

Fund expenses and why they matter

Most of our clients invest in a diversified portfolio of assets. Their return is made up of (A) the return from the underlying investments minus (B) the various expenses incurred minus (C) the marginal tax impact.

This note looks at the “various expenses” bit of the above equation.

Our investment beliefs suggest that at a fundamental level we can do little to absolutely affect (A). We can engineer portfolios cleverly to reduce volatility and this in itself can produce higher compound returns. To this extent, and this is a material factor, we can enhance (A) somewhat, but it is pointless if (B) is huge.



In many UK retail situations (B) is indeed huge (by retail we mean the investment funds available to the general public through conventional distribution channels).

If one is looking at a portfolio of unit trusts and other pooled investment vehicles there are a lot of expenses to be aware of. The easiest one to find is the Annual Management Charge (AMC). In the UK most standard retail funds charge an AMC of 1.5% per annum.

However, there are many fees that are not included in the AMC. These include:-

- Depository expenses – the main ones are depository services typically 0.035% per annum, transaction costs (say £20 a deal) and custody charges which are usually between .0075% and .18%
- Registrar expenses – the main ones are registration costs typically £12.50 per shareholder per class per year, dealing costs at £18.50 per transaction, valuation and accounting costs of between 0.03% and 0.075% per annum, management accounting at say £3,500 per annum per fund
- Audit fees – at least £6,000 per annum per fund
- Newspaper listings – perhaps £4,000 per annum per fund

It all adds up doesn't it?

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All the above fees are generally included in something that has come to be known as the Total Expense Ratio (TER). The TER is published by nearly all retail fund managers. The Financial Services Authority and the European Commission rules will in most cases force this figure to be published. This is a better measure of total expenses than the annual management charge.

As at the end of 2005 Average TERs in the UK were 1.62%*.

Why are we bothering to draw attention to this? Because of the huge long term effect deductions have on net results. Consider a portfolio of £1,500,000 growing at 6.5% per annum before charges and paying out income to the investor of 4% per annum. If total expenses are 1% per annum, after 10 years the portfolio will have grown to £1,720,271 and the investor would have enjoyed income of £634,148. If total expenses are 2% then the portfolio only grows to £1,554,556 and the investor has enjoyed income of £602,904.



That is a difference of very nearly £200,000. Not enough for Eaton Square but just about enough for a small house in the suburbs, or a student house in some reputable cities.

Some of the broadsheets conclude that one should therefore look through the small print for the TER and examine this carefully before investing.

But even that is not the full answer.

The trading within a fund has a sizeable effect on returns itself. None of the following are included in the TER – they cannot be because they are dependent on the fund manager's activity: -

- Commissions
- Bid offer spreads
- Stamp duty and
- Market impact

Market impact is the effect that fund managers have on a stock price simply by choosing to sell it. If a huge unit trust decides to sell 2% of its holdings in Stock A for instance, then this action will itself influence the price of Stock A.

The more a fund manager trades the higher the expenses become and these expenses are not included in the TER. On average this will lead to a net drop in performance. The fund manager will be concerned about his own pay and so will try and claw back this performance. How will he do this? By engaging in yet more trading, and for the effect of this action please jump three sentences back. This tale does some of the superb fund managers a disservice, but the point is one of fact not fiction. Higher portfolio turnover increases costs. Increased costs, other things being equal, reduce returns.

What is the size of these trading costs? This is a tough question - the answer is that the geographical investment area and the market capitalization of the stock significantly affect this number. It is cheaper to trade Shell shares than a recently floated high tech Spanish company.

In February 2000 the FSA estimated the cost of a round trip trade as 1.80%. There are many US studies – Carhart (1997), Orton (1999), Wilcox (1993) and more. Their conclusions are remarkably consistent. A portfolio that is turned 50% per annum incurs a further drag of between 0.475% and 0.65%. 100% turnover takes the range to 0.95% to 1.3%.



So how often are funds (or for that matter stockbroker's portfolios) "turned"? An authoritative 2005 study concludes that the average equity fund has portfolio turnover of 74.2%, the weighted average is 63.8% and the median is 58.1%. These are frightening numbers. The same study looked at passive funds - the figures for these funds are average 14.5%, weighted average 13.3% and median 8.2%.

The handicap for the active fund is then even greater.

Conclusions

Fund expenses affect returns to investors. Typical UK funds have annual management charges of 1.5%, Total Expense Ratios of 1.62% or so but total costs of at least 2.2%. As long as it is legal to obscure these costs it is unlikely that they will receive widespread publicity. We will continue to recommend funds with significantly lower charges than average until we see convincing academic evidence that paying higher fees is a good way of achieving better results. So far the reverse is true.

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*Fitzrovia UK Fund Charges 2005

For more information on any of the issues raised your current Hillier Hopkins contact will be happy to assist you. Alternatively, please call us on 01442 220788 to speak to one of our advisers.

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