The 10 Essential Elements of Investing

Essential Element 6
Control cost

Beaver Investing

The investment guide for Canadian foundations and charities
Third edition

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In Essential Element 5: Balance risk, we saw the importance of limiting the risk of short-term loss in order to follow an investment strategy over the long term. While risk can be a vivid experience for investors, cost is often not given the importance it deserves.[1]

We will focus on direct costs rather than indirect costs. Direct costs are fees for investment management, together with the costs of holding and transacting securities. Indirect costs represent the costs of bad behaviour, such as panicking during market turmoil, buying high and selling low or taking the wrong risks at the wrong times. Vanguard, one of the world's largest asset managers, estimates the value that can be added by advisors to individual clients is about 3% in net returns (half of which or 1.5% relates to behavioural coaching).[2] Although these indirect or behavioural costs are profound, they are also more subtle than direct costs and not easy to address. In contrast, foundations and charities can more easily realize savings in direct costs, representing 1.5% or more in net annual returns.

Fees and costs

Investment management fees are charged by an investment manager to coach behaviour, provide advice on investing and execute transactions in the portfolio – in descending order of importance. Below are competitive investment management fees (including a reduction of 25% for registered charities).

Table 1: Investment management fees, schedule

Portfolio value	Regular fee	Charitable fee
First $1 million	1.00%	0.75%
Next $4 million	0.75%	0.56%
Next $5 million	0.50%	0.38%
Above $10 million	0.25%	0.19%

Fees are tiered, based on portfolio value. For an institution with a $5 million portfolio, the investment management fee is 0.60% (based on 0.75% for the first $1 million and 0.56% for the next $4 million). The table below outlines the investment management fee for institutions with portfolios ranging from $1 million to $50 million.

Table 2: Investment management fees, specific portfolio values

Portfolio value	Charitable fee
$1 million	0.75%
$5 million	0.60%
$10 million	0.49%
$25 million	0.31%
$50 million	0.25%

In an asset-based model, fees go down in relative terms as assets go up.

With these investment management fees as a starting point, let us consider a typical range of fees in the investment industry. At the low end of the range, we will assume institutions are paying 0.50%. The high end of the range is difficult to know. Some institutions pay around 1%. Others pay as much as 1.50% – a rate that is often charged to individual investors, rather than institutions with millions of dollars who are investing for the public good. And of course fees are even higher when investing in alternative assets such as hedge funds and venture capital. Advantage to the careful investor: 0.50% annually.

When investors buy and sell securities, they incur transaction costs. If they buy a security for $100.05 and sell it back, then they might sell for $99.95 (this assumes there has been no change in the price of the security). This is known as the bid-ask spread, reflecting the transaction cost of buying at a slightly higher price and selling at a slightly lower price. These transaction costs are even larger when buying and selling frequently (portfolio turnover) and when dealing in thinly-traded issues, where the transaction itself affects the price (market impact). Investors who mostly hold exchange-traded funds can have transaction costs of less than 0.25%. In contrast, investors who trade aggressively can easily run up transaction costs of more than 1%. Advantage to the careful investor: 0.75% annually.

When investors hold funds or other investment products, they incur holding costs (expressed as an annual Management Expense Ratio). Investors who mostly hold exchange-traded funds can have holding costs of less than 0.25%. In contrast, investors who use mutual funds can have holding costs of more than 1%. Advantage to the careful investor: 0.75% annually.

While other costs are called ancillary costs, they still need to be carefully managed. These ancillary costs include custody (holding investment assets at a third-party custodian can cost up to 0.20%, although charitable clients should expect a rate of less than 0.10%); foreign currency (foreign currency costs are negligible, since they are executed at low institutional rates); and cash drag (this can be reduced by promptly reinvesting dividends and interest on a quarterly basis). We will acknowledge these ancillary costs but not include them in the analysis below. Below we outline low and high ranges of fees and costs.

Table 3: Low and high ranges of fees and costs

Item	Low range	High range
Investment management fees	0.50%	1.00%
Holding costs	0.25%	1.00%
Transaction costs	0.25%	1.00%
Total fees and costs	1.00%	3.00%

Net return

Industry guidelines for expected returns are about 6.5% for stocks and 4% for bonds, implying an expected portfolio return of 5.5% (before inflation, fees and costs) for a benchmark portfolio of 60% stocks and 40% bonds[3]. Since expected returns are relatively modest, fees and costs make a significant difference to the net returns realized by long-term investors.

Below we show net returns with low fees and costs, versus high fees and costs.

Table 4: Net returns with low fees and costs, versus high fees and costs

Item	Low fees and costs	High fees and costs
Nominal return	5.50%	5.50%
Less inflation	2.00%	2.00%
Less investment management fees	0.50%	1.00%
Less holding costs	0.25%	1.00%
Less transaction costs	0.25%	1.00%
Net return	2.50%	0.50%

Below we show the difference between growing at a net rate of 2.5% with low fees and costs, versus growing at a net rate of 0.5% with high fees and costs, applied to an initial $10 million.

Table 5: Impact of fees and costs over the long term, net (after inflation, fees and costs)

Net return	After 10 years	After 20 years	After 30 years
Low costs: 2.5% growth	$12.8 million	$16.4 million	$21.0 million
High costs: 0.5% growth	$10.5 million	$11.0 million	$11.6 million
Difference	$2.3 million	$5.4 million	$9.4 million

Fees and costs may look small but, in depriving institutions of compound interest, they make a substantial difference over the long term. After 30 years, the difference between low costs and high costs is $9.4 million, almost equivalent to the entire initial balance of $10 million.

Hidden in plain sight

In theory, it should be clear that fees and costs can make a big difference to long-term returns. In practice, it is not clear. This is because many fees and costs are hidden. Investment fees are deducted, not invoiced. Imagine that an institution with $10 million in long-term assets engaged a firm to manage the portfolio, for an uncompetitive fee of 1.2% of assets under management. This fee is equivalent to $120,000 per year. If the investment firm were to send the institution an invoice at quarterly intervals for $30,000, then perhaps there would be more questions asked about the quality of the investment process and service. Instead, fees are simply deducted from the account balance, leaving some institutions unaware that they are even paying fees.

Holding costs, which can be as high as 2% for mutual funds, are not routinely disclosed in a charity's annual report. For example, a charity can state long-term assets of $10 million and investment income of $600,000 or 6%. This is shown net of investment management fees and holding costs, but only the former amount is typically reported. As a result, it is not apparent that the return gross of holding costs could have been say $800,000 or 8% and that $200,000 in needlessly high costs was paid to a mutual fund. Because of the way reporting focuses the mind, some institutions might be unaware that they are paying such high costs.

Conclusion

To the extent that institutions are aware of high fees and costs, they might regard them as annoyances. In a low-return environment, they are more than annoyances; they are risks. We have experienced a long bull market for stocks from 2009 to 2019 and an even longer bull market for bonds since the early 1980s. Financial markets typically revert to their long-term average performance, where periods of high returns are followed by periods of low returns. Charitable investors would be well advised to control their investment fees and costs. This provides greater confidence that they can continue to achieve their objectives, even if investment returns will be less favourable in the future.

[1] If readers were to consult only one book on the importance of controlling cost, it would be hard to improve on *The Little Book of Common Sense Investing* (2017) by John Bogle, founder and former CEO of Vanguard, the company that invented the low-cost index fund in 1976.

[2] Vanguard Advisor's Alpha, September 2016.
http://www.vanguard.com/pdf/ISGQVAA.pdf

[3] FP Canada Standards Council, 2019 projection assumption guidelines.
http://www.fpcanada.ca/docs/default-source/standards/2019-projection-assumption-guidelines.pdf