your wealth

YOU WORK HARD FOR YOUR MONEY AND IT SHOULD WORK HARD FOR YOU

BY J. PETER HODGSON CFA

$219,322 is the answer to this jeopardy question, "What is the difference of 1% return on $500,000 over 25 years?" While this may seem like a long time and a large number there are tens of thousands of 60 year olds with significant retirement savings and lots of them will live well into their eighties and nineties. A 1% improvement matters, so then, how to get it?

Traditionally, investors built portfolios with larger allocations to equities to get the returns but also added risk. However, more attention could be placed on fees as they may represent a "free ride" in terms of improving returns without adding risk. The great news is you can do this and still get professional advice, which is one of the cornerstones of accumulating wealth.

Recently it has been easy to forget fees. Canada has been on quite a winning streak. We have had three consecutive calendar years with heady returns. Is it sustainable? If the long run average for Canadian equities is 10.3% since 1960, why is it we deserve to think it will be 20% plus going forward? Moreover, what do we think the next few years will look like? Mean reversion (returning to the average) reigns supreme in the markets.

Back to fees then: at 20% returns one might think they do not matter, however at 10% or less, they matter a lot. Much more so for bonds, we'll deal with that specifically later. If fees are critical and advice matters what is an appropriate balance? Before I answer that, let's be clear, there is no such thing as an asset that does not have carrying costs. Let's take my house for example. Here is the list, taxes 1%, insurance 0.5%, amortization of legal, deed transfer, and commissions over 7 years (roughly the average holding period of residential real estate) of 0.5% and I quickly get over 2%. If it is rental property, you need to add vacancy costs and I have left out maintenance to be charitable. So you could imply that the Management Expense Ratio (MER) of real estate is north of 2%. Again, simply to point out that carrying costs are a fact of owning assets.

The hard question is, what is fair given it is desirable to have advice, diversification, accounting, reporting, a plan and oversight? A useful rule of thumb is that around 20% of expected long term returns (historical returns could be used as well but over a long time frame – it is unreasonable to take the last five years of Income Trust returns and think they will sustain those returns consistently going forward – use ten years or more) should cover the costs of investing, administration and advice. So if expected return is 10% then 2% is fair and reasonable. If it is 4% then they should be no more than 0.8%. When dealing with fixed income (bonds, GICs, bond funds) this is most important.

Now that you have the 20% (or less) rule of thumb that will serve you well for the balance of your investment life, what about some specific thoughts on how to apply it.

First, lets discuss bonds or fixed income and in the context of Mutual Fund investments. Because of the low rate environment we currently find ourselves in, it is critical to contain costs. When yields for 5 year bonds are in the 4-5% range (depending on the quality of issuer) it makes little sense for someone to pay anything more than 1% for someone to manage them. Managing low risk bond portfolios is pure math and there is very little room for a manager to add value. This is why bond funds have a hard time beating the index (indexing is not as strong an argument for equities in Canada – a topic for a later date). Any bond fund with a MER north of 1% will find it very difficult to beat the index and cover its costs. The 20% rule is very important here. Case in point: I was asked to do a portfolio audit for someone who had a fee-based wrap program (bundle of funds). They were paying an all in fee of roughly 2.8% which included the bonds. So over half the bond return was being consumed by fees and, if we consider the historical long term return for equities, almost 30% of those returns were being eroded as well.

A fine point on balanced funds. It is almost universally better to buy the bond fund and equity fund separately and have your advisor rebalance either with new contributions to the portfolio or as needed. Most advisors would be happy to do this. You want to avoid the situation of paying equity level fees on the bond part of the portfolio. Be diligent on fund of funds or balanced funds.

How about GICs? I like them, a lot. Here is why. Since 1960 bonds have returned 8.3% (a blend of the Gov't Intermediate Index 60-78 and Scotia Capital Bond Universe 79 to present) and rolling 5 year GICs 7.5%. What most do not realize is that you cannot purchase the bond index without fees. You can contain costs by purchasing index funds or ETFs (exchange traded funds) but that 8.3% return is pure fiction. So at best you may be able to pare costs down to 0.5% so 7.8% might be a better number looking backward (it is unlikely in the current rate environment that those sort of numbers can be achieved going forward without significant amounts of risk).

Here is what is great about the GIC historical returns. Where the bond index is gross of fees if you will, the GIC rates in a manner of speaking, include them. Also the historical GIC rate is constructed using posted rates rather than negotiated rates. An advisor should be able to shop for premium rates on your behalf from a number of issuers. This allows for great rates and may allow for maximizing CDIC coverage by spreading around the deposits amongst different issuers. With the GICs you can have a very competitive low cost fixed income alternative as long as liquidity is not an issue you may be able to add another 0.25% on average returns.

You may also be able to buy individual bonds directly and build your own portfolio. This may also be a sensible alternative to a bond fund. The lower risk the portfolio the lower the need for a managed approach. The risks to running a portfolio of Government of Canada bonds is vastly different than a corporate bond portfolio.

Here are some other ways to contain costs. You also can set up a fee for service program where the fund management fee is separated from the advisor fee. This approach can amount to significant savings for clients. The reason is that it strips out all the service and marketing fees from the fund. Not all advisors use the marketing services of fund companies and those advisors are less expensive to service for the fund company. The fund company often passes these savings on in a special class of funds In this format, F-Class funds are used. The advisor charges separately for the advice and service. This allows for clarity on fees and potentially significant savings. It is a bit like the old gas station promotions where you got a free set of glasses for filling your tank. Most of us would rather forget the glasses and save on the gas. F-class funds often allow the opportunity to do just that. For example where most international equity funds will have MERs between to 2.5% to 3% it is possible to have them in the 1.7%-2.2% including the advisor fee. Depending on the amount of money involved it could be lower. For domestic funds it is possible to be well under 2%.

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Lets tackle Deferred Sales Charges (DSC or ISC). The client does not pay up front but the commission is embedded in the MER and the advisor is paid up front. Often they come with penalties for redemptions within 7 years. They constrain freedom of choice for the investor, which is a critical element for successful investing.

There are two issues with the DSC option. Firstly if a DSC fund is sold to an investor with a 7 year DSC schedule – the advisor/firm receives 67% of the compensation within the first year. The advisor/firm receives 5% up front and .5% as a service fee. It is very unlikely the client will have 67% of the return within the first year. DSC funds mismatch the outcomes of the client and the advisor. Again most advisors with a long term perspective will be happy to provide clients with alternatives.

There are other strong reasons to avoid DSC funds going forward. Fund companies do get sold, fund managers change, advisors change, and firms change. There are no strong benefits and lots of pit falls for clients with the DSC fee approach. Discuss with your advisor about your choices. Key questions to ask are as follows: "Are there any deferred sales charges? If I need to change firms is there a deferred sales charge?" If the answer to any of these questions is "yes", then it may be best to ask the advisor to present other alternatives. Also ask if you can transfer this investment to another firm. This can be a problem for some of the wrap programs (fund of funds) If they do not present other alternatives to the above, then you may have another decision to make. If the DSC option is presented as a way to finance a Financial Plan – pay for it separately, it is likely tax deductible. As an investor you must preserve flexibility.

DSC funds have been around for some time, today however there are many other alternatives for investors that offer broader choice and flexibility. Many advisors with a long term focus are happy to provide funds without DSCs with a very small commission up front or no commission at all. These funds usually provide a service fee to the advisor/firm of 1%. They may also use the F-class model as above and charge separately

One of the growing options for investors is using the fee-based approach I alluded to above. It may be a flat fee on advice, it may be tiered based on asset classes and the amount invested may have some influence. Many of them have the ability to accommodate most investment choices including individual stocks, bonds, funds, GICs, ETFs and closed-end funds to name a few. If you keep the 20% rule in mind you should be able to sort through the different options fairly easily. The attractive part of this approach is that it aligns the interests of the advisor and client very well. The advisor does well when the client does well. Transactions costs are eliminated from the discussions on investment strategy where a commission based approach, may add friction to investment decisions. It may well be the best decision to sell a security but the commission cost makes it more difficult to come to that decision. Perhaps doing nothing at all may be the best decision but to arrive at that decision will require the same amount of research and diligence. In essence the fee-based approach models the institutional approach to wealth management.

A couple of things should be kept in mind if you do use a fee-based solution. If you do like to invest in new issues, split shares and closed end funds you may want to have a separate account for these securities as they often will have service fees or commissions built into them. Ask your advisor and they should help you.

Fees matter and advice matters. The great news is you can get both and have a good balance that works for you and your advisor. Keep an eye on fees and MERs, Fixed Income choices, and DSC options. Perhaps consider a fee-based approach as there are many great options. Work with your advisor on placement of new issues, split shares, closed end funds if you use a fee-based model. F-class options are something worth looking into if you have a larger portfolio and use mutual funds. For larger portfolios you can get institutional level pricing somewhere between 1% and 2% depending on the size and asset mix of the portfolio. A vast improvement from the 2.20%-2.80% you see in many balance funds or other programs. A significant improvement and you do not need to add risk. Work with your advisor and they should help you.

Between this article and my last which you can access at www.jpeterhodgson.com you will have a solid framework to consider your choices in advisors and fee structures. After all you work hard for your money and it should work hard for you. There may be $219,322 waiting for you. It is your wealth.

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