WALKERCRIPS
STOCKBROKERS

A PERSONAL VIEW FROM PETER BENNETT

Costs and Investment Performance

Many investors will be wholly unaware of how substantially costs affect returns. This only hit me when I read a piece by Vanguard of the USA. This firm, started by John Bogle, is surely the investor's guardian angel. They were leaders in the introduction of low cost index tracking vehicles.

What caught my attention was a note they wrote on 4 June 1999. *Inter alia*, they showed the effect of 2.5% pa total costs – the cost of a typical Mutual Fund. $10,000 invested for 40 years at a growth rate of 10% pa becomes $452,600 invested, imaginarily cost-free, in the Index. In the Fund; $180,000. 62% of the return is trousered by you know whom. Jaw dropping. I have in front of me an FT article suggesting that UK unit trusts probably cost, in total, 3%+ pa. There is, in fact, no regulatory statistic that captures the full cost of unit trust investment, i.e. Total Expense Ratio does not mean total expense ratio. No doubt vested interest saw to that. The trade association, of course, goes puce and gets into a data mining frenzy, when such maths receives publicity. Thanks to the likes of Mr Bogle and regulatory changes clearly the industry is now on the back foot. Correctly, in my view.

Added to which, study after study, whose conclusions I have read over the years, shows that long-term, only 20%-25% of active managers beat chimpanzees with darts. I mean benchmark 'index'. The 1 / 3 / 5 year league tables are probably worse than irrelevant. Such short periods prove nothing – except someone may have got lucky. They are hotbeds for the marketing departments to get stuck into your wallet. Another study showed that Pension Funds, who typically kick a 3 consecutive year lower quartile manager into touch, are more likely to be jumping from the frying pan into the fire. On average the higher rated replacement manager, judged over the previous three years, will have an off period, whilst the loser has a better period. Add in the costs of transferring mandates, more often than not the Pension Fund loses from making the switch.

I have dealt with Hedge Funds at length on more than one occasion. Suffice it to say I have never recommended investing in one.

Statistics

Investors may also be unaware that, brutally stated, Hedge Fund / Unit Trusts (UTs) aggregated performance statistics are not fair statistics. As regards Hedge Funds, readers are aware that supplying statistics is voluntary. So you've lost 80% of investors money? Are you more likely to publicize your statistics than if you had made an 80% profit?

In the UK a similar data bending affects aggregate UT statistics. Almost as many Unit Trusts have been closed down or merged as new ones brought to the market this century. Which do you close and get removed from the statistics, the big success or the lemon? No prizes. 1998 to 2010 there were 2,486 Unit Trust closures and 2,660 launches. In fact, a near 100% turnover of the statistical universe. If it were possible to back-adjust for the already dire statistics of active managers relative to Index benchmarks, the numbers would probably appear even worse. Zero cost investing, of course, doesn't exist but, for example, many Vanguard Exchange Traded Funds (ETFs) charge but a handful of basis points per annum as fees. There are, of course, also transaction charges incurred in order, occasionally, to rebalance the tracking portfolio and various hidden charges. In the UK buyers do not pay Stamp Duty on ETF purchases. Investment Trusts (ITs) typically charge more than ETFs but measurably less than UTs and their ilk. They also often have some modest gearing, that slightly leverages returns. I personally like that as I do not invest in ITs expecting them to lose value over time. Berkshire Hathaway is estimated to have about 40% 'free' gearing from its insurance float. I should be so lucky. In a bull market 40% free 'performance'. I can't remember when I last invested clients/self in a UT. I always chose ETFs or ITs. As you would expect, studies show that, on average, ITs produce superior results to UTs and other high cost alternatives. As for Hedge Funds and their outrageous charges and, worse, Funds of Funds stuck on top – spare me. Indeed, it is well known that **costs** are by far the main determinant of returns. Forget the cheerleading about amazing skills, and investment genius. These are extremely rare- long-term.

Sectoral

Interestingly, the alternation of good and bad performance by numerous Fund Managers also occurs across investment sectors, not just amongst managers. In a 1977 (I believe) Bulletin, I illustrated a study of M&G Unit Trusts. Far, far more money was made (I believe by around a factor of three over 10 years) by, each year end, selling the best performing sector and buying the worst - as opposed to the opposite; (what I would call the IFA model!!!). This latter explains the following data: during the big bull market ended 1999, the S&P rose 13%+ income reinvested; the average mutual fund about 10%; the average investor 6%+. They were 'sold' the easy sell – last year's mutual fund winners.

Recently the Investors Chronicle (31/01/2013) reported on another similar study covering the past 30 years. The worst Fund sector over five years rose 73.2% in the following five years; the best 41.4%.

RDR

The Retail Distribution Review finally – and certainly not before time – is, supposedly, about to stop the kickback scam, where so-called Independent (Ed: I'll do the jokes, again) Financial Advisors, surprise, surprise, so often recommended the Unit Trust or other product with the largest kickback on charges. From this you will have guessed: ITs and ETFs, which neither give kickbacks nor charge sales commission ("front end load", exit charges), were seldom recommended. It stinks. The demise of this method of paying for advice was frantically and successfully resisted for years by the vested interests. On hearing of RDR, howls have come from the IFA brigade. Hundreds of firms will have to close their doors, it is claimed. (Ed: probably. And be thankful.) Practitioners will, for future business, have (at least in theory) to charge fully disclosed fees – just like accountants, lawyers, barristers, private medics, i.e. people who like to call themselves true professionals – with all that that implies. If those seeking financial advice felt that it really was 'free', they must have believed in Father Christmas too. I suspect an awful lot probably did! Message - costs are by far the dominant influence on 'performance'.

Good luck,

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