

Volume 11 //

Acuity

The greatest wealth is **your peace of mind...**



BARNETT
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WEALTH MANAGEMENT

Hands out of my pockets, please!



‘ If you pay executives at Sara Lee more, it doesn’t make the cheesecake less good. But with mutual funds, it comes directly out of the batter. ’

Don Phillips (President, Morningstar)

If you thought investment bankers were rapacious, a closer look at the fund management industry reveals similar proclivities for transferring client wealth into its own pockets. Little and frequent deductions, of one sort or another, lead to huge wealth transfers over time. Costs are often hidden and sometimes related to how we behave.

As humans we face a number of challenges when it comes to thinking about costs:

- It is hardly an exciting topic
- We are used to paying for value in most areas of our lives
- We find the maths of costs hard and tend to ignore the power of small numbers
- We fail to identify who has their hands in our pockets and if they are delivering value in return

Yet costs really do matter and understanding them helps you to see why we place such emphasis on managing them.

Hands out of my pockets, please!

Since the credit crisis, no-one wants to put their hands up to being a banker. Hardly surprising really, given the tale of greed, poorly structured incentives (heads I win, tails you lose), and product mis-selling both to institutions, who should have known better, and to individuals, who deserved better.

Perhaps less well known is the tsunami of costs charged by the investment industry that enriches it at the expense of investors’ future lifestyle dreams. A bit over dramatic? Make your mind up once you have read this volume.

The human mind struggles with the issue of costs

The problem of discussing costs is a challenge for a number of reasons:

- It’s an unexciting, if not downright boring, topic!
- We tend to believe that there is a relationship between what we pay and the value we receive (think Lada versus Aston Martin).
- As humans, we are hopelessly bad at maths, particularly when it comes to computing anything that does not have an easily calculable answer; and we tend to ignore the impact of small numbers.
- We often only look at the costs we can see, ignoring or missing less obvious costs, which can really make a dent in investors’ wealth.

To a greater or lesser extent, the investment management industry plays on each of these failings in its slow and stealthy transfer of wealth from those who have earned it and are taking the risk of investing (investors like you), to the middlemen (fund managers, brokers, taxmen). Let’s take a closer look at this seemingly boring issue.

Challenge 1: Costs are a dull subject

Costs are hardly a riveting topic, so let's get started by looking at an extreme example of their insidious nature to get your attention.

Most readers will have heard of hedge funds and the exploits of their extremely wealthy managers. They make money by charging clients an annual management fee, commonly around 2%, which should be small fry compared to the returns they will, hopefully, make. In addition, most take a performance fee of around 20% of returns above an agreed benchmark, which seems reasonable, perhaps, if they make money for their investors. Or is it?

Warren Buffett is acknowledged as being one of the world's most successful investors, managing his broad conglomerate of businesses via Berkshire Hathaway, a publicly listed company in the US. Berkshire's shares have delivered a staggeringly good compound rate of return of 20% per year over the past 42 years. Shareholders, Mr Buffett among them, have all received the same return. He is worth around \$62 billion.

John Kay, one of the UK's leading economists, has performed a simple experiment¹ to demonstrate the destructive nature of costs: imagine that Mr Buffett put in place, on day one, a hedge fund-like 2% and 20% fee structure (as described above) on his own wealth pot. In this scenario, he extracts the fees each year and puts them into a new hypothetical company 'Buffett Investment Management' and reinvests the proceeds in Berkshire shares. The remainder of the assets (less the fees that have been taken) are placed in a hypothetical entity 'The Buffett Foundation'. Given the incredible annual returns delivered by Berkshire, you would imagine that The Buffett Foundation would still be well ahead in terms of wealth at the end of 42 years. Surprisingly to many, it most definitely is not. Buffett Investment Management would be worth \$57bn and The Buffett Foundation only \$5bn. Has that got your attention?

This example is supported by the findings of Simon Lack, a hedge fund expert, in his recently published book 'The Hedge Fund Mirage' which demonstrates that from 1998 to 2010 the hedge fund industry's share (not the investors' share) of total profits was around 84% of the pie. This is a remarkable, legal confiscation of wealth. John Kay's advice is simple:

'So, the least risky way to increase returns from investments is to minimise agency costs to ensure that the return on the underlying investments goes into your pocket rather than someone else's.'

We concur. A penny saved is a penny earned and it is guaranteed every year. Money that is extracted from the portfolio cannot be compounded by returns over time (see the maths challenge below). Cost savings are in the bank, future market-beating performance promises are not.

Challenge 2: You get what you pay for, don't you?

In most walks of life, you get what you pay for. Need a good barrister? Pay up. Want a beautifully made car with a silky V8 engine? Pay up. Want to lie flat on the flight to Sydney? Pay up and turn left on the plane. Want a great fund manager who will beat the market for you? Pay up? No way!

As the legendary US investor and grandfather of the passive investment industry, Jack Bogle, would say:

'In investing you get what you don't pay for'

The problem is simply this: every active fund manager hopes, and probably expects, to beat the market - that is their job - yet only a few are talented or lucky enough to do so. It takes considerable resources to try: bright fund managers, investment committees, economists, research analysts, information systems, etc, all of which need to be paid for - and don't forget the plush offices either². The other tyranny is the fact that success in the active management world is often synonymous with assets under management - more assets mean more revenue. Marketing budgets to attract new assets are big and again they need to be paid for.

Active managers, and advisers who use active funds, will defend their high costs as being a necessary evil and the entry fee for access to superior market beating performance. That's all well and good if they deliver on their promises, but that is a rare outcome indeed, as other volumes of Acuity point out.

Unfortunately, the mathematics of the market are such that the average active manager will be beaten by the market by the magnitude of the costs of the industry. Research in the UK indicates that the average manager is beaten by the market by around 2%³, which is a close estimate of the average active UK equity fund cost estimate (see below). Let's not just pick on active funds – owning a high cost passive fund makes absolutely no sense whatsoever, either.

When it comes to the importance of lower costs, we should perhaps listen to Morningstar, a firm that researches funds and assigns them with Morningstar 'star' ratings from one to five. It has concluded the following, based on its research⁴:

“If there’s anything in the whole world of mutual funds that you can take to the bank, it’s that expense ratios help you make a better decision. In every single time period and data point tested, low-cost funds beat high-cost funds.”

So, the key take-away is that costs really do matter and there is no relationship between higher costs and better outcomes. In all probability the reverse is true.

Challenge 3: We are hopeless at long-range maths and small numbers

The human brain has evolved to help us to survive by making quick, rough-and-ready, short-term calculations and decisions. It is poorly adapted to do complex, non-linear mathematical calculations. The Warren Buffett scenario above is a good example. Yet that is exactly what investing is all about. Our minds tell us that one or two percentage points of cost is not very much, yet the calculator, and capital market history, tells us that it is.

Over the past 112 years, the UK equity market has delivered a return, after inflation, of about 5% per year⁵. That does not sound much, but (using the Rule of 72) you would double the purchasing power of your assets every 14 or so years (72/5). Take out 2% in costs and your money would double every 24 years, almost twice as long. Take a look at the simple table below that shows the effect on £1 million purchasing power, at different rates of return and over different time horizons.

Table 1: Compounding and time are powerful forces – effect on £1 million (in £M)

Return %	10 years (£)	20 years (£)	30 years (£)	40 years (£)	50 years (£)
1%	£1.1	£1.2	£1.3	£1.5	£1.6
2%	£1.2	£1.5	£1.8	£2.2	£2.7
3%	£1.3	£1.8	£2.4	£3.3	£4.4
4%	£1.5	£2.2	£3.2	£4.8	£7.1
5%	£1.6	£2.7	£4.3	£7.0	£11.5

Small differences in return make big differences in outcomes. It is no wonder that the wise old sages of the investment world tell you to start saving as young as you possibly can. Remember:

Seemingly small costs + compounding + time = large impacts

Challenge 4: We only see the obvious costs, unaware of what else we are paying

For a client using an advisor, there are a number of costs involved in arriving at, implementing and owning a sensible portfolio of investments. These costs need to be viewed in the context of the value that each component of the service delivers. Let's look at each in turn.

Advice costs and value

In a good financial planning firm, the value delivered to a client in return for the fees that they pay (on average around 1% a year), is the peace of mind that comes from having confidence in a clear and flexible wealth plan, which is being continuously monitored and administered by their adviser. Remember that 'advice' has never been free; in the old world of opaque commissions, it just felt free!

Trying to avoid this fee is a little like trying to build your own home. It may seem to be cheaper (land + bricks + builders, etc), but it is not without considerable risk, time costs, mistakes and stress – anyone who has ever watched *Grand Designs* will see the parallel.

What many clients also initially miss is the value that comes from having an investment coach to stop them from making decisions based on emotions, such as chasing 'hot' funds and investments, or bailing out of markets when the going gets tough. It is estimated that these emotional costs alone are in the region of 2%-3% a year⁶. A good adviser who helps clients to avoid these emotional pitfalls has already warranted their fee a couple of times over.

Custody and safe keeping and value

Owning a broad array of financial assets, housed in a number of tax wrappers and accounts, such as personal pension plans and ISAs, is quite complex and these assets need to be carefully administered and held in safe keeping. Wrap platforms have a useful role to play for many clients. Fees vary, but are usually in the region of 0.2% to 0.4% of assets on the platform.

Some investors may believe they have never paid for administration and safekeeping in the past, as they have not written a cheque, but they have, by way of rebates (kick-backs) to the platform from the fund manager, paid for out of the fund's charges. This is probably in the region of around 0.25% per year.

Fund costs and value

Let's now look at the costs associated with investment funds (eg, OEICs).

Fund managers: They charge an annual management charge (AMC), which can be found in the fund's prospectus. On average, an actively managed UK equity fund has an AMC of around 1.5%⁷. This AMC incorporates around 0.5% trail commission paid to advisers and around 0.25% paid to platforms. The fund manager will pocket around 0.75%, unless of course you don't use an adviser and then they will pocket the trail commission as well for advice you never received. Some active funds have 'initial' costs of up to 5%, but let's ignore those as they are on the wane, in practice.

Others involved with the fund: The assets of the fund need to be administered, custodied, and audited, and a number of other sundry costs need to be paid, such as legal expenses. These are paid for out of the fund's assets and generally amount to 0.2% per year. When you add them to the AMC you end up with the fund's Total Expense Ratio (TER) of around 1.7%⁸ for actively managed UK equity funds. Recent research shows that active fund costs have continued to rise in the UK and Europe^{9,10}.

The TER is not the total costs that a fund will incur, because funds buy and sell the investments over time. The costs incurred are not included in the TER figure. Active managers trade in an attempt to beat the market, while passive funds do so to reflect the benchmark they are tracking and any changes to it. Let's explore who the key players are in the chain when a fund's assets are bought or sold.

Brokers: The fund manager will place an order with a broker to sell or buy some specific shares. The order is placed with brokers who charge a commission. Commissions are estimated to be around 0.1% to 0.15% on each trade.

The broker also takes a spread between those buying shares and those selling them, known as the bid-offer spread. These costs are less transparent but market data provides some insight. For large cap stocks this spread is around 0.15% and higher for mid/small-sized companies at about 0.5%¹¹. In less liquid markets, such as emerging markets, spreads and commissions may be materially higher.

In addition, large funds can incur what are known as market impact costs when they move the market against themselves as they try and trade large positions. Quantifying these costs is very hard, but they are probably somewhere between 0.1% and 0.5% depending on the liquidity of the equities being traded and the size of the sale or purchase order.

The Chancellor of the Exchequer: We must not forget the occupant of number 11 Downing Street, who also has his hand in the pie, extracting 0.5% of the purchase of UK listed shares, a tax called Stamp Duty.

All-in-all, turnover costs of a 'round-trip' sell-and-buy trade in the UK are probably in the region of about 1% including tax. This figure then needs to be adjusted for the turnover rate of a fund's assets. On average this is around 90% for active UK equity funds¹² and generally less than 10% for passive funds. It is worth noting that new Key Investor Information Documents (KIIDs) that must be provided to investors, no longer require a fund's turnover rate to be disclosed, which is a setback for transparency. These costs are summarised below.

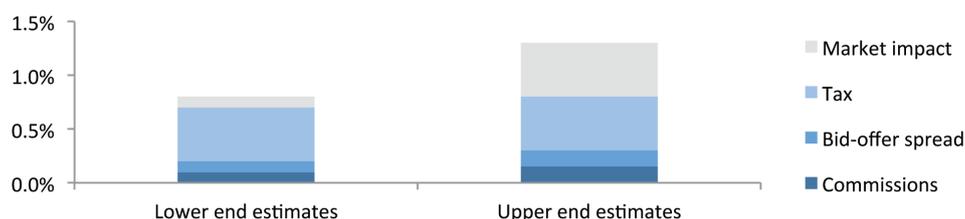


Figure 1: Reasonable estimates of a 'round-trip' sell-and-buy trade in the UK

'On-the-road costs' of active UK equity management

Putting this all together, the 'on-the-road' figure for an actively managed UK equity fund costs is probably in the region of 2%, which is the degree to which UK active funds have, on average, been beaten by the market, as indicated earlier. Recent estimates of costs have ranged from 1.95% as calculated by the active industry's trade body (the Investment Management Association¹³) who estimate the TER to be 1.57% and the trading costs incurred on turnover to be 0.38% and others¹² who believe the all-in costs to be more like 2.25%. They are material, either way.

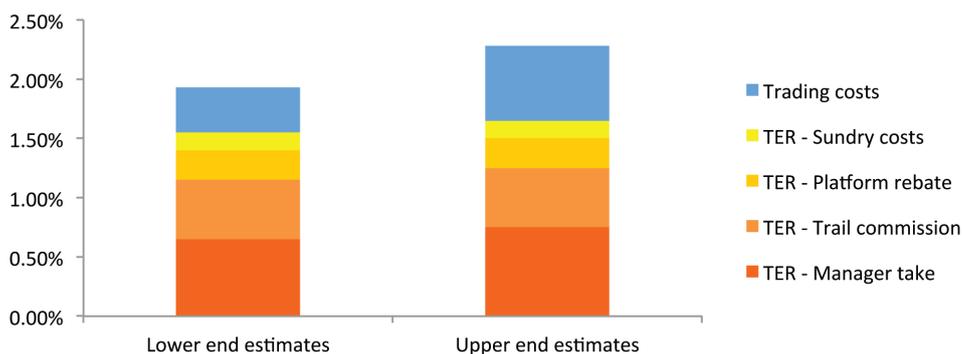


Figure 2: Reasonable estimates of the 'on-the-road' costs of a UK active equity fund

In conclusion

While every active manager believes that he or she is capable of beating the market, most will not, therefore failing to deliver value for the fees they take. The cost hurdle is immense, given that markets work pretty well. While a few managers may be exceptional, they are hard to identify in advance, and often difficult to live with emotionally. The probability of success is very low. Never invest in a passive fund with a high TER – it will never be good value either. Low cost funds are the better bet.

The one true certainty is that costs truly matter. Saving every penny of cost where value is not delivered or unlikely to be delivered, makes enormous sense and will pay dividends in the long run.

End notes

1. John Kay, 'The long and Short of It: Finance and Investment for Normally intelligent People who are not in the Industry', Erasmus Press
2. At a recent industry conference, it was interesting to note that in the product exhibition centre, active fund managers tried to attract potential clients to their stalls with things like simulated races in a full-scale Ferrari FI cockpit, while the passive managers handed out the odd bag of jelly beans!
3. Schneider, L (2007), Diploma thesis: Are UK fund investors achieving fund rates of return? Submitted in July 2007, Fachhochschule Kufstein, Tirol, Austria
4. Morningstar (2010), How Expenses and Stars Predict Success, www.morningstar.com
5. Barclays Equity Gilt Study 2012
6. Phillips, D (2011, October 15th). Five Lessons from 25 years. (Business & Wealth Management Forum, Interviewer) Morningstar
7. This varies by category of fund and from fund to fund.
8. Atherton, M, (2012), Hidden costs are still lurking beneath the surface of TERs, The Times, 15th September 2012, p84
9. Marriage, M, (April 9, 2012) Little take-up of 'low-cost' active funds, FTfm (April 9, 2012) p12
10. Recently reported Lipper data reveals that in Europe of 784 funds that have changed their management fees, 80% increased them; when the UK is added in, that number rises to 90%
11. According to iShares a major market participant and based on their on data - referenced in the article in the footnote below
12. Miller, G, (2012) IMA's analysis of costs 'is flawed', FTfm May 14 2012 p10
13. Bryant, C, Taylor, G, (2012) Fund Management Charges, Investment Costs and Performance, IMA Statistics Series Paper: 3 May 2012

Other notes and risk warnings

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