What is the impact of fees and charges on long-term net returns?

Warren Buffett tells a story in his 2006 letter to Berkshire Hathaway shareholders which every financial adviser should read. It concerns a family he calls the Gotrocks, which owns corporate America, and receives the full value of the profits earned by every listed company in the country.

All is fine until a group of people, which Buffett labels Helpers, offer to assist some family members to outsmart the others, "for a fee, of course". So, while the total profits generated by businesses and earned by the Gotrocks family doesn't change, they have to pay a share of it to their Helpers.

What do the Gotrocks do as their net returns decline? You've guessed it, they hire more and more Helpers, charging more and more fees, which inevitably results in the family's share of the profits being eroded even further.

No magic shower of money

"The most that owners in aggregate can earn between now and Judgment Day," says Buffett, "is what their businesses in aggregate earn. There is simply no magic — no shower of money from outer space — that will enable them to extract wealth from their companies beyond that created by the companies themselves.

"Indeed, owners must earn less than their businesses earn because of 'frictional' costs. These costs are now being incurred in amounts that will cause shareholders to earn far less than they historically have."

Pay for nothing, get everything

Buffett's friend, the indexing pioneer John Bogle, makes the same point in *The Little Book of Common Sense Investing*. "The grim irony of investing," writes Bogle, "is that we investors as a group not only don't get what we pay for, we get precisely what we don't pay for. So if we pay for nothing, we get everything."

Of course, investors can't literally expect to pay nothing for a share of the proceeds of capitalism. Even those US investors who've taken advantage of one of Fidelity's zero-fee index funds still have to pay a platform fee.

The important thing, then, for the investor, and for their adviser if they use one, is to keep the number of Helpers to a minimum and dispense with the services of any intermediaries who aren't adding at least enough value to justify the cost of using them.

Hundreds of Helpers

So how many different kinds of Helper are investors using, apart from their adviser? Let's put it this way: the fund manager's annual management fee is just the tip of the iceberg. Underneath are a whole range of implicit costs — transaction charges, custody charges, brokerage fees, foreign exchange fees and so on — some of which are very hard to pin down.

In a recent edition of Money Box on BBC Radio 4, Dr Chris Sier, the former policeman and statistician hired by the FCA to produce a cost disclosure code for the asset management industry, said he had identified several hundred fees and charges investors are unwittingly paying.

The very first product he looked at, a simple equity ISA, had no fewer than 16 different layers of intermediation — in other words, 16 companies "sitting between you and investing your money. Every one of those companies takes a piece of the pie as it passes through. The total it added up to was over 3.5%."

Every bip counts

What, then, is the impact on an investor's net returns of paying fees and charges of 3.5% (which, remember, excludes the cost of any advice)? Well, if you invested £100,000 for 30 years, and assuming an annual rate of return of 6%, you would be left with £209,555. You would have lost £364,594[1] of your return in costs.

That's all very well, you might argue, but no one pays as much as 3.5% nowadays, do they? Actually, you may be surprised at how many do. But even with a total cost (including transaction costs, custody charges and everything else) of 1.5%, you would still be paying almost £200,000[2] — or nearly half — of your return to intermediaries.

Another objection which advisers raise at this stage is the following: the whole point of hiring a fund manager is to try to deliver market-beating returns. It's not about the cost, in other words, but about the value added.

Most funds subtract value

I'm going to be tackling this subject in more detail later in this series of articles. But suffice it to say for now that, over the long term, only a tiny proportion of funds outperform the relevant benchmark index on a risk- and cost-adjusted basis. Dr David Blake at the Pensions Institute puts the figure at around 1. What's more, identifying in advance the funds that will outperform is very difficult.

Conclusion

In conclusion, we can only guess at how a particular manager will perform relative to the index, but one thing that investors do have control over is how much they pay. To quote Warren Buffett again, "performance comes, performance goes, (but) fees never falter."

Advisers in the past have placed far too much emphasis on short-term performance with no statistical significance and far too little on what their clients are actually paying to have their money managed. If they want to be true fiduciaries — genuine Helpers, if you like — and act in their clients' best interests, they urgently need to redress the balance.

Robin Powell is a journalist and marketing consultant. He blogs as The Evidence-Based Investor and is the founder of Regis Media, a boutique provider of content to financial advice businesses.

How useful is cost as a predictor of future fund performance?

It's a curious irony of the investing industry that, despite constant reminders that past performance is not a reliable indicator of future results, many investors (and alas, a sizeable proportion of financial professionals) continue to behave as if it is.

There's a very good reason why regulators insist on such warnings being included in marketing material. Past performance, especially a track record shorter than ten years, tells us next to nothing about how a particular fund will perform in the future.

If anything, a very strong record over, say, two, three or five years, could be seen as an indicator that a fund is due for a period of underperformance.

The most reliable predictor

What, then, does give us a real clue as to future performance? Academics and other serious researchers have consistently found that the most reliable predictor of all is cost; more precisely, the more the investor pays, the lower their net returns are likely to be.

Researchers at Morningstar have conducted detailed ongoing research on this issue, for which they divide funds into five quintiles based on how much they cost. They also separate funds into two groups — "successful" ones, i.e. those that survived for the whole of the period in question and outperformed their peers; and unsuccessful funds, i.e. funds that were either liquidated or merged with other funds, or underperformed their peers.

Their most recent analysis showed that, in the five years to the end of 2015, funds in the cheapest quintile were three times more likely to succeed than those in the most expensive quintile. They found, moreover, that using expense ratios to choose funds helped in every asset class and in every quintile from 2010 to 2015.

You may at this point be wondering about the impact of falling fees. Ongoing charges figures have indeed been coming down. UK investors can now access ETFs for just a few basis points, and further fee reductions are likely across the industry.

As fees fall, you might have thought that cost would become less important as a factor in predicting future returns. Analysts at Morningstar have recently addressed this question too, and found, perhaps surprisingly, that the opposite is true.

Funds are performing more alike

Researchers examined the rolling returns and fees of all domestic US equity funds over the period from September 1998 to August 2018, including those that didn't survive the full 20 years.

They started by measuring the return difference between the best-performing funds and average-performing funds, and also between the best performers and the worst performers. What they found was a significant narrowing of the performance gaps between funds. In early 2002, for instance, it wasn't unusual for there to be differences in performance of 10% or more. In recent years, however, returns have been much more closely bunched together.

Fee differences have remained consistent

Next the researchers measured the difference in fees between the cheapest and the costliest funds. For the five-year period to the end of August 2003, the difference in annual expenses between the average fund in the cheapest quintile and the average fund in the third-cheapest quintile was 0.64%. For the five-year period ending on 31 August 2018, the figure was very similar, 0.60%.

Similarly, there was very little difference in the average fees charged by the cheapest funds and the most expensive funds. For the 60-month period up to the end of August 2003, the difference was 1.63%. For the five-year period to the end of August 2018, the difference was only slightly lower, 1.56%. In other words, fees have come down fairly consistently across the board.

The relationship between fees and performance

Now for the crucial part. The difference in returns, we've established, is much narrower now than it used to be, and the difference in fees is only very slightly narrower. What, then, can we conclude about the connection between fees and performance?

To work that out, Morningstar calculated the average fees charged over time by funds across all five return quintiles, and then compared the differences in their fees to the differences in their returns.

The conclusion the researchers came to was that cost has not become any less important as a contributory factor in the outperformance delivered by the best-performing funds over the 20-year period. On the contrary, expense ratios have become far more important.

Over the entire period, the researchers calculated, the average fee advantage between the top-performing and third-highest-performing quintiles was around 1% of the overall return advantage. But for the five years to the end of August 2018, it accounted for around 10% of the return advantage.

The lesson for advisers

So, what can we take away from this latest research?

To quote Morningstar's global research director Jeffrey Ptak, "fee differences appear to account for an even greater share of performance differences than before, suggesting that investors are well advised to continue to factor cost heavily into their fund assessments."

Identifying, ex ante, the relatively few funds that are going to outperform the market over the long term is a very difficult task.

Quantifying costs is altogether easier. True, we don't know what the transaction costs are going to be, but we can come up with an estimate based on what they've been in the past. And we do know in advance the annual management charge.

In the absence of any more reliable predictors of future fund performance, then, advisers who genuinely want to act in their clients' best interest should focus on cost.

Robin Powell is a journalist and marketing consultant. He blogs as The Evidence-Based Investor and is the founder of Regis Media, a boutique provider of content to financial advice businesses.

How do you calculate the total cost an investor pays?

I often wonder what would happen if investors were sent a bill each month for how much they're paying to have their money managed. How would they react on opening the first one?

Would they think it steep? Would they start exploring options for getting the bill down for future months? I suspect, for most people, the answer to both of those questions would be Yes.

Significant household expense

Asset management, even excluding the cost of advice, is a significant household expense. Yet because they don't see how much they're actually paying in pounds and pence, very few investors stop to question it. As long as the size of their retirement pot increases as the years go by, they have no reason to believe that they aren't receiving value for money.

The truth is that investment returns are mainly driven by the financial markets, not by skill or expertise. In many cases, fund managers and other intermediaries are extracting value from the investment process rather than adding it.

The OCF is only part of the story

The problem is that working out the total amount an investor pays is extremely difficult.

The first thing to realise is that the explicit cost, effectively the ongoing charges figure (or OCF), is only part of the story. Underneath are a whole range of implicit costs — transaction charges, custody charges, brokerage fees, foreign exchange fees and so on — some of which are very hard to identify.

More than a decade ago, Chris Sier from Newcastle Business School started to look into the true cost of asset management. The very first product he investigated was a simple equity ISA, and yet he found no fewer than 16 layers of intermediation.

"That's 16 companies sitting between you and investing your money," Sier told BBC Radio 4's Money Box in December. "Every one of those companies takes a piece of the pie as it passes through."

Dr Sier was so appalled at what he found that he started to ask asset management companies for more information.

"When I asked for it," he told Money Box, "the rebuttal I had initially was, Don't ask, you're damaging a fragile savings culture. They weren't happy with me at all."

Non-compliance with MiFID II

In theory, calculating the cost of investing should be very much easier now. Since the start of 2018, asset managers in the UK and the rest of Europe have been required to provide a figure for total fees and charges, and not just an OCF, under the EU directive MiFID II.

In practice, however, as Alan and Gina Miller from the True and Fair Campaign have demonstrated, many firms have failed to fall into line. To add insult to injury for investors, the Financial Conduct Authority has yet to get tough with firms that haven't fully complied.

Investors pay up to four times the OCF

Undeterred by the industry's reluctance to come clean over the full extent of fees and charges, the lang cat, an Edinburgh-based consultancy, has tried to come up with a more accurate picture of what investors are paying.

It found that many investors were paying almost double the OCF in the UK's most popular funds once transaction costs are included. That could rise to up to four times OCF if implicit costs were included.

The OCF for the Janus Henderson UK Absolute Return fund, for example, was 1.06% a year. But when platform and performance fees were factored in, the total cost of investing jumped to an average of 3.82% if purchased via Hargreaves Lansdown.

Index funds, of course, incur lower transaction costs, but even trackers are considerably more expensive than the OCF when all costs are included. The lang cat found, for instance, that the BlackRock iShares FTSE All Stocks Gilt tracker fund had a total cost of 75 basis points — nearly four times its OCF of 0.20%.

The onus is on advisers

So where does all this leave advisers?

Make no mistake: fees and charges are substantive, they severely impact returns, and they vary hugely. Cost is also, as research by Morningstar has shown, the most reliable predictor of future fund performance. As a fiduciary, it is therefore essential that an adviser knows exactly what their clients are paying.

Yes, it's still a minefield. Because different funds are using different methodologies for calculating costs, weighing them up can be like comparing apples with oranges. There is also bound to be an element of guesswork; for example, you can't know in advance how frequently a particular fund manager is going to trade. That said, there is far more cost-related information available now than there has been in the past. The onus is on advisers to find it.

Remember, the law requires asset managers to be completely up front with you about the cost of investing. If they aren't, or if they can't explain their fees and charges clearly enough for you as an adviser to understand, you owe it to your client to choose a different provider.

Robin Powell is a journalist and marketing consultant. He blogs as The Evidence-Based Investor and is the founder of Regis Media, a boutique provider of content to financial advice businesses.

Is it worth paying a premium for active management?

Despite the growing popularity of passive investing, the majority of financial advisers continue to favour actively managed funds. So, are they justified in doing so?

Long-term outperformance is very rare

There can arguably only be one justification for an adviser recommending an active fund; it's that they genuinely believe it will outperform the market after costs. In truth, however, consistently beating the market over the long term is extremely hard, and only a small proportion of investment professionals manage to do it.

There've been numerous studies on this subject, including an ongoing study into the performance of active equity funds in Britain and the US by a team led by David Blake at the Pensions Institute. It found that very few funds beat the market over the long term on a cost- and risk-adjusted basis.

That conclusion is consistent with data regularly produced by S&P Dow Jones. In the ten years to the end of 2017, S&P's SPIVA analysis shows that the vast majority of UK fund managers failed to beat their benchmarks. In the US equity sector, for instance, fewer than 7% of funds outperformed, and only around 5% in global equities. Active managers in the US have performed even worse. In fact, there's now SPIVA data available on fund performance all around the world, and the figures are remarkably consistent across different countries and asset classes.

There are some who question the independence of the SPIVA analysis, given that S&P Dow Jones has a foot in the passive investing camp (it primarily generates revenues by licensing the use of its indices to asset managers). But the Active/Passive Barometer published by Morningstar paints a very similar picture, and Morningstar has no obvious commercial interest in promoting index-based investing.

Why is beating the market so hard?

Why, then, is active management so difficult? Why do so few active managers consistently beat the market? There are three main reasons.

1. Market efficiency

Security prices reflect publicly available information quickly and accurately. At any point in time, prices represent the fairest assessment of value, until more information becomes available. Trying to beat the market is like pitting your wits against millions of traders around the world. The chances that any one fund manager will consistently have valuable insights that other market participants don't are slim. Even in cases where managers do outperform consistently, distinguishing luck from skill is a real challenge.

2. The zero-sum game

The financial markets are competitive, and most trading nowadays occurs between professional investors. Generally, the reason why an active investor sells a stock is that they think it's going to perform poorly relative to the market; the stock is bought by another active investor who believes it's going to perform well. They cannot both be right. One active investor can only win at the expense of another active investor.

3. Costs are a high hurdle

The final reason why so many active managers fail is that just beating the market isn't enough; they need to beat it by a big enough margin to justify the costs entailed in using them. On average, fund managers will produce average returns, but from those returns you have to subtract what Vanguard founder Jack Bogle used to call "the cost of playing the game". For the majority of managers, fees and charges are too high a hurdle to overcome.

Identifying outperformers in advance is very difficult

Of course, even though most funds underperform the market in the long run, there is a possibility that the funds you pick will outperform. Realistically though, your chances of identifying a winner, in advance, in every major asset class are small.

Some advisers give the impression that they can do it. In practice, however, they're far better at telling you which funds have outperformed in the past than those which will do so in future. Past performance is no guide to future performance. If anything, a fund that's been on a winning streak is more likely than others to go on a losing one.

To demonstrate the lack of persistence in outperformance, researchers at Vanguard Asset Management ranked all UK equity funds according to the excess returns they delivered for the five-year period to the end of 2009. They divided the funds into quintiles, separating out the top 20%, the next 20% and so on. They then tracked the funds' excess performance over the next five years, through to the end of 2014.

If the funds in the top quintile displayed consistent performance, we would expect them to remain in the top 20%. But the results were relatively random. About a third of the top-quintile funds retained their position over the subsequent five-year period, but the same funds stood around a 40% chance of falling into the bottom two quintiles, or even being shut down.

Conclusion

There's nothing intrinsically wrong with active management, particularly if it's of the low-cost, low-turnover variety. It's true as well that the markets need active managers to help set prices.

Ultimately, what active investors are paying for is the possibility of outperformance. But client in active funds have to be prepared for the overwhelming likelihood of long periods of underperformance too.

Robin Powell is a journalist and marketing consultant. He blogs as The Evidence-Based Investor and is the founder of Regis Media, a boutique provider of content to financial advice businesses.

Is it worth paying for so-called smart beta?

Much has been made over the last few years of so-called smart beta. Different people call it different things; for example, strategic beta, fundamental indexing or factor investing. But what exactly is it? And, given these sorts of funds are more expensive than cap-weighted index funds, should advisers be recommending them to their clients?

In simple terms, beta refers to the market return; alpha refers to any returns that an active fund manager is able to deliver over and above the market return. In practice, consistently delivering alpha net of costs is extremely difficult, which is why a market-cap-weighted fund like the Vanguard Total World Stock Index Fund is such a sensible option.

But are there certain sections of the market that tend to deliver higher returns than the overall market over the long term? Research conducted by the Nobel Prize-winning economist Eugene Fama and his colleague Kenneth French suggests that there are.

The different factors

What Fama and French discovered was that, over the long term, stocks of smaller companies outperform those of larger companies, and stocks of undervalued companies (or value stocks) outperform growth stocks.

To those size and value factors (or risk premiums as they're sometimes known) they have since added a third factor, profitability; in other words, over time, stocks of companies with high profitability generally outperform those with low profitability.

Although their primary focus has been on US securities, Fama and French have also observed these risk premiums working in financial markets around the world. Data from Dimensional Fund Advisors shows, for example, that in the ten-year period to the end of 2017, UK small-cap stocks outperformed UK large-cap stocks on an annualised basis by a whopping 4.91%.

The downsides

There are, however, significant downsides to tilting a portfolio towards these different risk premiums. First and foremost, there is no guarantee that the size, value and profitability factors will outperform in the future to the same degree that they have in the past. Indeed no one can be certain that they will beat the broader market at all.

There are some who suspect that the value factor, for instance, has stopped working altogether. In that same ten-year period referred to earlier, UK value stocks have underperformed growth stocks by an average of 4.02%. High-profitability stocks have also underperformed low-profitability stocks in the UK – by 1.92% a year – although they have outperformed in Europe, the US and the emerging markets.

Another problem with small-cap and value stocks is that they carry greater risk than the market as a whole. Nor is it possible to predict when a particular premium is about to show up, because outperformance tends to come in random bursts.

A long time horizon is essential

Over the longer term, however, the case for factor tilts is much stronger. Dimensional's data shows that, for ten-year rolling time periods, size has outperformed growth 83% of the time in the UK since January 1970; value has outperformed growth 78% of the time since January 1975; and high profitability has outperformed low profitability 83% of the time since January 1990.

Another reason why it's especially important for factor investors to have a long time horizon is that small-cap and value stocks are imperfectly correlated. In other words, they outperform and underperform the rest of the market at different times. So, the shorter the time horizon, the more unpredictable your returns will be. The longer you invest for, the easier it will be to harvest the returns of the different premiums.

Fixed-income factors

Given sufficient time, factor investing also works in the fixed income space. Academics have identified two main factors that tend to produce higher bond returns. The first is term premiums; in other words, bonds with distant due dates have returned more than bonds that are due soon. The second one is credit premium; that is, bonds with lower credit ratings have returned more than bonds with higher credit ratings.

But is it worth it?

So, is a financial adviser justified in recommending smart beta funds to a client? There is certainly plenty of data to justify allocating at least part of a client's portfolio to factor-based funds.

There are, however, important caveats. First, of course, you need to ensure that any additional returns more than compensate for the additional expense the client will incur compared to investing in a low-cost index fund.

Crucially, you also have to manage the client's expectations. These risk premiums won't shoot the lights out, especially over short time periods. The client has to be willing to stick with their strategy for a very long time. And because small and value stocks are likely to fall even further than the broader market in a crash or correction, factor investors need to be even better able to handle extreme volatility than cap-weighted indexers.

Ultimately, smart beta only offers the *possibility* of outperforming the market. It may or may not happen. Indeed, recent research by AJ Bell suggests that, because of the uncorrelated nature of factor returns, factor-based performance can be readily replicated using a multi-asset portfolio of purely passive funds.

Smart beta, then, may suit some clients, but for investors who simply want to capture market returns cheaply and efficiently, traditional cap-weighted index funds may well be the better option.

Robin Powell is a journalist and marketing consultant. He blogs as The Evidence-Based Investor and is the founder of Regis Media, a boutique provider of content to financial advice businesses.

Pension transfer update – suitability

The FCA published an update on 6 December 2018 focusing on work regarding defined benefit pension transfers and suitability. You can find the official publication here.

Although the FCA admits that the update is based on targeted work and a small number of firms, 18 of those firms had given advice on 48,248 clients since the introduction of pension freedoms, resulting in 24,919 actual transfers. As Benjamin Fabi of Principled Paraplanning commented on social media – akin to an "industrial scale process."

Staggeringly, less than 50% of the DB transfer advice the FCA reviewed was suitable (the remaining files were split between unsuitable and unclear). Contrast that with the 2017 general suitability review of pensions and investments where over 90% of advice met this basic requirement.

Assuming the regulator already views a risky sector with a healthy degree of cynicism – I think there is a lot to be drawn from the continual use of 'disappointed', 'unacceptable' and 'concerned' in relation to the work they reviewed. These feelings are also echoed by the advice industry itself – including those who have been behind initiatives to promote good practices and processes in pension transfer advice, such as the Pension Debate.

So where are these particular advisers falling down?

Suitability

The FCA found that suitability failings in relation to files and reports were persistent when compared to the results of other work.

In some cases, full information on other pension arrangements was not gathered at all, or where it was gathered, was not fully considered in any recommendations.

In terms of objectives, the general theme was the use of generic or template objectives such as 'flexibility' and 'death benefits' without specific reference to the client's own situation and no exploration of the motivation behind them and their relative importance. Even if verbal discussions were had and real, meaningful objectives fleshed out – if it isn't in the file, it didn't happen.

The use of template objectives isn't an issue exclusive to pension transfers, but collecting details of a client's income and expenditure position when assessing how they might meet future liabilities, their desired lifestyle in retirement as well as details of other arrangements is absolutely crucial. In some cases income in retirement was assumed to be the same income now, without exploring options, dates, goals and aspirations.

The stated need for 'increased death benefits' was often not matched with an analysis of how that could alternatively be met (for example, by the use of insurance). Assessments of the sustainability of drawdown funds in the proposed receiving schemes were lacking, particularly how the costs of the recommended wrappers and solutions would eat further into assumed investment returns. Increased death benefits are of no use if they are not available from a drawdown fund that won't even last a client's lifetime.

Firms also used attitude to investment risk results as a reason to justify a transfer without always assessing the specific risks of transferring a guaranteed income stream. Where attempts were made to address specific pension transfer risk, it was using language that steered answers in a particular direction.

Communication and disclosure

Over 60% of communications and disclosure by firms to clients was found to be non-compliant. The disclosure failings were largely in relation to standard documentation and in some cases, exactly what fee(s) were payable. It could be argued that fee disclosure is another issue that is not exclusive to pension transfer advice but the prevalence and persistence of it in the most active firms in this sector is interesting when compared with the larger sample of firms in 2017's general suitability review.

Turning back to suitability and reports – communication and documentation of the reasons for transferring, and information about scheme solvency, employer strength and the Pension Protection Fund was not presented in a manner that was clear, fair and unbiased.

The language in suitability reports was often confusing and in some cases so unclear that it was impossible to understand what the actual advice was amongst long lists of generic risks and benefits of transferring pensions.

2019 and beyond

As firms active in pension transfers will be aware, the FCA has now collected data on all transfers since 2015 and this recent communication contains a clear warning shot that work in this area will continue. Firms have been reminded of the ongoing basic requirement for suitability and communications as well as the new framework for pension transfer advice that has been in place since 1 October 2018.

What stood out in the findings were the level of suitability and disclosure issues by a small number of firms providing high volumes of transfer advice, particularly given industry efforts to highlight issues and promote best practice prior to and since the new rules framework.

To understand why, maybe we need to take a step back. Many advisers and industry figures have been highly vocal about DB transfers, with a view to improving client outcomes. The debates have been detailed, well covered and widely available, and at times very heated. The FCA itself has been criticised for not issuing guidance on 'best practice' quickly enough. The reality suggests, however, that there is a minority of firms that aren't interested in making their good advice great advice, don't read papers or guidance issued by anyone, and simply want to make a quick buck and disappear before the consequences are felt.

Perhaps whilst some of us were arguing about the differences between stochastic and deterministic models, a small number were charging tens of thousands for a template report and two-page fact find, while working to a business model predicated on speed and brevity, not long-term relationships or reputational and regulatory risk.

For those firms that are looking to make their good advice great, Rory Percival, ex FCA regulator and founder of Rory Percival Training and Consultancy, has written an article and full report that covers the FCA's rules and guidance. This, along with a wealth of other information and case studies on issues around suitability and controls, is available now on the AJ Bell Investcentre hub.

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