Transparency and the True Cost of Investing

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"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

Recent turmoil in the fund management industry sheds new light on the dark practices and attitudes which continue to pervade – and which cost investors more than just money.

Fund management: an industry not covering itself in glory

It is unlikely that many readers of this paper 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 of assets globally – to put this another way, given The Investment Association's huge reach, it is almost certain that everyone you know who holds investment assets is a client of a member firm.

The Investment Association's 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:

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

As you can see, it is surely impossible not to agree with all ten principles, but given that only 25 of 200 firms actually signed up to them, the CEO felt compelled to leave his position as a result of the resistance he faced and that some members preferred to quit The Investment Association altogether, the inference is extremely worrying; the industry does not appear to want to participate.

Surely, however, every investor has the right to know what charges and costs they are incurring, 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?

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

The facts, the evidence and the simple mathematics

As clients of Chamberlyns will know, when it comes to investing, we have no particular axe to grind about a 'right and wrong' approach; rather, since our clients pay us to look after their best interests, we are focused on establishing and continually stress-testing what might be 'better or worse' approaches and accordingly, we are simply interested in what the facts, evidence and unarguable mathematics says is the approach most likely to deliver our clients with a comfortable, successful investment experience over time.

With this in mind, clients of Chamberlyns will be very familiar with our views on costs, the importance of only incurring them where there is a reliable expectation of corresponding value, the decades of academic research and empirical evidence which proves beyond any doubt that excessive costs, both physical and behaviour-driven, lead to a huge destruction of wealth and that in trying to win the investing game that the vast majority of investors lose, pursuing an active investment management strategy is unlikely to be a wise decision in the vast majority of cases.

With the recent and ongoing turmoil at The Investment Association as the backdrop, we take the opportunity in this paper to make an up to date 'best-estimate' comparison between passively and actively managed portfolio costs and as you will see, this would seem to help to confirm (again) why there may be such a reluctance among fund managers to be open and honest with investors.

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, in aggregate, a zero-sum game. 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 need to take into account the costs of transacting in the market.

It is also important to note that, on average, passively managed funds 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

Market return **before** costs (average all investors)

Market return **after** costs (average all investors)

Lower costs

Higher costs

Market return less lower costs (investors in passively managed funds)

Market return less higher costs (investors in actively managed funds)

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 the majority of investors invested in higher cost active funds. Of course, this is a galling conclusion for the clever and hardworking active fund management community, as well as for those who believe in, promote and recommend their funds, but unfortunately for investors, it is also a conclusion many are unable or unwilling to reach, since as Upton Sinclair famously pointed out:

"It is difficult to get a man to understand something when his salary depends on his not understanding it"

The table below, which illustrates the percentage of actively managed funds beaten by an appropriate benchmark, provides some evidence of the power of the 'zero-sum-game-less-costs' environment. As such, it is noteworthy 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.

Restricted 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.

However, we are able to estimate it using the latest third-party data and research but before we do, we first need to be clear on what components of cost we should be especially interested in, so accordingly we have focused on pure investment costs, rather than the broader costs associated with obtaining proper financial planning advice and avoiding the behavioural costs of emotionally driven, wealth destroying decisions (which have both over the long-term been proven to cover their cost several times over).

Table 1: SPIVA – % of 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 equity
77%	82%	59%	88%	87%	84%	90%
US REIT (property)	**US Government long bond**	**US Government 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/research/

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. However:

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 therefore in the dark.

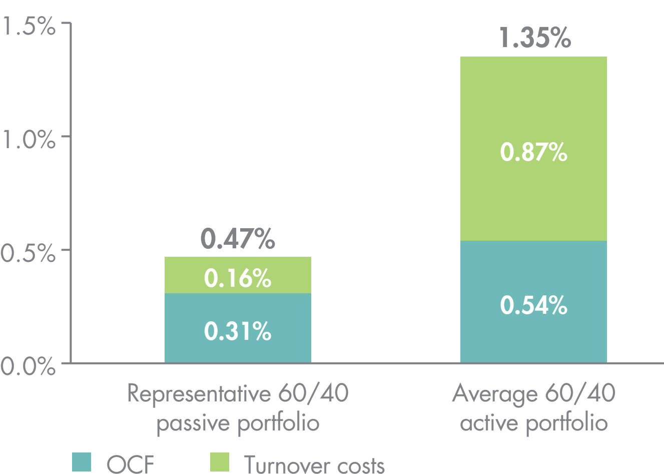
However, turnover costs can be broken down into three categories:

- Visible cash costs, which 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, which include: bid-offer spreads (the difference in price between what a broker can buy and sell a security for) 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, which include: market impact costs that occur when buying or selling securities, where the price moves against the trade (in the zero-sum-game, someone must be benefitting from the adverse price movement, so in theory, this cost is net zero to the industry and could thus 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 seen and hidden costs. The figures relate to a 60% growth assets (equity) and 40% defensive assets (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 of this document).

Figure 2: Cost comparison – costs matter

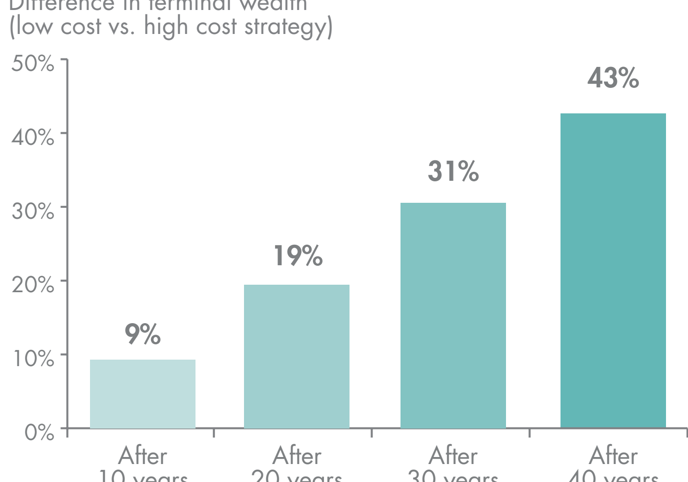


Source: Albion Strategic Consulting

The cost differential* is clearly material on a year-to-year basis, but its significance is magnified when the power of compounding and time are factored in. The figure below (which for illustrative purposes uses 0.47% for lower costs and 1.35% for higher costs, as per Figure 2) 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 and as such, you will be able to see why the resistance to greater transparency appears to be endemic in the fund management industry.

* Despite the material cost differential, we were quite surprised that the differential was as small as indicated, as we almost always see higher costs than this when we first begin working with new clients – perhaps this is because it is the average figure across all active funds, rather than the often much higher fees associated with the most well-marketed funds?

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



Source: Albion Strategic Consulting

The significance of the reduction in terminal wealth which comes from pursuing a higher cost investment strategy is something much more important than the loss of money itself; rather, it is that the lost money translates into a significant loss of life and lifestyle choices and perhaps also into compromised long-term financial security, all of which is highly undesirable, since to provide these things is, of course, the true purpose and value of wealth.

Obtaining value for money

The most important thing about incurring costs is that they should, each in turn, represent value for money. It can therefore perhaps justifiably be argued that using active funds in a portfolio is likely to be poor value for most.

In addition, as alluded to above, despite the clear negative implications of pursuing an expensive, active investment management approach, the evidence suggests that the biggest cost of all for investors is making poor, irrational, emotion-led decisions that lead to wealth destruction, so it is important to remember that ongoing fees relating to comprehensive financial planning should not just be considered as an investment management fee, but the small price, returned over time with interest, 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 deal only with transparent, client-focused institutions and to manage costs of all kinds tightly. This is something that we continue to do on behalf of our clients, through our systematic, evidence-based, low cost approach to investing.

As the legendary Jack Bogle[3] once said:

'In investing, realise 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 couldn't agree more.

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

Endnote

Albion Strategic Consulting's 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.

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In addition to being a Chartered Financial Planner, Michael holds the globally recognised Certified Financial Planner qualification and is a Fellow of the Personal Finance Society. Michael also sits on Chamberlyns' Investment Committee and helps to produce the firm's regular series of in-depth 'Insights' articles, which explore, explain and demystify often complex wealth planning issues.

Chamberlyns provides a refreshingly different Wealth Management service for executives and professionals, who want to make the most of their money and the life that lies ahead of them.

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