The Cost Of Investing

When we think about investing, we are inevitably drawn to focus on the upside. We love words and phrases like earnings potential, yields, ROI or profit outlook. On those occasions when we let our thinking walk on the wild side, we broaden our horizons to encompass concepts such as investment mix, risk profiles, portfolio lifecycles and market volatility.

Rarely it seems do we pause to consider every investment comes with costs attached. Even at the most surface level, you are taxed on your gains and likely encounter fees and charges along the way, often regardless whether your investment is successful or not.

Hidden Pain

Investment costs are the perennial Cinderella's of investing. Underestimated and largely unappreciated, the costs related to acquiring and holding an investment, regardless of its form can determine the attractiveness of an investment' or act as a sea-anchor on an investment's long-term performance.

Real estate fees, service provider fees, broking commissions, entry and exit fees, they all represent a significant potential drag on investment performance. Costs can make a major difference to our return on investment both for individual investments and across a portfolio. If we're paying a one percent charge of our managed funds portfolio to a fund manager each year, that's a significant amount of cash that isn't earning you compounding returns each year!

The Usual Suspects

Investors dipping their toes in the stock market or mutual funds will quickly encounter a trio of ever-present costs in the form of management fees (for furnishing sage investment help), transaction fees (buying or selling fee, often referred to as a commission) and brokerage fees (fee for matching buyers to sellers when trading a stock or security).

Then there is often another bevy of fees in the form of payment fees (fee for transferring cash in or out of your investment account), ETF fees (admin charges), administration fees (accounts non-investment activity), overdraft fees cost of (borrowing plus administrative charges) and trailing fees (third party commission).

Unfortunately for investors, these different forms of commission charges are payable regardless of whether your investment is successful or not.

Costs To Watch For: Management Fees

Some investment commentators argue forcefully that all management fees are bad for investors. Generally, management fees vary widely depending on the type of fund involved. Bond funds generally carry lower management fees, while international equity funds trigger higher expense loadings, as the funds have to track the complex web of companies they invest your funds in.

Naturally, higher management fees impose a higher performance threshold for fund managers to jump, as their investments have to offset the value dip represented by their management fees. However, if a fund out-performs its competitors, it can justify its steep fees compared to a fund charging lower management fees. This is why focusing on a fund's performance rather than its fee structure is often the key to managing your overall fund performance.

Costs To Watch For: Front-End Loads

Brokers are often paid a commission for their efforts in selling mutual funds. Front-end loads adopt varying permutations and are generally bad news for investors, as the moment you buy into a front-end load fund you have lost a chunk of your investment to those fees. If you invest $100,000 in a fund and the broker receives a $5,000 commission, you'll have to recoup your $5,000 simply to break even. Paying an up-front load also deprives you of the benefit of the compounded growth your full investment would have otherwise received. Consequently, it will take longer for you to achieve your financial goals.

Costs To Watch For: Expense Ratios

Mutual funds investors are generally well aware of most of the expenses they pay to fund management firms. The iconic expense ratio shows investors the costs they are paying for the privilege of having an outside firm manage their money, overseeing the investment process and ensure the selections the fund manager are making are consistent with the fund's stated investment objective and are likely to deliver reliable long-term growth.

What many investors often don't realize is that the expense ratio doesn't necessarily cover all of the costs incurred in the course of business by a typical fund.

The expense ratio often excludes brokerage commissions paid by fund managers to execute their trades. Moreover, funds that rely on dynamic securities trading often burn through significant sums in what's known as the bid-ask spread. This aspect of share trading reflects the amount collected by market makers in exchange for agreeing to stand by ready to buy or sell shares at all times.

Costs To Watch For: Brokerage

These days savvy investors treat service costs such as brokerage in much the same way they approach utility bills, they have learned to shop around. Be on the lookout for ways to reduce your investment costs wherever you can, such as negotiating your conveying fees and the landlord insurance premiums for real estate investment

Look to apply the same frugal mindset share market brokers as well. There is an upfront brokerage cost to buy shares but from there on in there are no ongoing fees. Look at companies with dividend re-investment schemes to squeeze more investment bang for your stock buck.

Then there are Australia's perennially high brokerage fee levels. Compared to other markets, Australian brokers are some of the most expensive.

Technology is bringing down brokerage prices a lot, but they're still expensive compared to other countries. Look at some of the rates offered by the discount brokers active in Australia such as IG or CMC. Their prices are significantly cheaper than the fees charged by our big four banks.

Saving on brokerage costs gives you more to invest or to put towards another investment. Over your investing lifetime, you are likely to spend hundreds of

dollars on brokerage fees. Any strategy you adopt that reduces the structural cost of investing in the share market is a good thing for your investing activity.

Why Are Costs An Important Consideration

As with any aspect of investing, fees and charges for services should represent value for money. All costs combine to reduce both the attractiveness of your ultimate returns and depress the pool of funds you have available to you to invest for your future.

Hence, being savvy about the real costs of each investment can make a significant difference to the overall performance of your investment portfolio.

Final Observation

Like most aspects of investing, you ultimately get what you pay for. If an investment costs less, it might not be the best financial product you can buy. Never choose an investment just because its entry costs are less, however, make sure you're not paying too much either. There are literally thousands of investments available to choose from and their costs naturally vary. Be an informed investor. Understand what costs are involved when you're choosing your investment and be sure to clearly identify both the investment's entry and its exit costs. You just have to know what the different costs are. Remember, every dollar you save in costs is another dollar you can put into your actual investments.

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