CFA Montréal

INVESTMENT PRINCIPLES

INFORMATION SHEET FOR INVESTORS

THE IMPACT OF FEES

2

IMPORTANT NOTICE

The term "financial advisor" is used here in a general and generic way to refer to any duly authorized person who works in the field of financial services, including the following:

- Investment brokers
- Mutual fund brokers
- Scholarship plan dealers
- Exempt market dealers
- Portfolio managers
- Investment fund managers
- Life insurance agents
- Financial planners (F.Pl.)

CFA Montréal

Copyright © 2016 CFA Montreal. All rights reserved.
Reproduction in whole or in part without written permission of CFA Society Montreal is prohibited.

THE IMPACT OF FEES

There are two types of fees: investment-related fees (such as those directly related to product management and transaction costs) and advisory fees (such as those related to the support a financial expert can provide). Total fees can be significant, and investors would be wise to ensure they are paying reasonable all-in fees. Investors must assume greater risks in order to hope for greater investment returns, but fees will reduce returns whether the investment strategy is successful or not. While higher returns have a positive compounding impact on final wealth (as illustrated in Document #1), fees have the opposite effect.

WHAT IS A REASONABLE LEVEL OF FEES?

There is no evidence that paying higher investment-related fees leads to higher investment returns before fees. Most studies conclude that the average mutual fund generates a performance before fees equal to that of a standard index product.[1] Furthermore, evidence also shows that fewer than three managers out of 10 outperform the market after fees over horizons of five to 10 years. Identifying a manager that has outperformed in the past is easy, but identifying one that will outperform in the future is a challenge.

The role and benefits of investment advisors will be discussed in Document #6. However, part of their role is to help investors identify cost-efficient investment opportunities. Investment products have become more commoditized in recent years and generally less deserving of higher management fees than previously. Why pay 2% for an investment product that has the same return expectations before fees as another product offered at 0.30%?

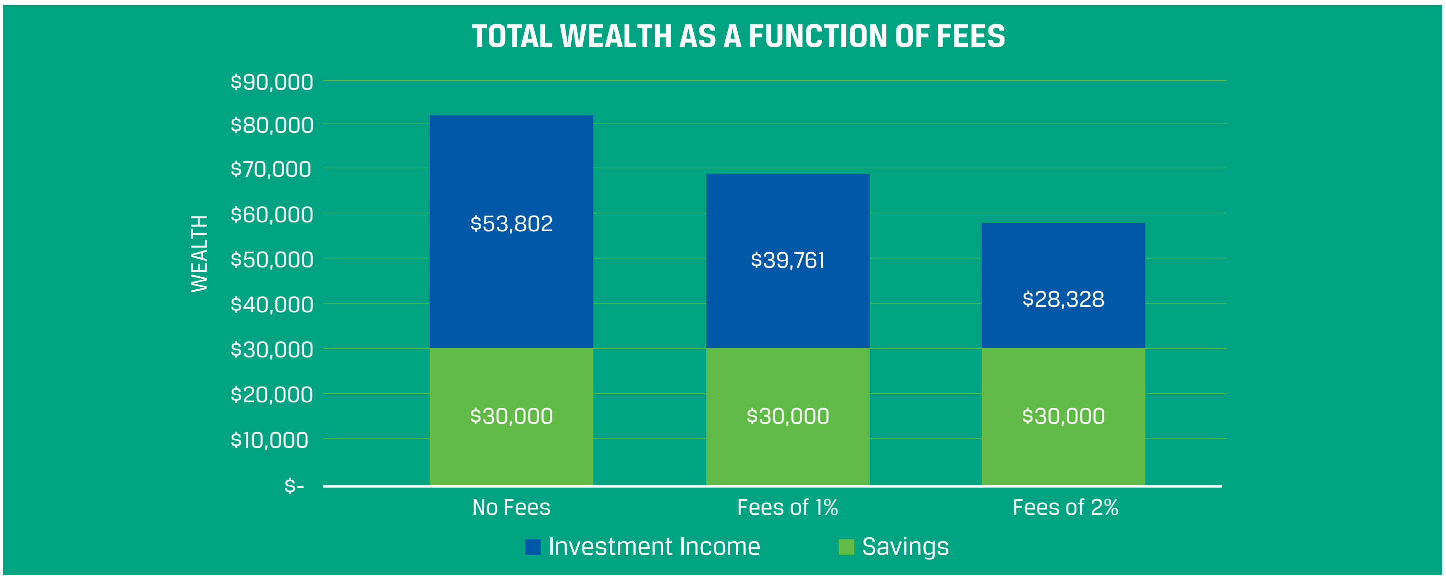
[1] This should not surprise us, since investing is a zero sum game before fees. In other words, since all securities in the market are owned by all investors, for each investor who outperforms the market by $1 before fees, there has to be an investor or several investors who together underperform the market by $1 before fees. It's an accounting reality.

In the US, the average active bond and equity mutual funds charge management fees of respectively 0.65% and 0.89%, while index funds cost as low as 0.11% and 0.12%. Most exchange-traded funds (ETFs) have fees ranging from 0.10% to 0.50%.[2] Mutual funds in Canada have a costlier structure than in the US because, among other reasons, they usually integrate advisory fees. If you do not believe in the ability of active managers to outperform the market in the long term and/or if you do not have expertise and/or the advisory support to identify "performing" strategies or managers, cheaper index funds or ETFs may be more appropriate.

Fees required by advisors vary greatly and are usually charged in excess of investment-related fees in the US (although they are often included in Canada). Some advisors charge a fee based on a percentage of assets under management (usually using a declining scale as assets grow), while others may charge a flat fee or even an hourly rate. However, advisory fees can be as low as 0.5% of assets for large portfolios, while they can be greater than 1.0% for small portfolios of less than $100,000. Hence, some investors may knowingly or unknowingly pay more than 2% in all-in fees.

Smaller investors can purchase blended portfolio solutions that are well diversified for much less than 1% (such as balanced ETFs, balanced indexed funds and target date funds[3] that incorporate both fixed income and equity), while larger investors in need of more dedicated portfolio solutions can find knowledgeable advisors willing to manage their portfolios for an all-in fee of about 1%. As a rule, investors should resist paying 2% all-in fees for standard portfolio solutions and advice.

The following chart illustrates the impact of all-in fees of 1% and 2% on an investor who is saving $1,000 a year for 30 years, assuming the return before fees is 6%. The base case (no fee) is the same as in Document #1.



A 1% fee scenario amputates total wealth by 16.8% (from $83,802 to $69,761), while a 2% fee scenario reduces final wealth by 30.4% (to $58,328). Fees matter to your standard of living in retirement.

[2] Advisory HQ, Financial Advisor Fees – Wealth Managers, Planners, and Fee-Only Advisors October 11, 2015. http://www.advisoryhq.com/articles/financial-advisor-fees-wealth-managers-planners-and-fee-only-advisors/

[3] A target date fund (TDF) is designed to balance portfolio risk with the expected timing to retirement. For example, assuming we were currently in 2015, a 40-year-old investor planning to retire in 25 years may buy a 2040 TDF. The allocation to equity within the product would be gradually reduced until retirement and in some cases, the allocation would also be adjusted post-retirement. Such products may be appropriate for investors who lack the discipline, expertise, and advisory support to manage on a more discretionary basis. Furthermore, some of these funds are offered inexpensively (however some are expensive), and research has shown that investors who use TDFs or professionally-managed accounts do much better than average investors left to their own devices and who lack a disciplined strategy.

SUMMARY AND CONCLUSION

Investors cannot avoid paying investment-related fees, but such fees can often be reduced without impacting the portfolio's expected return before fees. There is little evidence that higher investment fees lead to higher gross returns on average. A knowledgeable advisor can help achieve a lower cost portfolio solution.

Furthermore, most investors require the support of an advisor. As will be discussed in Document #6, a knowledgeable advisor provides needed expertise in retirement planning and portfolio construction and even helps manage the anxieties that come with investing. As with all professional services, investors must ask for transparency of all fees that are paid and avoid paying more than necessary. From now on, we will be working under the assumption of a 1% all-in fee scenario.