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Smart ideas about wealth

Beware! Charging dinosaurs

Abstract

Investors seeking a firm to manage their portfolio are today faced with a wider choice then ever before in terms of how this is done. While the focus of most managers when seeking such mandates tends to be on their claimed ability to deliver higher returns than others based on superior skill, the cost to the investor of delivering this is also of vital importance.

- When investment returns fall, the impact of costs becomes more important;
- Every pound saved on costs is a pound left in the portfolio to grow;
- Managers who derive a significant proportion of their income from trading have an incentive to trade even when it may not be in the investor's interests to do so;
- High portfolio turnover now carries the risk of loss of taper relief from CGT;
- Investors should be wary of paying so much in fees to managers who claim that they can deliver superior returns that the benefit of those returns is absorbed by the fees charged to achieve them
- The choice generally comes down to three basic options:
  - The discretionary active investment manager (whether of directly-invested or collective fund portfolios) who does not do comprehensive financial planning;
  - The fee-based comprehensive financial planner who employs active investment management but only on an advisory basis;
  - The fee-based comprehensive financial planner who employs passive investment management on an advisory or discretionary basis but to an agreed asset allocation mandate for an all-in asset-based fee.

As we move into what looks like being a period of lower inflation and thus lower nominal returns than we have seen in previous decades, it is appropriate to look in more detail at the costs borne by investors for having their portfolios professionally managed. When returns are running at around 20%pa, few people think twice about paying 2%pa (10% of the gross return) in costs but when they drop to perhaps 8%, that represents 25% of the gross return, which can make the difference between it being worthwhile to invest in riskier equities and just holding cash or gilts with no management costs. There is not much point paying a manager most or all of the risk premium so that you end up with the same return as if you had taken much less risk.

There are several options for investors who wish to appoint a portfolio manager. The traditional one is the private client stockbroker, who invests in a portfolio of mainly individual securities although may also hold some collective funds such as investment trusts. Financial planning is rarely if ever part of the service and objectives are usually expressed in terms of an 'income, growth or balanced' portfolio target. Charging is generally by means of an annual fee for management and a percentage charge for transactions. For private clients (institutional rates are around 0.2%), the latter is typically around 1.8% on each transaction (buy or sell). While 1.8% might not sound a large figure, if the portfolio has a turnover of 50% in a year, which is not untypical, that 1.85% becomes an annual 1.85% (i.e. 1.85% x 50% each for sales and purchases). Indeed, even if the turnover is only 25%pa, the additional cost from transactions is not far short of 1%pa. From experience, a turnover of 40-50% is not unusual for such managers; indeed, a colleague once saw a portfolio which had been managed by the same broker for many years in which none of the securities had been held for longer than six months.

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In addition, it is now more widely recognised that the inherent problem with a directly invested portfolio (apart from the current CGT taper relief regime which discourages shorter holding periods) is that of diversification or, more specifically, the lack of it. Irrespective of how smart the manager is, holding a portfolio of 50 stocks will bring more risk than holding a portfolio of 500, as the impact of a price fall on one of them will be greater if it is 1/50th of the portfolio than if it is 1/500th. Since there is no additional expected return for taking such specific risk since it can be diversified away, it makes little sense to hold an undiversified portfolio. Consequently, many advisers now manage portfolios of pooled funds, which reduces this risk, at least to some extent, although there is a risk of duplication if several funds in the portfolio hold the same securities and the underlying funds' compositions change without the portfolio manager being aware of it.

Most managers of such portfolios focus largely if not exclusively on the use of actively managed funds, their rationale being that they are able to add value at both the asset allocation (the portfolio split between asset classes) and security selection (the particular funds selected) stages and that by employing only the 'best' managers within their portfolios, they can deliver superior returns. While this may be true in some cases, the evidence to date does not support such a contention as being reliably predictable; nevertheless, our focus here is on the costs involved. A typical discretionary manager of pooled fund portfolios charges 1.25%pa, plus 1% for the purchase and sale of collective funds. While it is difficult to estimate turnover within the portfolio, 25% is perhaps a reasonable guess. In addition, there are the total costs of the underlying funds, which (even allowing for trades being conducted at creation price) are typically 1.25%pa or higher for most active funds. This equates to an annual 2.75% plus the cost of trading at the portfolio level. Again, financial planning is rarely provided as the manager's focus is on delivering returns and not on managing the client's wealth most effectively to achieve their goals with as little risk as possible.

A recent phenomenon in the UK has been the availability of passive pure asset class funds. These are similar to index-tracking funds in that they seek to capture the broad return of a market and their managers do not try to make decisions about which companies and sectors will perform best and when they will do so. However, an index-tracking manager, since they are aiming to track a particular stockmarket index, measures their success by the closeness with which they do so. Unfortunately, this brings about its own problems, in that rigid tracking of an index requires that purchases and disposals be made to rebalance to the index weights even though to do so might cause the fund to incur higher costs than might be desirable. This is because some indices are rebalanced at known dates and so other investors can exploit the fact that they know what the manager will be doing to move prices against them before they deal. Frequent trading to rebalance the portfolio weights to the index also results in increased direct dealing costs. Passive pure asset class investors on the other hand aim to capture the return of the asset class in which they are investing (such as the broad market, value stocks or smaller companies) but prefer to focus on controlling costs even at the expense of a higher tracking error against the index.

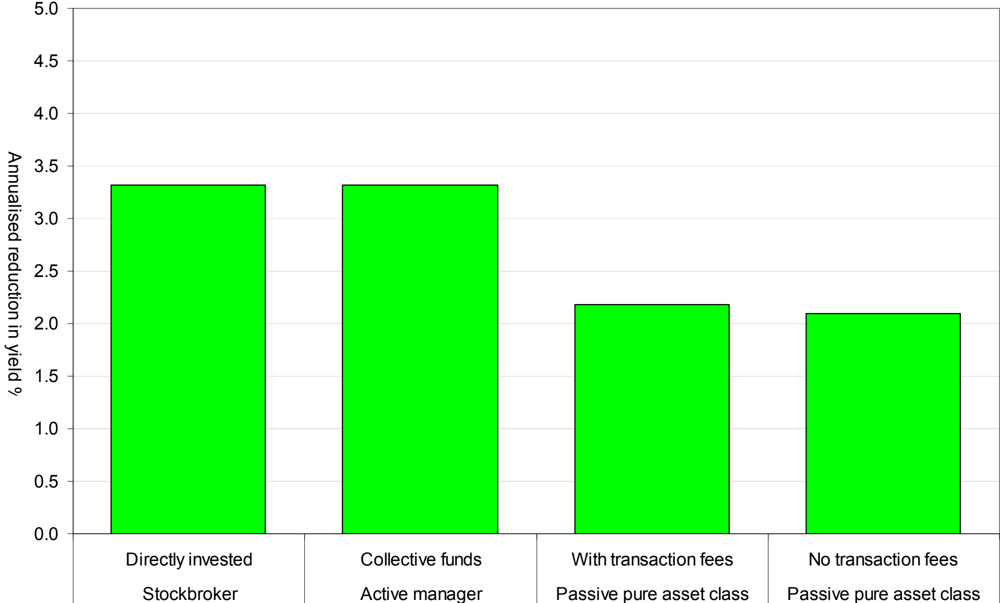
Both types of passive fund can have lower costs than actively managed ones (although even some large index tracking funds have high charges) and so the portfolio costs tend to be lower. In addition, stock turnover tends to be lower with passive funds (around 20%pa compared with typically more than 50%pa in active ones). Most if not all UK managers who use such funds (in the retail sector, they tend to be fee-charging firms with professionally qualified staff including one or more Certified Financial Planner certificants) do so via a wrap/custody service and one of the best of those in terms of the scope of assets which can be held is Transact, whose charging structure (tiered from 0.39% to 0.21%pa according to portfolio size, and switch transactions - on purchases only - charged at 0.1%) has been used in this example. In addition, an annual fee to the adviser of 1% has been included. To reflect the lower turnover at portfolio level (since weights only need be rebalanced back to the target allocations) only the annual gain is assumed to be realised and reinvested each year. The result is a significant reduction in costs, even taking account of the fact that with the whole of the portfolio gain being realised each year, the CGT liability could be higher than for a portfolio in which only the proportion of the gain equivalent to the percentage turnover were subject to CGT.

While there are few enough UK portfolio managers taking advantage of the benefits offered by passive pure asset class funds, most of those who do use them still appear to be charging for executing transactions, although the funds themselves lack initial charges. While the impact of this is not great (the cost of switching within Transact is minimal, particularly with no-load funds and even if the adviser takes 1% on such switches, the effect is small as portfolio turnover tends to be low), there is still an

impact and the risk of a perceived incentive on the part of the adviser to make changes, whether to maximise revenue or to attempt to maximise returns by taking market and sector bets. The former is much easier to do with other portfolio management methods while the latter rather undermines the whole philosophy of passive pure asset class investment, under which the portfolio's asset allocation is set in relation to the investor's goals and risk tolerance and not 'improved' by making predictions about which sectors will deliver better returns than others.

Adopting a 'cost-free to client' transaction model based around the use of passive pure asset class funds, as Bloomsbury has done recently, combined with a low cost global custody service, offers a small improvement in the total annual cost but the additional peace of mind for clients (most have, after all, previously had their portfolios managed according to one of the first two models) makes for a greater comfort factor of knowing that there is absolutely no incentive for transactions to be carried out unnecessarily since it would be the adviser who paid for them. However, the even more valuable benefit to the investor with this approach is that within the portfolio management fee, they also receive an overview, a full financial planning service, the commission-free purchase of tax-advantaged wrappers such as offshore bonds and pension schemes, general tax planning advice, performance reporting against their own required investment returns, ongoing personal attention and co-ordination of financial planning advice with that of other professionals in the fields of tax and the law.

Total annual costs for portfolio management models



The chart is based on a £1m portfolio split 50/50 bonds/equities and an annual return assumption (before costs and tax) of 6.71% (of which 2.61% is assumed to be income), for a basic rate taxpayer with tax being charged at an average of 20% on realised gains.

The concern with charging for transactions, particularly where a portfolio manager is receiving a significant (e.g. over 50%) proportion of their income from that source, has to be that the manager's profitability is, to at least some extent, dependent on the continuation of trading activity within the portfolio. This raises the risk that such a dependence may encourage trading when it is not necessarily desirable from the investor's perspective and that there is some divergence between the interests of the investor and those of the adviser, usually to the latter's advantage. Indeed, even where the overall cost might be the same, the transparency advantages of an all-inclusive annual fee offers significant advantages to both parties in terms of expected future costs and revenues respectively.

The choice toady is principally between a discretionary manager which does not carry out financial planning, a financial planner who tries to add value by using active funds despite the evidence to support claims that this can be done economically and reliably and a financial planner who uses funds which deliver capital market returns at low cost and thus frees up resources to provide the one thing

that clients really want – personal service that helps them to achieve their goals as painlessly as possible.

Charging for transactions brings to mind the warning about having an annual medical checkup – if you go to a surgeon for it, expect to come away with a lot of scars.

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