



## The Hidden Cost of Compounding: An Analysis of Mutual Fund Fee Structures and Long-Term Returns

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This paper analyzes the impact of Expense Ratios (TER) and hidden transaction costs on the long-term performance of mutual funds. This study demonstrates an inverse relationship between fees and net returns. The findings indicate that small, yearly fees compound into massive wealth erosion over 10–20 years, with over 80% of active funds in some categories failing to outperform passive alternatives after fees. The "hidden" cost of fees is not just the payment itself, but the lost opportunity cost of that money failing to compound.

**Keywords:** cost of compounding, total expense ratio, mutual funds, long term returns, net asset value, asset under management

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## 1. Introduction

Before we dive deep to understand mutual funds returns over long term and delve deep to understand impact of fees on long term returns let us define some common terms used frequently in mutual fund industry.

**Assets under Management (AUM):** Assets under management (AUM), also called funds under management, is the total market value of the securities a financial institution (such as a bank, mutual fund, or hedge fund) owns or manages on behalf of its clients.<sup>1</sup>

**Total Expense Ratio (TER):** The Total Expense Ratio plays a significant role in mutual fund investments. It measures the total costs of managing and operating a mutual fund, expressed as a percentage of its assets.

When the TER is lower, a larger portion of the fund's assets is invested to generate returns for the investor. This could lead to better investment performance, as more money is being put into work.

On the other hand, a higher TER implies that a larger chunk of the fund's assets is being used to cover expenses. This can reduce the net returns to the investors as the costs incurred by the fund eat into the profits.<sup>2</sup>

**Formula for calculation:**  $TER = (\text{Total Annual Expenses} / \text{Average AUM}) \times 100$

**Net Asset Value (NAV):** The difference between assets and liabilities for companies and business entities is known as the net assets, the net worth, or the capital of the company. NAV is also applied to fund valuation and pricing. A fund's per-share NAV makes pricing easy for investors to understand, so it's used to value and conduct the buying and selling of a fund's shares.

NAV per individual share is often close to or equal to a business's book value per share. Companies considered to have high growth prospects are traditionally valued more than NAV might suggest. Per-share NAV for closed-end funds is frequently compared to the stock price or market value per share to find undervalued or overvalued investments.<sup>3</sup>

**NAV Formula:** NAV is calculated by using the following formula.

$$NAV = \text{Assets} - \text{Liabilities}$$

$$NAV \text{ per unit} = (\text{Assets} - \text{Liabilities}) / \text{Total number of outstanding unit}$$

**Active Management of Funds:** The term active management means that an investor, a professional money manager, or a team of professionals is tracking the performance of an investment portfolio and making buy, hold, and sell decisions about the assets in it. The goal of any investment manager is to outperform a designated benchmark while simultaneously accomplishing one or more additional goals such as managing risk, limiting tax consequences, or adhering to environmental, social, and governance (ESG) standards for investing. Active managers may differ from other is how they accomplish some of these goals.

For example, active managers may rely on investment analysis, research, and forecasts, which can include quantitative tools, as well as their own judgment and experience in making decisions on which assets to buy and sell. Their approach may be strictly algorithmic, entirely discretionary, or somewhere in between.<sup>4</sup>

**Passive Management of Funds:** passive mutual funds aim to replicate a market index like the Nifty or Sensex. These funds invest in the securities of the selected market index in the same proportion as they are present in the index. Fund managers of passive funds do not conduct any research to actively pick up stocks that can be a part of a fund's portfolio. They simply imitate the index composition.

For example, a passively managed fund tracking the Nifty 50 index will invest in the stocks of 50 companies that make up the index in the same proportion. Therefore, compared to active funds, these funds charge lower fees as they do not need to conduct in-depth market research to select investments individually.<sup>5</sup>

**The Compounding Effect of Fees:** Mutual fund expenses are expressed as a percentage of Assets Under Management (AUM), known as the Total Expense Ratio (TER). These are deducted daily, meaning investors do not see an explicit bill, but their Net Asset Value (NAV) is lower.

**Active vs. Passive:** Active funds aim to beat the market. They are managed by professional fund managers.

These managers research companies, track trends and take investment calls based on data and judgment. The goal is simple. Generate returns higher than the benchmark. But this approach comes with higher costs. Expense ratios for active equity funds in India usually range between 1% and 2% annually.

Passive funds work very differently. They do not try to beat the market. They simply replicate a benchmark index, such as the Nifty 50 or the Sensex. Index funds and ETFs are the most common passive products. Since there is no active stock selection, costs remain very low. Some passive funds charge expense ratios as low as 0.05%. This difference in cost becomes critical over time.<sup>6</sup>

**The Hidden Aspect:** A 1% difference in fees over 20 years can cause a substantial difference in final corpus, often reducing it by 25% or more.

Hidden commissions in regular mutual fund plans can significantly erode long-term investor wealth, with most investors losing more than a quarter of their potential gains over a decade, according to a new study by 1 Finance Research.

The report found that over a 10-year holding period, more than 80% of equity mutual fund schemes delivered at least 25% lower wealth to investors in Regular plans compared with Direct plans of the same fund. Nearly one in five schemes showed a wealth gap of over 50%, driven purely by the compounding impact of higher expense ratios embedded in Regular plans.<sup>7</sup>

## 2. Relationship Between NAV and Fees: There is an Inverse Relationship Between NAV and Fees Charged on it

**2.1. Negative Correlation between Fees and Returns:** An analysis of Indian Large-Cap funds (2019-2023) shows a strong negative correlation (e.g., -0.85 to -0.97) between expense ratios and NAV growth.<sup>8</sup>

**Result:** As expense ratios decrease, net NAV tends to increase significantly.

**2.2. The 20-Year Impact:** Total Fees and growth multiples for different fee levels.

The example below is for Rs 10,00,000 initially invested (with no further contributions) over 20 years with annual gains of 10%.

Table 1

Fee Level	Final Balance (In Rs)	Growth Multiples	Fees Paid (in Rs)
0.05%	6666604	6.67x	28,475
0.50%	6141612	6.14x	2,70,611
1.00%	5604411	5.60x	5,11,601
1.50%	5112046	5.11x	7,25,655
2.00%	4660957	4.66x	9,15,239
2.50%	4247851	4.25x	10,82,617

**Key Finding:** A difference 1.95% (2.00%-0.05%) in fees level resulted in nearly Rs 20,00,000 lost in wealth, of which only a fraction is the fee itself; the rest is lost compounding.

When the expense ratio is 0.5%, the investment grows to about Rs 61,41,612, with about Rs 2,70,611 in fees. But with a 2.5% expense ratio, the investment grows to only about Rs 42,47,851, with about Rs 10,82,617 paid in fees.

## 3. Expense Ratio Trends

The good news for investors is that expense ratios have been decreasing because of growing competition among fund providers and other changes that have lowered overall expenses. For instance, improved operational efficiencies have helped fund providers reduce administrative costs.

## 4. Key Components of Hidden Costs

Following are the components of hidden costs-

**4.1 TER (Total Expense Ratio):** Management fees, admin, and marketing.

**4.2 Transaction/Turnover Costs:** Brokerage fees incurred when the manager buys/sells stocks within the portfolio, often high in active funds.

**4.3 Regular vs. Direct Plan Commissions:** Regular plans, which pay commission to brokers, can be over 25% worse off than direct plans over a 10-year period.

**4.4 Taxation and Exit Loads:** Exit loads of 0.25%–3% for early withdrawal reduce net returns.

## 5. Conclusion

The "hidden cost" of mutual funds is not just the annual fee but the exponential loss of potential future growth (negative compounding). To maximize long-term returns, investors must prioritize low-cost, direct-plan, and passive options, especially over long holding periods where the fee impact becomes dominant.

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