



## Costs kill

- **Do you know what you're paying?**
- **Do you know the impact?**
  
- **The scale of the costs of an equity product with typical charges and trading activity means you lose:**
  - **HALF the normal market return - in real terms**
  - **ALL the normal risk premium – the expected excess return relative to the normal return from a risk-free alternative**
- **The impact is you may unintentionally make bad gambles.**

### It pays to know

The scale and impact of product and service costs are explained in Chapter 11 of the book. It shows exactly where the costs come from (the sources are listed in the box) and what the range of total cost levels is for different types of product and management approach.

Where costs are likely to come from:

Stamp duty

Selling commission or load

Annual management charge

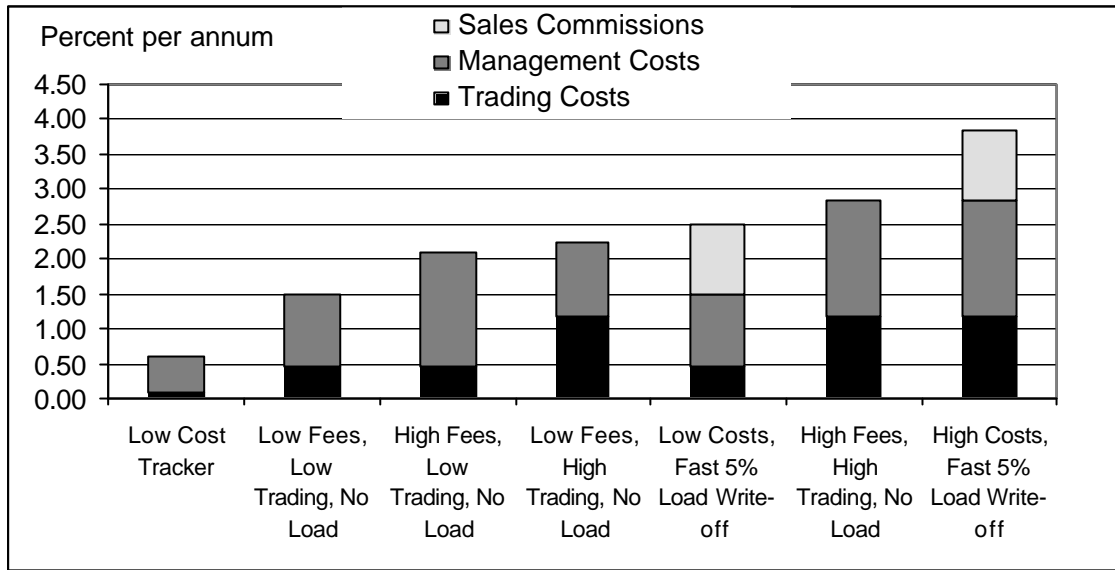
Double charges when products held inside a portfolio

Custody, audit, trustee fees

Transaction costs borne by the fund or portfolio

This is presented as a wedge. A low-cost index tracker is the thin end (the unavoidable minimum) and a fund with high charges and a hyperactive portfolio manager is at the thick end. Arrangements involving double charging (two lots of management charges, as in 'funds of funds') could push the wedge even higher.

Along the wedge, there are many combinations of the three different types of cost: selling commissions (or front-end loads), fund management costs and market trading costs. The chart shows a few examples of cost combinations.



Note: selling commissions are 5% written off over 5 years on the basis the fund is only held for that long. Disappointment with active funds tends to lead to higher turnover after the event than is typically anticipated before the event. Lower loads or longer holding periods will move a front-end loaded fund down the wedge.

### How deep does the wedge go?

Compare them with the expected investment growth

Costs should be compared with the growth driver for the fund, not the existing size of the fund. Growth is what makes investment worthwhile. Growth is measured as a 'return on investment', which can either be ploughed back or taken out. Costs are like attaching a ball and chain to the growth driver and must impact whether the exercise is still worthwhile.

The driver is a small number, particularly when inflation is taken out of it and it is expressed as real growth. The book shows a historical equity trend of just 6% pa in real terms. Adjusting for inflation is important: by jacking up 'nominal' returns inflation can easily conceal the fact that costs are taking a big proportion of the real growth. *Real growth* is what counts if you are going to be using the money to buy things whose prices may rise (like your bills in retirement). *Money growth* is the right measure for a future target fixed in money terms (like your mortgage).

Compare them with the expected risk premium

Costs should also be compared with the expected risk premium – the growth driver minus the risk-free return. This is the element of growth that is a rational expectation for an investor who has a risk-free alternative investment. Costs can force people into making irrational bets without realizing it.

In the table from Chapter 11, how deep the wedge goes is illustrated by showing different cost examples (down the left) as a percent of various examples of return driver and risk premium (along the top). *Where the industry pockets more than 100%, the percentage is shown in bold type.*

	1% pa Out-performance Target	High Market Return	Ave. Market Return	Low Market Return	High Risk Premium	Ave. Risk Premium	Low Risk Premium
Costs % pa							
3.85	<b>385</b>	43	64	<b>128</b>	92	<b>140</b>	<b>385</b>
2.85	<b>285</b>	32	48	95	68	<b>104</b>	<b>285</b>
1.50	<b>150</b>	17	25	50	36	55	<b>150</b>
0.60	60	7	10	20	14	22	60

Interpreting the impact:

For a fund with typical costs:

- ‘Typical’ costs for active products of 2.85% pa absorb 48% of the normal market real long term return
- Based on the latest Market Value ratio for the UK (calculated by the Fifth Freedom model), the cost wedge now grabs 60% of the mean expected return
- If you bought a UK equity fund with those costs at the top of the market in 2000, costs would have taken all of the mean expected real return
- The current risk premium relative to index linked gilts is near normal, so costs are now taking just over 100% of it
- For a US equity fund, the cost gap is currently 77% (because the mean expected return is 1.3% pa below the UK)

For a fund with high costs:

- Only when markets are exceptionally low in price, high in terms of future real return (third column from right), is the risk premium actually less than costs

Now contrast these with a low-cost tracker:

- At the worst level for market values, costs are still less than 20% of the market return
- And there is a positive risk premium – whatever the market level
- At the current level of the UK market, costs are about 13% of the mean expected return
- The current low value of US equities make a tracker the only means of having even a 50% chance of earning a risk premium relative to safe harbour returns

Warning: tracker costs also vary. Some charge a load; some have annual management charges as high as 1% pa; some have higher transaction costs. Giant funds generally have lower total costs.

Bad gambles

This simple explanation lies behind the illustrations in the book of bad gambles:

- For a holding period of ten years the chance of doing better than an index-tracking fund when paying industry-average costs is no better than one in four
- At the higher cost of many popular products, the chance falls to one in ten
- Doing much better – the whole point of the exercise – carries a negligible chance

No Monkey Business

Topical feature: Costs kill

- Exceeding the 'efficiency' (ie risk-adjusted, after-cost return) of a tracker has a negligible chance - even for typical active products and services

Enticing individuals into making bad gambles as a matter of course is part of the evidence in the book that the industry has become 'systematically corrupted' – strong language but a deliberate distinction.