfolio Transaction Costs

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Brokerage commissions and other portfolio transaction costs are the largest shareholder cost not reflected in the expense ratio of a mutual fund. The most quantifiable of these costs should be disclosed in a more transparent manner, as it is a real expense borne by shareholders.

After several years of inaction, the SEC should take steps to improve the disclosure regime for these costs. And, as an immediate step, mutual fund boards should use the existing regulatory framework to improve the transparency of these costs for investors.

Under current rules, the cash amount paid for brokerage commissions is disclosed annually in a mutual fund's Statement of Additional Information. Unfortunately, this number has little value to an investor unless it is compared to the average net assets of a mutual fund and converted into a percentage ratio.

This disclosure problem is further complicated by the fact that mutual funds do not always pay a cash commission to transact in portfolio securities. For example, some stocks and many bonds are traded via a bid/ask spread, with brokers on both sides of the transaction being compensated by the difference between the price offered by the buyer (the "ask") and the price offered by the seller (the "bid"). This "market spread" cost is not considered a cash commission payment. Therefore, it is not included in the disclosure presented in the SAI. Instead, the higher price paid by the buyer and the lower price received by the seller are reflected in a fund's capital returns over time.

A further problem is how best to evaluate the other indirect costs of portfolio trading. For example, a mutual fund that seeks to purchase a large block of an illiquid security may have a "market impact" cost if its own actions raise the price of that security as the fund accumulates a position. Similarly, a fund that expects to have a certain level of redemptions in its shares may need to retain a larger cash balance, creating an "opportunity" cost for this uninvested amount.

The SEC should develop a standardized approach to quantifying and measuring these portfolio transaction costs. The SEC should also establish a disclosure format that provides comparability among different mutual funds, in order to improve investor education and decision-making. The SEC started this process by issuing a Concept Release on transaction costs in 2003, but the agency has not taken any additional steps for the past six years.

The process of developing a standardized and comparable disclosure format will be complicated and time-consuming. As an interim step, the SEC should consider a more practical approach that improves upon the disclosures investors now receive regarding transaction costs. This "walk before you run" approach can also be adopted and implemented by mutual fund boards, under existing disclosure rules.

As noted earlier, each mutual fund already calculates and discloses the actual brokerage commissions it pays in cash each year, a dollar figure that is presented in the SAI. To help investors compare these costs across funds, this figure should be converted into a percentage of the average net assets of each fund and

disclosed as a Transaction Cost Ratio.

To calculate this Transaction Cost Ratio, a fund would take the amount of aggregate brokerage commissions paid each year and divide this amount by the average net assets of the fund over the same time period. This ratio should be provided on an annual basis and it should be separate from the expense ratio, for comparability purposes. A mutual fund should explain in a footnote why this number could be higher or lower, as a result of any purchases of stocks or bonds via bid/ask spreads and not cash commissions.

Once the SEC has completed its evaluation of the more indirect costs of portfolio transactions, a fund can disclose these additional costs — along with the brokerage commissions that it pays each year — in a format that provides a more robust financial measure to investors.

As a goal, transaction costs need to be measured in a standardized and comparable manner. However, investors should not have to wait until academics and regulators devise a perfect formulation of these costs. As legendary investor Warren Buffett is fond of saying, “It is better to be approximately right than precisely wrong.” Mr. Buffett was referring to the inadequacies of “beta” as a financial gauge in this quote, but the analogy is quite appropriate when applied to the issue of portfolio transaction costs.

The information needed to develop a simplified Transaction Cost Ratio is available today. Brokerage commission costs should not be buried in the SAI, but disclosed to shareholders in a more meaningful way. The SEC should require this type of disclosure by all funds. And fund boards should use the current regulatory framework to provide this calculation today — with appropriate explanations — in fund prospectuses and shareholder reports.

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