CFA Montréal

INVESTMENT PRINCIPLES

INFORMATION SHEET FOR CFA PROFESSIONALS

ISSUES AFFECTING BENEFITS

THE IMPACT OF FEES

4A

IMPORTANT NOTICE

The term "financial advisor" is used here in a general and generic way to refer to any duly authorized person who works in the field of financial services, including the following:

- Investment brokers
- Mutual fund brokers
- Scholarship plan dealers
- Exempt market dealers
- Portfolio managers
- Investment fund managers
- Life insurance agents
- Financial planners (F.Pl.)

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THE IMPACT OF FEES

While successful investing requires good planning and efficient investment products, we must remain diligent about the level of overall fees paid by investors. The impact of fees on investors' financial well-being can be very significant. There are at least three forms of fees: product management fees; other product fees (such as transaction and custody costs, which are less transparent to investors); and advisory fees. Sometimes, advisory and product management fees are blended together, such as in Canadian mutual funds.

THE MATHEMATICS OF FEES

Let's consider a single scenario first. An investor saves $1,000 a year for 30 years and realizes an annual rate of return of 6%. If we exclude any fees, the final cumulative value of the portfolio will be $83,802 of which $30,000 consists of capital contributions (30 x $1,000) and $53,802 of compounded income from performance. If total annual fees were 2.5% (some investors knowingly or unknowingly pay as much as 2.5% in total annual fees or even more), the total compounded income would have been only $23,429. Thus $30,373 ($53,802 – $23,429) or 56.5% of all income earned would have been paid as fees. Some fees are unavoidable but, considering the uncertainty of gross returns and the certainty of fees, investors must avoid paying more than necessary.

Let's now consider several scenarios. A portfolio generates an annual return of 3% or 6% over horizons of 10, 20, or 30 years. The investor invests $1,000 a year. The total annual fees vary from 0.5% to 2.5%. The following two tables illustrate how much total wealth will be accumulated at the end of the investment period in the absence of fees, how much of this total wealth is attributed to compounded investment income and how much of this income is left after fees depending on the level of the fees (from 0.5% to 2.5%).

LOW RETURN ENVIRONMENT = 3% ANNUAL			EARNED INCOME AFTER FEES OF:				
Horizon	Total Wealth	Earned Income	0.5%	1.0%	1.5%	2.0%	2.5%
10 Years	$11,808	$1,808	$1,483	$1,169	$863	$567	$279
20 Years	$27,676	$7,676	$6,183	$4,783	$3,471	$2,239	$1,084
30 Years	$49,003	$19,003	$15,000	$11,379	$8,102	$5,133	$2,441

HIGH RETURN ENVIRONMENT = 6% ANNUAL			EARNED INCOME AFTER FEES OF:				
Horizon	Total Wealth	Earned Income	0.5%	1.0%	1.5%	2.0%	2.5%
10 Years	$13,972	$3,972	$3,583	$3,207	$2,841	$2,486	$2,142
20 Years	$38,993	$18,993	$16,786	$14,719	$12,783	$10,969	$9,269
30 Years	$83,802	$53,802	$46,419	$39,761	$33,752	$28,328	$23,429

A few obvious conclusions can be drawn from these two tables:

- In a low-return environment, fees can represent a very large proportion of all income earned. For example, assuming a 3% return environment, a 30-year horizon, and 2.5% annual fees, fees would amount to 87% of the gross income earned [($19,003 - $2,441)/$19,003].
- Even if we assume a higher-return environment, such as 6%, fees would still account for more than half (57%) of the gross income earned. Fees reduce the ability of a portfolio to compound returns.

We must also be realistic. Investors cannot totally avoid paying fees, and most investors require advisory services, an issue we will discuss in 5a. But they should take care not to overpay. Let's consider a 30-year horizon and 6% return. We'll assume the investor pays 1% in total fees instead of 2%. Let's also assume that the gross return (6%) is not affected by the amount of fees paid. As indicated in document 3e, investing is a zero-sum game before fees, and the typical investor will realize a performance similar to that of the market before fees. Thus the most rational hypothetical scenario for the average investor is to assume that the performance gross of fees will be similar to that of the market, no matter what the level of annual fees is. Assuming a gross return of 6% in both fee scenarios, the investor will have accumulated total capital of $69,761 at the horizon end if the fees are 1.0% ($30,000 from capital injections and $39,761 from compounded income) instead of $58,328 if the fees are 2.0%, a difference of 19.6%.

How significant is a 19.6% difference? The income investors can draw from their savings at retirement is pretty much proportional to the amount of assets they have accumulated. Therefore, we can conclude that if assets under a 1.0% total fee scenario are 19.6% higher than those under a 2.0% fee scenario, the annual income at retirement could be at least 19.6% higher. And that is significant. Furthermore, during retirement, higher fees will also drain portfolio income, which may amplify the drain on expected income during retirement.

WHAT IS A REASONABLE LEVEL OF FEES?

The range of fees investors pay varies widely. For example, at the low end, fully automated digital (robot) advisors provide all-in fees of about 0.25% to 0.50% annually. But the investment planning services and guidance provided to investors by such systems are usually limited. At the high end of the fee spectrum, some investors knowingly or unknowingly pay all-in fees of 2.5% or more annually but do not necessarily get superior investment results before fees. Within this range,

there are several possibilities. There are digital, but advisor-assisted, wealth management platforms (mostly in the United States) that provide all-in fees below 1.0% and more complete financial advice and allow for direct investment in single stocks. There are also advisory firms that provide excellent investment planning to high-net-worth investors, sometimes for an all-in fee of less than 1.0%. The main concern is for investors who do not have millions of dollars in assets. Such investors are at risk of paying too much, and many of them still need appropriate guidance.

Studies consistently show that the average investor does poorly when investing on his own, far worse than a balanced portfolio of 60% equities and 40% fixed income rebalanced at fixed intervals. The decisions of average investors, including when to buy and sell, are often driven by emotions. As will be discussed later, an important role of advisors is to help investors manage their own emotions and fears, in order to set an appropriate investment plan and stick to it. There is significant financial value in the guidance and reassurance that can be provided by a good advisor. In fact, in document 5c, we attempt to quantify the value of advisory services by estimating the potential long-term cost to the average investor of investing without the benefit of appropriate advice and guidance.

Investors also deserve transparency concerning all the fees that they pay. Only then can they properly compare the costs and benefits of choosing specific investment vehicles and the value of dedicated financial planning. At a minimum, investors should be informed about:

- the cost of advisory services;
- the cost of asset management services and how they compare with alternatives;
- the total of all other costs affecting financial products (transaction, custody, ticketing, auditing, etc.) and
- any charges for entering or exiting financial products. Such charges should be considered with even more care.

Fees cannot be avoided entirely. According to the literature, there is little evidence that greater portfolio management fees lead to higher gross returns on investments. Furthermore, there are wide discrepancies in fees among financial products, and the cumulative impact of fees on the accumulation of wealth is significant. Therefore, investors should know how much they are paying in product fees and have the ability to compare such fees with alternatives. All else being equal, advisors should find the most cost-effective products for their clients. Investors must also better understand the value and purpose of advisory services (to be discussed in 5a).