Where Are the Customers' Yachts?*

A visitor was being shown the wonders of the New York financial district, and his guide pointed out some handsome ships in the harbour. "Look, those are the bankers' and brokers' yachts." "Where are the customers' yachts?" asked the naïve visitor.

**Title and quotation are from the 1940 classic investment book of the same name, which described the excesses of 1920's Wall Street.*

Today's capital markets may be a far cry from those that existed in 1920's Wall Street, but as Alphonse Karr said, "Plus ça change, plus c'est la même chose". In fact, you could be forgiven for thinking that the modern investment management industry is even more adept at transferring your wealth into its pockets than ever before.

The latest Fitzrovia[1] research indicates that the annual costs of UK investment funds have continued their relentless rise, with the asset-weighted average total expense ratio (TER) of UK actively managed equity funds increasing to 1.54% per annum by the end of 2005. The TER represents the drag effect on fund performance caused by annual fees and expenses, not just the basic annual management fee. The figures for multi-manger funds, which have become very popular, are even higher, with a range of 1.5% to 3% with an average TER of 2.2% per annum. This compares with a TER as low as 0.30% for some index funds.

However, the TER is not a comprehensive measure of the actual costs borne by fund investors. The impact of undisclosed or hidden costs is substantial. The Financial Services Authority[2] have calculated that an investor would need to invest £1.50 in an actively managed UK unit trust or life fund just to obtain the market rate of return on £1. This takes into account explicit costs, undisclosed costs and any underperformance as a result of unsuccessful investment decisions. Taken together these hidden costs were twice as high as the explicit costs. This means that over this 10 year period an average investor would have needed to invest 50% more than the 'market' just to get the market return from UK equities – a frightening statistic.

Thanks to recent FSA rule changes, collective funds must now disclose their portfolio turnover rate (PTR), which is a measure of trading activity and represents how often a portfolio manager buys and sells the aggregate value of a portfolio over the year. This can help us to estimate some of the undisclosed costs, which include commissions, bid offer spreads, stamp duty and market impact.

What is the size of these trading costs? This is a hard question to answer and depends on a number of factors including, geographical area, the market capitalisation of the traded stocks and the liquidity of the market. Trading small company stocks is significantly more expensive than liquid large capitalisation stocks such as BP or Tesco. In 2003 Bloomberg calculated the spread on small companies with market values of under £60 million was 6.56% and between £60 and £300 million as 2.98%. A portfolio manager who either seeks to buy or sell a position in a security is also likely to impact the market (usually, to his disadvantage). This is particularly so if dealing in illiquid markets such as small company stocks or emerging markets.

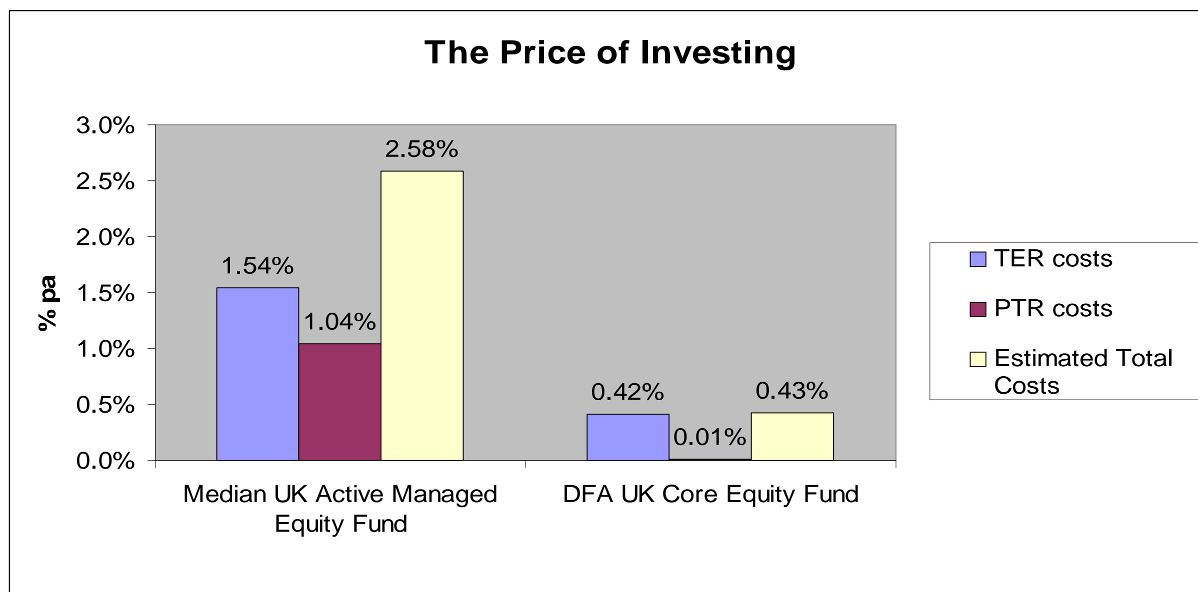
The FSA[3] estimated the total trading costs of a round trip trade in the UK (selling and buying replacement securities) to be 1.80%. This would mean that a portfolio which traded 100% of its securities in a year could incur a further 1.80% of trading costs in addition to its disclosed total expenses. In 2006, Fitzrovia[4] found that the median portfolio turnover for UK actively managed equity funds was 58%, with 25% of funds with a PTR of 95% or more. Based on the FSA's 1.80% costs this would mean that the median UK fund incurred 1.04% (58% x 1.80%) of trading costs in the year, with the 25% of funds incurring costs of 1.71% (95% x 1.80%) or higher. Combining these costs with the median TER would produce total fund costs of 2.58% per annum or 3.25% for at least 25% of funds.

Annual cost levels of 2.58% or more put incredible pressure on a fund manager just to keep up with the market. In fact, a fund manager with annual costs of 2.58% will have to be sufficiently skilful to outperform the market by 32% just to match the return offered by the FTSE All share index (assuming an 8% gross return from this index). To achieve a 10% out performance of the benchmark would necessitate a return of some 42% above the benchmark. For a fund within the top 25% turnover figures these figures increase to 40% just to keep pace with the market and 50% to beat it by 10%. These figures explain why investment managers continue to fail to

[1] Lipper Fitzrovia – 'Trend Analysis of UK Funds' Fees and Expenses January 2006
[2] FSA – 'The Price of Retail Investing in the UK' February 2000
[3] FSA - 'The Price of Retail Investing in the UK' February 2000
[4] Lipper Fitzrovia - 'Benchmarking UK Portfolio Turnover' December 2006

© 2007 Collins Ward Capital Management Ltd

out-perform the market on a sustained basis. Contrast this with the total costs of the Dimensional Fund Advisors UK core equity fund as detailed in the graph below. It has a TER of just 0.42% for 2006 and a PTR of just 0.38%, which if we use the same comparison formula as above would result in total annual costs of just 0.43% for 2006, some 83% less than the costs of 2.58% identified for the median UK active fund.



Conclusions

> **"Investment managers sell for the price of a Picasso what routinely turns out to be paint-by-number sofa art."**
>
> Patricia C. Dunn, former CEO, Barclays Global Advisors

Professional investment management comes at a price, but costs are an immediate performance drag on a portfolio and eat directly into the available equity risk premium. Disclosed costs form only a small part of the problem as the investment industry is notorious for obfuscation. If the historical equity risk premium (the additional return generated by equities over a risk-free bond return) of 6.0% per annum continues, then nearly half of the future return available from holding equities, would be sacrificed to your investment manager – not an appealing prospect.

The combined cost of our private client wealth management service is considerably less than the expense levels identified by Fitzrovia. Not only that, but our service includes comprehensive and bespoke financial planning, something which you will not find included with traditional investment management services.

If you would like to gain a fresh perspective on your finances and investment portfolio, with a review of your current costs and their impact on your risk adjusted expected returns, please contact our Managing Director, Christian Ward on 020 7073 2956 or via email at christian.ward@collinsward.com.

Collins Ward Capital Management Ltd
Token House
11/12 Tokenhouse Yard
LONDON
EC2R 7AS
www.collinsward.com

Collins Ward is a registered trademark of Collins Ward Capital Management Ltd (CWCM), which is authorised and regulated by the Financial Services Authority. Registered in England & Wales No: 5702350. Registered office 145-157 St John Street, London, EC1V 4PY. We have taken all reasonable care to ensure that the material and information in this article is accurate, up-to-date and complies with all prevailing legislation. However, no liability can be accepted for any errors or omissions, or for any loss arising from the use of information or material. The material is for information purposes only and is not to be construed as a solicitation or an offer to buy or sell any investments, securities or financial instruments. You should consult a qualified investment adviser before you make any investment decision. The value of any investments, and the income from them, can go down as well as up, and you may not receive back the amount originally invested. Past performance is not a guide to future performance.

© 2007 Collins Ward Capital Management Ltd