Investment costs – reasons not to be cheerful

It is remarkable how little attention is paid to investment costs at the time when it really would help – when formulating an investment strategy.

There are fourteen different types of cost that are likely to arise when we make an investment, summarised as those arising from:

- holding or managing an investment or portfolio
- making or disposing of an investment
  and
- the return your investment generates, including taxes and performance-related fees.

Most people planning portfolios, including investment professionals, consider the level and pattern of returns they expect from different asset classes, and choose a desirable mix of potential returns and risk. Only when they have done this do they consider how costs might impact. But that is too late. The reality is that investment costs can be so high and varied that they materially affect decisions about what investments to hold.

My clients hear three clear messages about investment costs:

- High costs are a key reason for disappointing returns, so they must be managed
- Manage costs <u>before</u> making an investment plan
- Planning costs from the outset is a good tool for subsequent cost management and minimisation

Of course the reason most people avoid taking costs into account when planning a portfolio is complexity. We like to characterise asset classes by the level and pattern of their long term average returns. That is what drives us to invest in equities and property, where returns have been found, long-term, and where they are likely to be found again. Or so it seems. But look at the numbers.

One frequently used measurement source suggests that the long-term return on (US) equities has been about 10% per annum. That is a 6% premium over cash (3-month treasury bills). These and similar data from other markets form the foundation of much of the forecasting behind long-term portfolio planning for all types of investor, from individual savers to the largest pension funds.

While costs may be low for the mega-funds, any other investor, including any Irish institutional fund, should not assume they will receive returns as indicated by market index data.

I have modelled two typical cost structures, one holding equities directly (as many individuals do) and the other through a fund. The impact of the full range of costs on historical returns is startling. Equity returns would not have been 10% per annum: in fact, only slightly more than 6%, or 3.5% more than the net returns on cash. This 3.5%

premium is a very modest reward for risking equity investment compared to the 6% suggested by the indices. To put it in wealth terms, if you invest €100,000 for 20 years in equities and happen to experience historic average rates, without withdrawal, you will accumulate €654,000. Cash will get you to €207,000. But after typical costs, these numbers collapse to €330,000 for equities and €170,000 for cash. Of course, costs vary for investors of different sizes, different instruments and providers. The damage could be much worse.

It is appalling to think that, of the €554,000 that equities could have generated on the original €100,000 invested, 59% (over €320,000) is lost to expenses and taxes (€200,000 to expenses, the remaining €120,000 in taxes). The need for management of such costs is beyond debate.

In this example, the ranking of equity and cash returns was not reversed by taking costs into account. But reversals can happen. In particular, hedge funds and layered funds of funds can rack up expenses at such a rate that the underlying nature of the source of investment return is entirely distorted by costs. And it is important to remember that even where the expected returns don't change their order, your decision about how much of a risky asset to hold will depend on the significance of the extra return you expect it to earn.

Planners like to avoid the complexity that arises from trying to anticipate the effects of costs. The trouble is that costs are neither simple nor standard. Management fees for essentially similar asset classes can vary by significant multiples and with the size of funds managed. Transaction costs are driven by turnover which can range from a small proportion of the fund per annum to a significant proportion of the fund per day. Transaction costs also vary with the trading capability and positioning of the manager or broker. Entry or exit costs occur once and therefore vary with the time the investment is held, and are subject to negotiation and distribution agreements. It is not easy to model costs accurately at a stage in the investment process when the implementation of strategy has not yet been contemplated.

The practical course of action is not, however, to forget about them. Instead, you can use a model of investment costs as a budget. Data are based on surveys of average prices and activity levels, aligned to any known intentions for the portfolio. The resulting numbers are used to make the investment plan. The plan, while not perfect, will be very different and much more realistic than the one that would be chosen without assessing investment costs.

By following this step, the investor, advisor or manager has from the outset a detailed cost (and tax) budget. You can use it as a guide when implementing the investment plan to choose efficiently priced investment services and to apply pressure in negotiation. Once a portfolio is implemented, you can measure actual costs systematically in detail and use any variances as an important factor in the ongoing review of the portfolio and its providers.

If an investment portfolio were any other business, such planning and management of costs would be regarded as necessary without question. Why would anyone with an investor's interests at heart adopt a different attitude?

Ronan Smith
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