How Much Is That Investment Costing You?

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As wise consumers, we often comparison shop to find the lowest price or best value for large purchases. We also have a good sense of how much things cost, like a litre of gas or a carton of milk.

When it comes to investing, however, we are often oblivious to the amount of investment management fees that we are paying. Yet the investment fees you pay are just as important as the investment returns you earn. Knowing what you are paying, and what you are getting, are key steps to prudent investing.

Measuring Fees

Investment management fees are typically quoted based on "basis points," or "bps" for short. 100 bps is the equivalent of 1%. A typical trust fund can pay investment management fees ranging from 15 bps to over 200 bps per year.

The fees paid depend on the investment products used. Actively managed funds (portfolios managed based on the manager's own judgement and research) generally charge higher fees than passive or indexed funds (portfolios that simply replicate holdings within an index). Alternative investments, such as hedge funds and private equity funds, will likely charge higher fees than traditional equity and bond mandates.

For institutional investors such as Aboriginal Trust Funds, the impact of fees can be tricky to gauge, as most managers express returns gross of fees (before fees). Furthermore, these fees are tiered based on the amount of assets under management – the larger the dollar amount, the smaller the incremental basis point fee.

The reality of how much a typical trust fund is paying in fees hits home when one is presented with actual dollars and cents. As shown in the table at right, a trust fund with $50 million of assets invested in a balanced fund would pay, on average, $170,000 annually in investment management fees alone, not counting any additional advisory or corporate trustee services fees.

A fee by any other name

Institutional investors must be aware of potentially hidden charges over and above the stated fee schedule. For example, some funds may charge a separate "administration fee" on top of the investment management fee. This is to cover any custody, record keeping and professional charges incurred by a typical pooled fund. Some managers may also charge a "redemption fee" when clients want to exit a fund. This fee could be as high as 0.10% of assets and is used to offset any trading costs associated with liquidating securities.

For alternative investments such as hedge funds and private equity funds, investment manager fees are often much more expensive, especially if they are compensated based on the performance of the fund. These "performance-based fees" are usually charged on a percentage of the excess return over and above a benchmark. One performance-based fee arrangement commonly used by hedge funds is the "two-and-twenty" structure. This is when the manager takes a base investment management fee of two percent of assets – regardless of performance – but also participates in twenty percent of any excess returns over and above a pre-determined benchmark.

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Median Investment Management Fees

Mandate	Median Fee for $10 million mandate	Median Fee for $50 million mandate	Median Fee for $100 million mandate
Balanced	$45,000	$170,000	$310,000
Canadian Bond	$31,000	$125,000	$200,000
Canadian Equity – Large Cap	$44,000	$170,000	$310,000
Canadian Equity – Small Cap	$75,000	$315,000	$580,000
Global Equity	$71,000	$335,000	$610,000
Emerging Market Equity	$104,000	$500,000	$970,000

Source: eVestment Analytics, based on actively managed, long only pooled fund mandates, November 2013

Eugene Lee *is an Investment Consultant at PBI's Vancouver office with over 15 years of financial industry experience. Working closely with the fiduciaries, his responsibilities include manager monitoring and research, asset mix studies as well as developing investment policies and governance guidelines for trust funds and retirement plans. He has particular expertise in the area of investment analytics and compliance monitoring. Eugene completed his Bachelor of Commerce program with a major in Finance at the University of British Columbia and is a Chartered Financial Analyst (CFA) charterholder.*

It all adds up

Fees can add up and, at the end of the day, will have a substantial impact on the spending power of the trust fund.

To illustrate the impact of fees on a trust fund, let us look at a hypothetical example:

Assume that a trust fund began investing in October 2003 with a total value of $50 million. No contributions or distributions were made over the past ten years. The trust has been invested based on an asset mix of 30% Canadian equities, 30% global equities and 40% Canadian bonds, with each manager providing index-like returns.

If the trust fund's investment management fees were 50 bps at the end of September 2013, the total value of the trust would have grown to $87.5 million. To see how fees would impact the value of the trust fund, let's assume that instead of 50 bps the trust is now paying only 45 bps. Just by reducing fees 5 bps, the trust would have an extra $436,000 in its bank account. On the other hand, if the management fees increased by 5 bps to a total of 55 bps, the trust would have $434,000 less to spend.

The point is that even a seemingly small incremental increase or decrease in the overall management fees can have a dramatic impact on the trust's financial position, especially over the long-run.

What's a wise investor to do?

As a rule of thumb, we recommend that trust funds:

- Review their investment management fee agreements at least once every five years.
- Review the total dollar amount of fees paid to each manager each year.
- Evaluate each manager's return versus the benchmark after fees and compare them with other similar managers.
- Assess whether the managers are generating any excess returns over and above the benchmark **after fees**. If not, consider other potentially cheaper alternatives such as passive (indexed) funds, low-volatility funds, or exchange traded funds (ETFs).

About PBI

PBI Actuarial Consultants Ltd. is a dynamic and growing company providing investment, actuarial and administrative consulting services for endowment funds, First Nations trusts, multiemployer pension and benefit plans and other institutional clients across Canada.

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