Financial Times - Keep a lid on costs to protect your investment

April 30, 2013

Many investors are sacrificing all of their income and more to investing charges

This is the final part of my series on the fundamentals of investment. So far I have looked at why most or all of us should not try so-called market timing, and should instead focus on buying shares in good companies and holding them. I've suggested that you should never invest primarily to avoid tax, and that overdiversification in a portfolio is not only pointless but injurious to your investment performance. My last piece of advice concerns investment costs.

Even if you run a concentrated portfolio of quality shares, your returns will be constrained if you fail to control costs. Many investors are unaware of precisely how much they are being charged for their investment activity, so let's have a look at the costs the average investor might incur.

Financial advisers and wealth managers typically charge fees of 0.5-1.0 per cent on the value of the portfolio, and will often use an investment platform to hold the individual funds or shares. That might cost another 0.25 per cent a year, usually collected as "trail commission" from the underlying fund managers. The investor may also use the platform direct.

If the investments are held in mutual funds, there will be an annual management charge (AMC) of 0.75-1.5 per cent. In addition, the funds charge certain expenses to the fund: typically things such as custody, administration and legal expenses, but they have been known to charge marketing expenses too. Add that lot up and you get to what used to be called the total expense ratio and is now known as the ongoing charges figure. That's typically 1.0-1.75 per cent; add in platform and advice costs and the running total is generally between 1.75 per cent and 3 per cent.

Even that isn't it. There is also a hidden cost which is not disclosed in any of these figures: the cost of dealing within the fund. When a fund manager or an investor deals in stocks, he or she pays commissions, stamp duty at 0.5 per cent, the levy that funds the Takeover Panel and the difference between the broker's bid and offer prices (the spread). A big order in a low-liquidity share might force the price up quite a lot.

Data published in a Financial Services Authority study (The Price of Retail Investing in the UK, by Kevin James, available at www.fsa.gov.uk) suggested that the average UK fund manager turned over about four-fifths of the portfolio each year. Apart from the questions this raises about the lack of conviction and hyperactivity, it would suggest that additional undisclosed costs of up to 1.4 per cent are being incurred each year on top of the "total" expense ratio.

All that would be bad enough, but these costs are in stark contrast to the income available from bonds and equities. The yield on the FTSE 100 is 3.8 per cent, on the S&P 500 it is 2.1 per cent and 10-year government bonds in countries such as the UK and the US yield significantly under 2 per cent. In other words, more than 100 per cent of the expected income on portfolios is being absorbed by charges.

Given this myriad of charges, you might ask how the funds are able to pay dividends. The problem is not immediately apparent, because many funds, and almost all income funds in particular, apply these charges to the capital value of the fund and not as a deduction from income. But this does not alter the fact.

John Bogle, the legendary US investor and founder of Vanguard, calculated that during the 81 years to 2007, reinvested dividend income accounted for approximately 95 per cent of the compound long-term return earned by the companies in the S&P 500. The bull markets of 1981-2000 and 2003-07 may have misled investors into thinking that equity investment is mainly about share price appreciation. But history suggests otherwise. No one can afford to throw away all or more than all of the income from their portfolio on charges. If you do, the inevitable result is that you will experience poor performance net of these fees.

So how do you avoid or reduce charges? The obvious routes are to cut out as many of the layers of intermediation as you can between you and the actual stocks which you own. It is those layers which add to the costs. Where you can, invest direct. The other method – though it might seem odd for an active manager to advocate this – is to buy an index fund, which just tracks an index. You should be able to buy an index fund for all-in charges of 0.25 per cent a year or less.

Given that the average active fund manager underperforms the benchmark index anyway, why would you pay more?

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