Investments: The Cost of Passive Fund Investing

The Costs of Passive 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 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, and then it becomes comparing between peers or funds managed the same way. Comparisons in general are 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. Another clue is to look at the return history. If 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" 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 funds 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 however as well as the advice will make a large difference in what return you will get after everything is done.

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 passive funds that make up a growing selection of products 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, 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 this cost. 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 invested in a fund, and the MER is 0.5% per year, you are paying $500 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. 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.

For American funds, this would be called the "Expense Ratio" which is the same thing as the Canadian MER, but advisory fees are not included in the ER. They 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.

What Is Tracking Error?

In many cases, when you are buying a passive investment, you want to imitate an underlying benchmark or index. Another way of saying this is that you want to achieve the average rate of return in a given market all the time. Since every fund has costs to operate it, you will not get the benchmark 100% of the time because this means that you would be investing for free. The tracking error is the difference between the measured return that the benchmark provides and the actual return that the passive fund or imitating portfolio provides. As an example, if the S&P/TSX index had a return of 5% for a 1 year time period and 10% for a 2 year time period, and your fund had a return of 4.5% for 1 year and 9.5% for 2 years, then the tracking error would be 0.5% each year. Tracking error tends to be pretty consistent over all time periods but not perfectly consistent because the costs of running a fund will vary, and sometimes the act of trying to follow an index can get tricky if that index is very volatile or illiquid. The tracking error is not a fee per se but it is a way of measuring the costs of owning the real fund versus the index that it is being compared to. Tracking Error is also useful in determining how consistently the fund is being managed from a cost perspective.

Early Redemption Fee

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.

Sales Loads

Sales loads for passive funds would 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 most 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 fee for the selection. 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 back 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 a 0.5% fee 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 can 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 the return hedged.

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 have a conversion charge when you change the final dollar amount to Canadian dollars.

Other Passive Costs

Passive investing has some unique fees such as account administrative fees, trading fees, foreign exchange conversion fees, spreads on trading, opportunity costs and separate advice fees which are not seen in the active investing world because the account will capture all of these fees.

Account Administrative Fees

The account administrative fees are charged by an institution for opening your account, transferring securities in or out of your account, or an annual administrative fee to keep your account open. These fees may depend on how much money you have with the institution, and can be reduced or waived as your account balance increases. These fees tend to be a flat amount as opposed to a percentage, which means they are comparatively small versus the assets that the account may have.

Trading Fees

Trading fees are fees charged for trading stocks or exchange traded funds. These fees will typically be a flat fee per trade and will depend on how often you trade and what type of investments you trade. Generally, the more frequently you trade and the more exotic the product that you trade, the more the expense. The further you are from home in terms of what you trade, the more expensive the trades are is a rule that applies most of the time. The longer you hold onto an investment, the less trading you will do, and the cheaper the trading fees become over time since this cost would be spread out over the life of the investment.

Foreign Exchange Fees

Foreign exchange conversion fees will occur each time you exchange currency. This could be for withdrawing, exchanging securities, rebalancing among the holdings you have, or getting into securities or funds that are denominated in other currencies. Most of the time, the currency exchange rate has to do with the U.S. dollar, but it can be any currency if you have foreign accounts and do the investing passively.

Bid Ask Spreads and Opportunity Costs

Spreads on trading refers to the bid and ask price for a given security. When you buy something, you always pay the “ask” price or the higher price that the seller wants to receive, and when you sell something you would receive the “bid” price or the lower price that the buyer wants to receive. The difference between them is called the spread. To know how much this would be, examine a price quote for the fund you want to buy when the market is open and you will see the bid-ask spread when you look at any quotation for the fund. The difference between the bid price and the ask price would be the amount you are paying in dollars. This difference divided by the price of the purchase price of the fund would be the costs in terms of a percentage. As an example, if a fund has a bid price of $8.00 and an ask price of $8.10, you would be paying 10 cents per unit or share as a spread. If you bought the fund at $8.10, the cost would be $0.10/$8.10 or 1.2%. This percentage is a “one-time” fee for every buy and sell pair of trades. The longer you hold your investment and assuming the price rises, the cheaper this spread will get in terms of percentages since the value of the investment tends to rise higher over time. The reverse would be true if the value goes down for a given investment. The spread can vary over time and depending on how much volume is trading at a certain time of day.

If you decide to fix the price for buying or selling a security instead of going in at the prevailing price in the moment or “the market”, you run the risk of not getting the security or having to pay much more for it at a later date. This is called the opportunity cost and it will vary a lot with each trade but it does exist and would be considered if you are trying to time your trades and if you are doing it frequently.

Advisory Fees

Separate advice fees refer to a scenario where you would pay separately for advice and the products you are buying. This would be relevant if you hire a fee for service financial planner, advice only financial planner, money coach, or consultant who charges a flat fee for advice separately from whatever products you invest in. If you do it yourself, there are costs for research, courses or software that you would purchase to help you do the passive investing. Once again, if you have a traditional advisor, you are not seeing these costs itemized anywhere because they are part of the MER of the funds you hold in their account, but these costs would be standing on their own if you invest for yourself and buying your own securities.

Fees of Holding One Fund Inside of Another One

If a fund that you want to invest in has other funds in it as part of its holdings list, then you will pay the MER fee for the fund you are buying as well as the fund(s) 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 tends to be a large holding so a fact sheet with a top 10 holdings summary should provide good information. If you want to be really thorough about this, you would have to get an entire holdings list with each and every holding in it so you can see if there are minor holdings that may be funds. This is typically not necessary as the further down the holdings list a security is, the smaller its weighting is and the less impact the fees will have on your total cost.

The actual numbers for each of these items will differ depending on specifically what the fund is and how it is managed. 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 contain other funds to get access to illiquid markets, or to trade in 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 to get an idea of what is really happening. Ideally, the costs should factor in time spent, effort spent on research, tools used for investing 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. When comparisons are done to the market index or benchmark, this is really an ideal (free) comparison which is not realistic. You cannot buy a free version of the index – the ETFs come closest to this and are represented as the passive way to invest.

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 fund management company only and then search for the product name on their web site. The fund companies will have these documents with the regulator 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:

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