Smoke, mirrors and the true cost of investing

Summary

In this day and age, price comparisons are quite easy to make, particularly when it comes to buying tangible goods, as the internet provides great transparency. When it comes to investing, gaining meaningful insight into the real costs incurred is extremely hard and approximate. We have a go using the latest insights available.

The result: a passive investment approach is extremely competitive.

Client Communication

October 2015

'The easiest way to make money is to take it from other people; that is what the financial services industry does..." Pauline Skypala, FTfm, 9th September 2013

Fund management: an industry not covering itself in glory

It is unlikely that many readers of this note will have noticed that the industry body that represents the fund management industry in the UK – The Investment Association – is in turmoil. By way of background, the Investment Association has over 200 member firms managing more than £5.5 trillion globally. Its aim is an honourable one: *'to make investment better for clients, companies and the economy so that everyone prospers'.*

Yet its CEO has just resigned, and two of the largest member firms – Schroders and M&G - are allegedly quitting the organisation because of recent reforms being undertaken. These reforms, delivered as a non-legally binding '*Statement of Principles*' to be signed by members, are aimed at aligning interests, placing clients first and providing investors with greater transparency on costs. Although these events may seem unremarkable, the inference is extremely worrying; the industry appears not to want to participate. Reading the list of principles makes one wonder why they object so much:

The Investment Association's Statement of Principles, April 2015[1]

1. Always put our clients' interests first and ahead of our own
2. Take care of clients' money as diligently as we would our own
3. Only develop, offer and maintain funds and services designed to add value for clients and help them achieve their financial goals
4. Maintain and apply the investment and operational expertise needed to meet the objectives agreed with clients
5. Make all costs and charges transparent and understandable
6. Disclose to investors the source and value of any other material benefit we receive as a consequence of our role as investment manager
7. Ensure regular, timely and clear lines of communication with clients
8. Set out clearly our approach to the stewardship of client assets and interests
9. Maintain a corporate culture that sustains these principles
10. Work with industry colleagues and stakeholders to develop and maintain guidance on industry best practice

It is almost impossible not to agree with all ten principles and it is astounding that only 25 of 200 firms actually signed up to them. In short, it appears that the industry does not want investors to know what charges and costs they are incurring. Surely, every investor has the right to know what is happening to their money and to be able to make an informed choice when deciding who has earned the right to manage it on their behalf.

In this note, we will make a 'best-estimate' comparison between passively and actively managed portfolio costs, which may explain some of the reluctance.

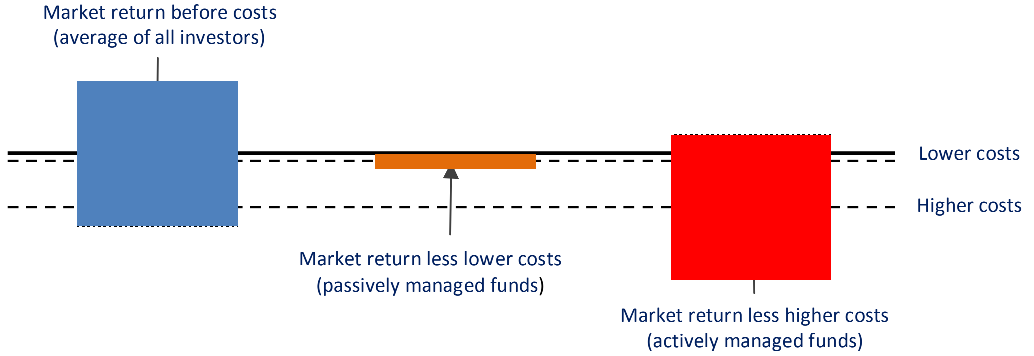
[1] This can be found at http://www.theinvestmentassociation.org/investment-industry-information/current-initiatives/statementofprinciples/

A recap on why costs matter

In order to understand the importance and impact of costs, one needs to understand that transacting in markets is a zero-sum game, in aggregate. The return of the market is simply the average return of all investors, before any costs have been deducted. Some investors may have done well and others badly. We know for certain that the gains of the winners must be funded by the losses of the losers. We also know for certain that in real life, the returns achieved by investors needs to take into account the costs of transacting in the market.

It is also important to note that, on average, passively managed funds – such as index trackers - have materially lower costs than actively managed funds, both in terms of the direct cost of paying the fund managers their fee and the indirect costs associated with trading the underlying portfolios (buying and selling shares) that the manager incurs. The figure below illustrates the concept of the zero-sum-game-less-costs.

Figure 1: The zero-sum-game-less-costs that investors play



Source: Albion Strategic Consulting

The simple maths of the less-than-zero-sum-game-after-costs therefore means that the average investor in lower cost passive funds will beat a majority of investors invested in higher cost active funds. That is a galling conclusion for the clever and hardworking active fund management community. The table below provides some evidence of the power of the zero-sum-game-less-costs environment. It illustrates the percentage of actively managed funds beaten by an appropriate benchmark. Note that even in markets where one might expect active managers to do well at finding mispriced securities – such as emerging market equities, small cap stocks and high yield bonds – around 90% fail to achieve their promise to beat the market return.

Table 1: SPIVA – US active funds beaten by their benchmarks over 10 years to end-2014

All US equity	US large equity	US large value equity	US small cap equity	US small value equity	International equity	Emerging market eq.
77%	82%	59%	88%	87%	84%	90%
US REIT (property)	**US Govt. long bond**	**US Govt. short bond**	**Investment grade long**	**Investment grade short**	**High yield bonds**	**Global bond**
78%	95%	68%	97%	58%	93%	75%

Source: S&P Dow Jones Indices[2]

[2] http://us.spindices.com/resource-center/thought-leadership/spiva/

Ante-diluvium access to cost information makes comparisons hard

Remarkably, it is quite difficult, even for those operating in the industry, to get a firm handle on what the true cost of investing actually is. In this note, we will try to estimate it using the latest third-party data and research. First, it makes sense to understand what components of cost we need to look at. We have focused on investment costs, rather than the broader costs associated with obtaining proper financial planning advice, administering assets and avoiding the behavioural costs of emotionally driven, wealth destroying decisions (buying high and selling low, based on greed and fear).

The elements of investment cost

The range of fees and costs incurred by investors is long, complicated and hard to put an accurate figure on, something the Investment Association's *'Statement of Principles'* would have done much to improve.

Ongoing Charges Figure (OCF):

The ongoing charges figure (OCF) is the overt cost that investors incur by investing in a fund. This is the sum of the Annual Management Charge (AMC) charged by the fund manager and the other direct costs incurred by the fund, which can be offset against the fund's performance. As such, the OCF is nearly always higher than the AMC alone. OCFs can be found in the Key Investor Information Documents (KIIDS) that each fund or ETF is required to produce.

- *These include:* depository fees, custody fees, audit fees, registration fees, legal and regulatory fees incurred by the fund.
- *They do not include:* performance fees charged by the fund manager, entry or exit costs, interest on borrowing, brokerage charges and other dealing costs incurred by the fund.

Turnover (dealing) costs:

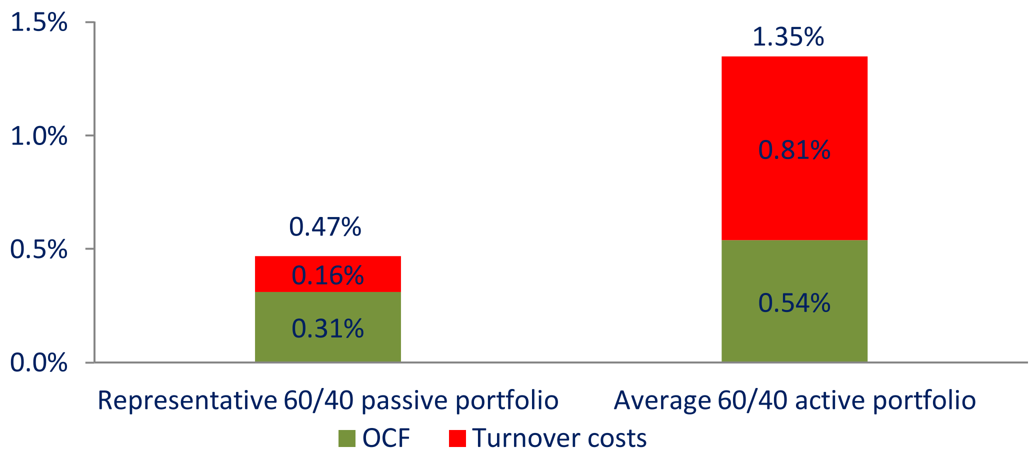
These are the covert costs incurred by investors when securities within a fund are bought and sold. The costs are the product of the proportion of the fund that has been turned over and the costs of transacting the trades to sell and buy securities. Currently funds do not have to reveal the turnover costs that they incur when managing client assets within the fund. The KIID documents, when they were introduced, took a step backwards in terms of transparency, by dropping the requirement of funds to report a turnover figure. Investors are in the dark. Turnover costs can be broken down into three categories:

- *Visible cash costs include:* brokerage commissions, taxes, fees, and acquisition costs (e.g. property purchases). These costs will be reflected in the accounts of the fund and can be accurately calculated, with a bit of hard work.
- *Hidden cash costs include:* bid-ask spreads, being the difference in price between what a broker will buy or sell a security at; and undisclosed revenue, such as retained interest and/or retained income from securities lending. The return drag of cash held in funds is also a cost. Whilst it may be possible for estimates to be made of bid-offer spreads, other costs are often more difficult to estimate.
- *Hidden non-cash costs include:* market impact costs that occur when buying or selling securities, where the price moves against the trade (in a zero-sum-game world, someone must be benefitting from the adverse price movement, so in theory, this cost is net zero to the industry and could be ignored); market exposure i.e. the consequence of being out of the market during the trade; and other costs when trying to execute a trade e.g. not executing at the best price.

Costs in practice

The figure below provides a summary of the estimated cost differential based on the latest research that we can find, capturing both the visible and hidden costs. The figures relate to a 60% growth assets (equity) and 40% defensive asset (bond) mix. The representative passive portfolio is based on a global portfolio with allocations to value and small cap equities, emerging markets and global commercial property, balanced by short-dated global bonds and inflation linked bonds. The average active portfolio is based on the same asset allocation and dealing costs, but uses average OCFs of UK domiciled equity and bond funds and sector specific turnover rates. (The sources that underlie the numbers can be found in the endnote[1] of this document).

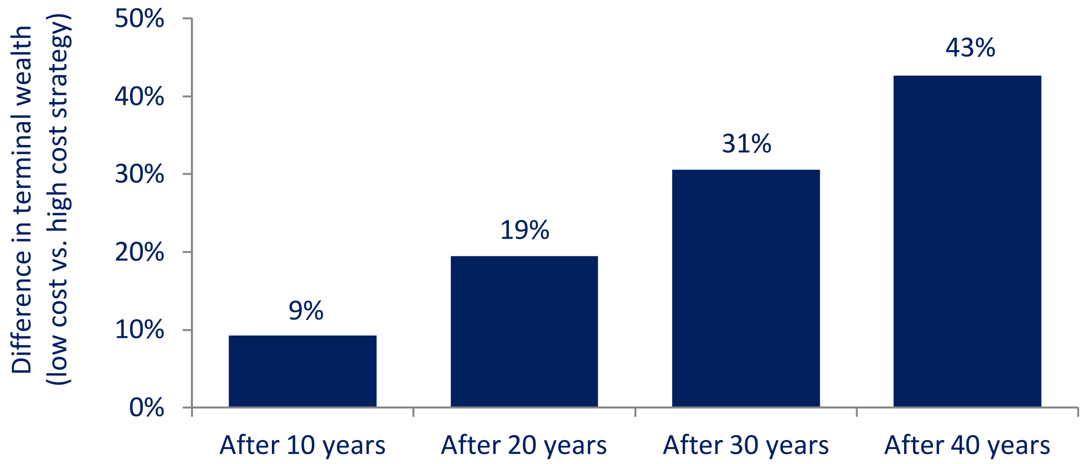
Figure 2: Cost comparison – costs matter



Source: Albion Strategic Consulting

The cost differential may not seem that large but, due to the power of compounding and time, it is. The figure below provides some insight into the effect of suffering higher costs; it shows the difference in total wealth (on a relative basis) between a lower cost strategy and a higher cost strategy. For illustrative purposes, we have used the 0.47% number above for lower costs and 1.35% for higher costs. Readers will be able to see why the resistance to greater transparency appears to be endemic in the fund management industry.

Figure 3: The relative difference in terminal wealth over different time periods



Source: Albion Strategic Consulting

Obtaining value for money

The most important thing about incurring costs is that they should, each in turn, represent value for money. It could, perhaps, be argued that using active funds in a portfolio is likely to be poor value for most. Other frictional costs, such as the administration of client assets by a wrap platform, should be managed as tightly as possible. Over the past few years passive fund costs have fallen significantly along with wrap platform fees, which is great news for investors. Perhaps the biggest cost of all is making emotionally driven decisions that lead to a buy high, sell low strategy of wealth destruction.

It is important to remember that ongoing fees relating to broad financial planning should not just be considered as an investment management fee, but the small price that is paid to allow clients to live the lives that they have chosen, comfortable in the knowledge that their financial affairs are in robust order.

Conclusion

It is impossible to overstate how important it is to manage costs of all kinds tightly. It is something that we continue to do on behalf of our clients, through our systematic, low cost, passive approach to investing. As the legendary Jack Bogle[3] once said:

'In investing, realize that you get what you don't pay for. Whatever future returns the markets are generous enough to deliver, few investors will succeed in capturing 100% of those returns, simply because of the high costs of investing—all those commissions, management fees, investment expenses, yes, even taxes—so pare them to the bone.'

We agree.

[3] In Investing, You Get What You Don't Pay For. Remarks by John C. Bogle, The World Money Show February 2, 2005, Orlando, Florida https://personal.vanguard.com/bogle_site/sp20050202.htm

Other notes and risk warnings

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[1] ENDNOTE

Comparison between the representative passive portfolio and the average actively managed portfolio draws on a number of sources:

Round trip transaction costs:

- True & Fair (2013) Investment Calculator: Full assumptions and calculations explained, p.6
- Miller, A., Miller, G., (2012), Promoting Trust and Transparency in the UK Investment Industry, SCM Private, www.scmprivate.com (refer to the Explanatory Notes section).
- Edelen, R., Evans, R., Kadlec, G., (2013), 'Shedding light on 'Invisible' Costs and mutual Fund Performance', Financial Analysts Journal, Volume 69, Number 1. (Purchase from FAJ).

Average clean share prices (OCF) of active equity funds in the UK:

- SMC Private, True & Fair (2014) Legalised Looting page 13 footnote 24 and footnote 21.

Average clean share prices (OCF) of active bond funds in the UK:

- Fitz Partners (2014): As quoted in Investment Week 'How has clean pricing affected the equity vs. bond fund price gap?' 07 Feb 2014.

Average turnover on active equity funds in the UK:

- Fitz Partners (2014), as quoted in FT Adviser 'Trading fee furore may be overdone', 17 November 2014.

Average turnover on active bond funds in the UK:

- Fitz Partners (2014): As quoted in Fund Web, 'How much is portfolio turnover adding to TERs?' 27 March 2014, by Michael Berry.

Average turnover and OCFs on passive equity and bond funds

- Directly from fund houses relating to specific funds used in the calculations.