Investments: The Cost of Active Fund Investing

The Cost of Active Fund Investing

By: Joe the Investor

There are many options for buying a group of securities in one product. The most popular ones are mutual funds, segregated funds and exchange traded funds. What they have in common is that these products are an easy way to buy a group of securities at once instead of buying each security individually. The fund can also proportion the securities so that you the individual investor does not have to. There are two main classifications for what type of fund you can purchase in terms of costs. It is important to know how these costs work so you can avoid paying too much for this convenience. These products differ in terms of how they are administered, access to the products and their costs.

Active Versus Passive Investing

Before getting into which of the products are suitable for you, there are some aspects that need to be considered so that you understand what the variations are among the products.

Active investing is when someone (a portfolio manager) picks the stocks that are in the fund and decides how much of each one to hold (the ***weighting***). This portfolio manager would also monitor the portfolio and decide when a security should be sold off, added to or have its weighting decreased. Since there is ongoing research, meetings and analysis that must be done to build and monitor this portfolio, this fund manager would have research analysts and administrative personnel to help run the fund.

Passive investing has the same setup as active investing, but rather than someone deciding what securities to buy or how much of each one to buy, the portfolio manager would copy a benchmark. A ***benchmark*** is a collection of securities which the fund is compared against to see how well it is doing. Since everything in investing is about how much money you can make and how much risk it takes to make that money, every fund out there is trying to compare to all of the other funds of the same type to see who can make the most money. The basis for the comparisons is the benchmark, which can also become comparing between peers or funds managed the same way. Comparisons are general in done only for returns. The risk aspect of the equation is handled by looking at what type of securities the fund holds or how specialized the fund is.

How Do I Know By the Fund Name If it is Active or Passive?

The short answer is that you have to get to know how the fund manager operates the fund. Some clues to know more quickly if the fund is active or passive are given next. If they are intentionally trying to pick securities according to some beliefs that they have about the market, this is active management. If the fund description talks about "beating the benchmark" or "manager skill" then it is actively managed. Looking at the return history, if the returns vary versus the index by different amounts each year, then the fund is actively managed. Lastly, the fees may be expensive and have sales loads.

If the name of the fund says "Index" or "Index fund" there is a good chance that the fund is passively managed. If the name of the fund says "ETF" or "Exchange Traded Fund" this could be a passive fund, but you need to make sure of this because some ETFs are actually active funds, but they are managed in a certain way. Most of the passively managed ETFs are provided by BMO, iShares, Claymore, Vanguard and Horizons in Canada and Powershares, Vanguard and SPDR (or Standard and Poors) and others if the holdings are from the U.S. Most of the other companies would have actively managed funds only. If the fund description states that the fund is trying to "imitate" the performance of an index or benchmark, then this implies that it is copying the index and this is passively managed. From the return perspective, passively managed funds will be very close to the index that they claim to imitate, but slightly less due to fees each year. The amount that the returns are under the index will be close to identical each year unless there are currency conversions or variances in cost which may come from currency fluctuations or hedging that the fund may do. Passive funds typically do not have sales loads as they are geared toward people who invest for themselves.

There are some funds that try to mix active and passive management. These products can be assumed to be actively managed, although their results will be closer to the benchmark than most of the other funds, so this is something to consider if the variation from the index is a factor.

Types of Costs

Whatever product you buy, there will be a cost associated with buying it, keeping it and selling it. This will be true whether you have an advisor versus doing it yourself, and whichever institution you go to. Even buying your own individual stocks will have trading fees which you must account for. How much you are paying for each product as well as the advice will make a large difference in what return you will receive at the end of the day.

There are many types of costs to be aware of when you are deciding which products to invest in. This article will focus on the active funds that make up most of the selection for retail investors.

The Management Expense Ratio (MER)

This is the largest cost for most funds and represents the cost of managing the fund. "Managing the fund" means running the investment company, researching the investments, advertising, overhead and the cost for the advisor or sales person when it applies. Administrative costs like GST within the fund and accounting for trades and record keeping are also part of the expense. The MER covers all of these costs in an actively managed fund. The MER is given as a percentage, which is the percentage of the assets that the fund manages or invests over a year of time. If you have $100,000 invest in a fund, and the MER is 2% per year, you are paying $2000 per year to keep this fund. The cost is subtracted from the return and what you see in your investment statement is your return net of fees, or after fees. There are exceptions to this rule if you have a high net worth account or a special arrangement with the fund company, but for the typical investor, this would be true. The Management Expense Ratio is the management fee plus the administrative costs. The administrative costs are usually between 0.05% and 0.1% of the assets of the fund. If the information you obtain states a “Management Fee” instead of a “Management Expense Ratio” you would have to add on the administrative costs to get the true fee. Seek out the prospectus and look up fund operating costs to find exactly how much the number is. In some cases, an advisory fee is also added to the management fee and administrative fee which can be substantial. If your advisor does not disclose this, the prospectus is the next best place to find out what the costs are.

For American funds, the MER would be called the “Expense Ratio” or “ER” which is the same thing as the Canadian MER, but advisory fees are not included in the ER and would be included in Canada for the MER if the product is actively managed. If the product is passively managed in Canada or the U.S., the same names apply, but no advice would be part of the cost since these products are used by people who invest for themselves and would pay for advice separately if they retain it.

MER Will Depend on Class

There are products that have various classes of the same product, the same way there are different models of the same car or the same cell phone. For investment products, the classes indicate how you came across the product, or what restrictions you have on access to the product. For example, Class A is usually a retail class where anyone can buy the product with any amount of money. There is Class I, which can be obtained through an employer or another institution. An example might be buying this product through your company pension plan. There is a Class O which typically has no fees embedded in the return and is reserved for non-profit institutions of high net worth clients that buy direct from the company. There are also classes that are part of different portfolios that are set up by the issuer, like Class F which would be available depending on who your investment dealer is. There are also classes that vary depending on what type of advisor you have and what relationship they have with the fund company. The best thing to do here is ask what class you are being offered and get material form the issuer on how much it would cost. In some cases, you can get the same product in a different class and pay less for it. Some companies may have “Series” instead of classes or some variation thereof. The key thing to note is that different versions of the same fund would different fees, and the differences can be substantial.

Sales Loads

Whenever you see the word "load" on a fund it refers to a sales load. This fee is paid to a sales person for advising you and recommending the product to you for the company. There are "front end loads" which are paid as a percentage of the amount you initially invest. If a front end load is 4% and you invest $100,000, you will pay $4,000 up front just to buy this fund. These funds may have the code "FE" in the fund name on your statement. Note that sales loads are not related to MER fees – they are separate fees. There is also a "back end load" or "Rear end load" which is a percentage charged to you when you sell the fund. These are marked with the code "DSC" or "Deferred Sales Charge". If a back end load is 5%, and you sell $120,000 worth of this fund, you would pay $6,000 in fees to exit the fund. These funds tend to have a DSC redemption schedule which means the sales load will decrease the longer you stay in the fund. Most companies stop charging the rear end sales load after 6 years of holding the product. Since each company varies, you should obtain the details of this schedule up front and understand how the numbers apply to your holdings. There are also "no load" funds which do not charge sales loads at any time. You may also come across "Low Load Funds" and "Level Load Funds". Low load is similar to the fees discussed above, but they are discounted or lower than average. The level load idea means that the same percentage of sales load is charged over time.

Some companies charge an early redemption fee if you sell their fund within a short period of time. How short the period is will depend on the institution. In some cases, it is 30 days, but it can be 90 days, 6 months, 1 year or some other time period. This fee is designed to discourage quick redemptions or short term trading of the product.

The best thing to do to clarify which load you have is to ask up front and have it explained to you. If the information is not forthcoming, it may be time to find another place to invest your money or do the research on your own. Note that sales loads only apply to a fund that is sold through a sales person. You may be able to get the same fund without the sales person in some cases. Passive investing generally does not have sales loads – but the exception would be if an advisor recommends these funds and charges you some type of referral fee. This would be another question to ask if you are being advised to buy a passive fund and are not seeing any direct cost to buying the product.

Currency Hedging Costs

This type of fee will occur in funds that trade in non-Canadian currencies and hedge them so that the price you receive would be in Canadian dollars. The cost of transacting the hedge itself is the fee being described here, and it can range from 0.5% to 1% per year. If the fee is not disclosed, assuming 0.5% is the cheapest that it will likely be. If you are investing in emerging market currencies or non-developed market currencies, the hedges are much more expensive to put in place and go higher than 1% per year. This is a cost embedded in the return of the fund, but should be examined to flesh out exactly what you are paying to have this hedged. Both active and passive funds pay the same fee for this type of activity.

The alternative would be to keep the securities in their home currencies and whatever changes happen to the foreign exchange rates would be reflected in the price of the product. The fact that currency exchange rates can change is a risk of your investment, but it is not considered a fee like the other fees discussed in this article. This fee does not apply if the fund price is in your home currency. You may have a U.S. dollar account, buy a fund that trades in U.S. dollars and then redeem this fund for U.S. dollars. Until you convert the money on your own to Canadian dollars, there is no currency charge. You would only have a conversion charge to change the final dollar amount to Canadian dollars.

Referral Fees or Trailer Charges

These can sometimes be called Service Fees. This type of charge is paid to a third party who sells the product to you on their behalf. It can be thought of as a referral fee or trailer fee. This fee tends to be captured by the MER, but this should be investigated with the company you are dealing with as this may vary. This type of fee tends to arise with active management as passive management products usually do not have any referrals attached to them.

Performance Fee

This fee is based on whether a fund achieves a return over a required benchmark – a reward for good performance. This type of fee is common with hedge funds or exotic types of products, but it is sometimes embedded in funds sold to retail investors. Like with most of the fees, ask questions and do your research because this type of fee will be different for every institution and product. This fee is optional in that it usually will not apply if the return on the fund is negative or positive but not that high, but the question should still be asked to minimize surprises.

Fees of Holding One Fund Inside of Another one

If a fund that you are investing in has other funds within it as part of its holding list, then you will pay the MER fee for the fund you are buying as well as the fund that the fund holds. The best way to check if this is happening is to look at the holdings list. If a fund holds another fund, it will be a large holding so a fact sheet with a top 10 holdings summary should provide good information. The actual numbers for each of these items will differ depending on specifically what the fund is and how it is managed. Some of the other fees like Sales Loads and Referral Fees would not apply to a fund held inside of another fund. If the fee is necessary to operate the fund, like currency hedging, then this would be included. Whether a fund holds stocks or another fund can also impact withholding taxes if the fund is investing outside of Canada – particularly for U.S. products. This topic can get complex, so it will not be discussed here. Some funds will have other funds to get access to illiquid markets, or parts of the world that have hundreds of securities. Buying a fund in these cases would actually save on time and trading costs, so it can be justified depending on the market being invested in.

Intangible Costs

The key takeway is that you need to do a cradle to grave analysis of what you have and see the costs from beginning to end of your investment period to get an idea of what is really happening. Ideally, the costs should factor in time spent, effort spent on research, and costs of discipline and assurance which would be available when dealing with an advisor that may not be there when you are doing it yourself.

Where to Find These Costs?

The most comprehensive place that will contain the most detail regarding fund costs is the prospectus. This can be found be searching for the product name and the word "prospectus". If you do not know the exact product name, you can search the internet by the company name only, find their web site and then search for the product name there. The fund companies will have these documents with the regulator (7) as well as their own web sites and they will be typically in PDF format which can be read and downloaded from your computer. A simplified prospectus would also have the same data that you would be looking for regarding fees.

Sources:

1) http://en.wikipedia.org/wiki/Segregated_fund
2) http://www.investopedia.com/terms/m/mutualfund.asp
3) http://www.investopedia.com/terms/e/etf.asp
4) http://www.spindices.com/documents/spiva/spiva-canada-scorecard-midyear-2014.pdf
5) http://www.theglobeandmail.com/globe-investor/investment-ideas/actively-managed-funds-vs-the-index-once-again-no-contest/article21580578/
6) http://www.etfinsight.ca/?p=26348
7) http://www.sedar.com/DisplayProfile.do?lang=EN&issuerType=03&issuerNo=00001760

Contact me, Joe Barbieri by email at joetheinvestor.today@gmail.com, or by telephone at 647-286-8020 for an independent consultation on what your options are. **Note: This site is intended for people who want to learn about the world of investments and how to research for themselves. If you would like to buy or sell investment products, or specific advice on investment products, tax or legal issues, please consult your investment advisor, accountant or legal counsel.**