

Bequeathing Your Assets to Your Broker

(Thank You, Paine Weber)

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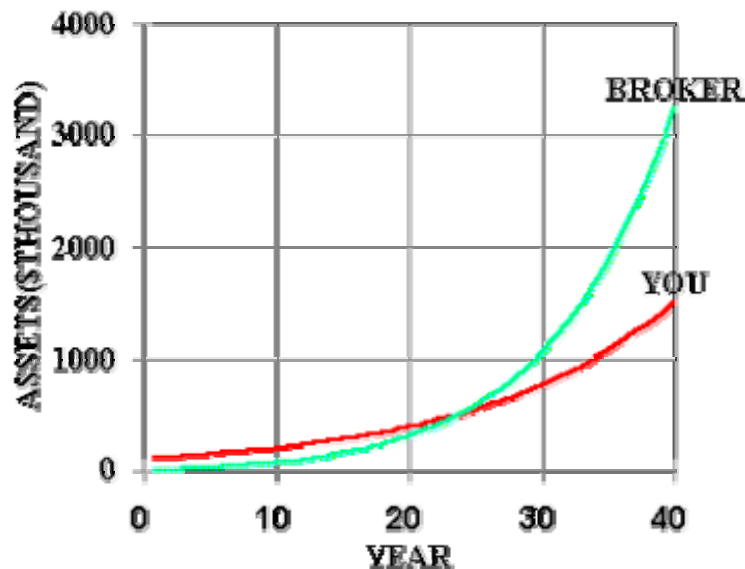
A hoary peice of stockbroker lore has a young broker asking a senior partner at the firm about his proudest accomplishment. The reply:

"Over the years I've gradually transferred the assets of my clients to my own name."

Awareness of investing expense has heightened in recent years, and it is instructive to examine the truth of this old joke. Imagine for a moment that you inherited \$100,000 at age 25. Not long after an enterprising broker at a "full service" firm calls and offers you his services. He is quite personable and always seems to have a snappy explanation for the behavior of the market; you engage his services. Considering your conservatism, he invests your portfolio in a 50/50 mix of common stocks and bonds. What can you expect in the way of long term return? What will become of his commision stream? The first question is easy to answer. Assuming that he is of average ability, this mix will produce a long term return of about 8% . (The long term return of common stocks is about 10%-11%, of long term corporates about 5%-6%.).

Unfortunately, *your* return will not be that high. Whether you use a "wrap" account or employ a straight comission basis, fees will reduce your returns by approximately 3% per year -- to about 5%. This is only 2% greater than the long term inflation rate of 3%.

This is discouraging enough. Now consider what the broker accomplishes with your comissions. He now has a steady income stream, consisting of 3% of your assets each and every year, to invest. He should also earn the same 8% return, but his investment return will not be substantially reduced by comissions and fees.



The above graph shows that in 24 years the brokerage will have parlayed your commissions into a sum equal to your own. When you retire at 65 you will have amassed \$704,000. Your broker has done far better; he has produced \$1,542,000 with the commissions from your account.

The above calculation is somewhat artificial. The grim reality is actually much worse. Since your broker will be turning over the assets in your account with some regularity to earn commissions and/or justify their fees, this will generate significant capital gains. Taxes on these gains, as well as your bond coupons, will reduce your investment yield about 3%, just keeping up with inflation. In contrast the broker will most likely manage his assets with little or no turnover, further widening his asset advantage.

For the full service brokerage customer, then, the old broker's remark is no joke -- eventually, your broker will wind up with more of your own assets than you do. For the no load fund investor, things are a little brighter, but still fairly grim. Assume Fidelity charges you 1% in expenses to manage your portfolio. Under the above 40 year scenario, this leaves you with \$1,479,000, but Uncle Ned still earns \$722,000 for himself. Vanguard should be able to invest your assets in their index funds for about 0.25% -- the numbers here are \$1,980,000 for you, \$169,000 for them.

Obviously, Paine Weber, Fidelity, and Vanguard do not get to keep *all* of their expenses. Fidelity will use a large part of their management fees for advertising, enabling them to manage an even greater portion of the wealth of Western Civilization. Vanguard's expenses are so low that it is doubtful that there is much profit margin. In any case, Vanguard is actually owned by its funds' shareholders; John Bogle is not getting terribly rich at your expense.

So, keep an eye on those expenses. Thank you, Paine Weber (Merrill Lynch, Smith Barney, etc., etc.).