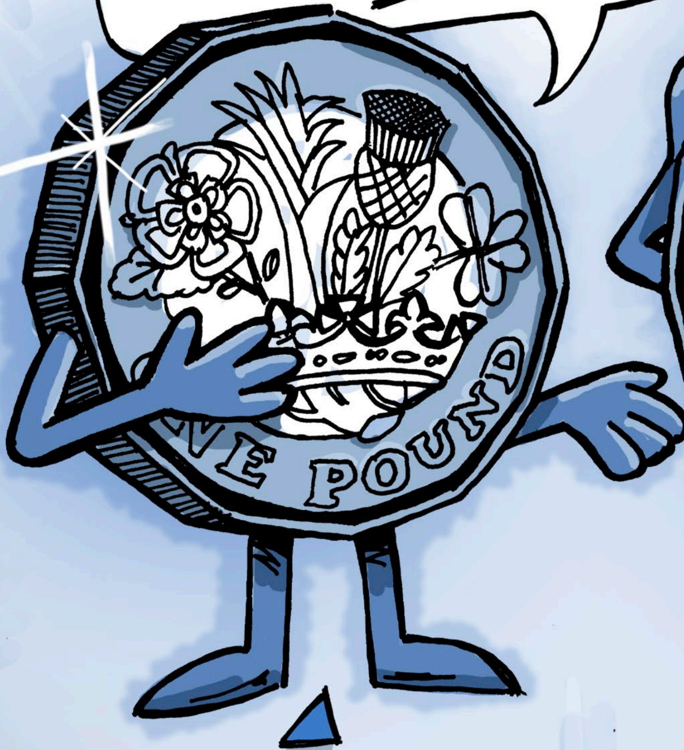
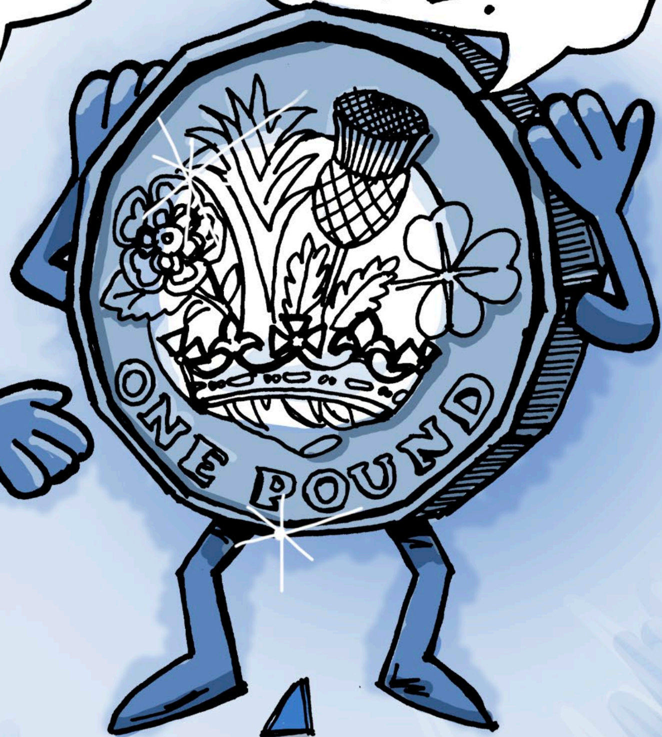
Volume 47 //

Acuity

The greatest wealth is **your peace of mind...**

How to get what you don't pay for





" Performance comes, performance goes. Fees never falter. "

Warren Buffett, investment legend, Chairman, Berkshire Hathaway
(2018 Letter to Shareholders)

Human beings are not well wired to be investors. Not only are we not very good with percentages – often accepting seemingly small percentage charges as immaterial - but we also grossly underestimate the impact of compounding these deductions from our portfolios over time. In fact, costs make an enormous difference to performance outcomes which, in turn, impact portfolio values and real financial and lifestyle goals. Multiple research sources identify the fact that low costs drive higher performance outcomes.

Costs, time and compounding are an insidious mix

Imagine three different portfolios that deliver returns of 1%, 3% and 5% per year after inflation, but before other costs, over a period of 30 years. £100,000 invested in each would result in a growth of purchasing power to around £135,000, £240,000 and £430,000 respectively. Seemingly small differences in the compound rates of return (geometric returns), turn into large differences, in terms of financial outcomes.

That's one of the great positives of a disciplined and patient approach to investing – small returns turn into big numbers, given time.

On the other side of the coin, costs – when compounded over time – eat away at these market returns to a far greater degree than many investors ever imagine. Let's compare two managers who deliver 3% gross (before fees) above inflation, where Manager A has costs of 0.25% and Manager B has costs of 1.00%. We plot the purchasing power impact of these different fee strategies on outcomes, across time, in the chart on page 2.

As you can see, costs matter a great deal; an investor in Manager B's fund is over £40,000 worse off than an investor with Manager A's fund over 30 years. Put another way, you end up one third more wealthy selecting Manager A over Manager B.

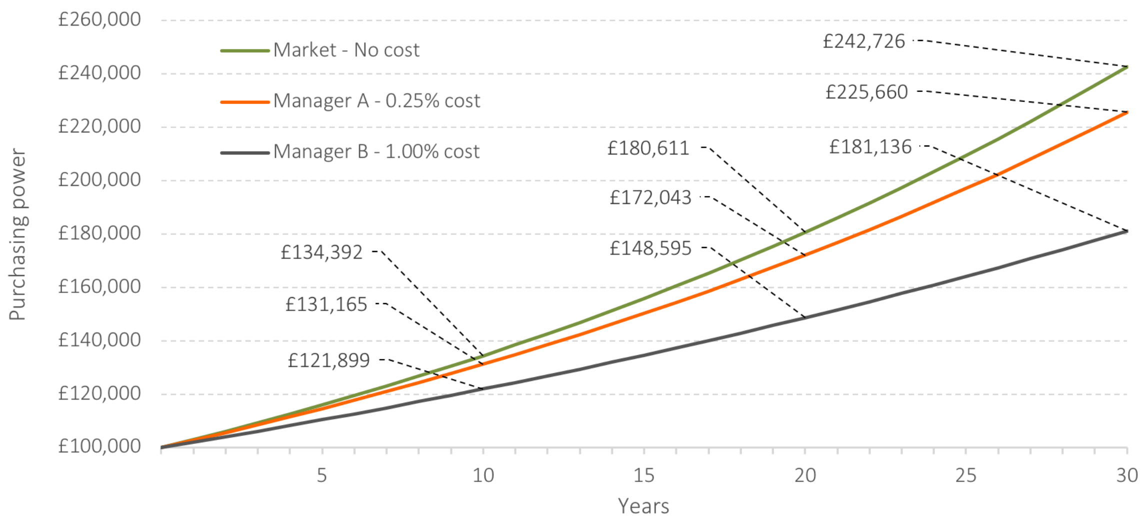


Figure 1: Compounding is a powerful concept[1]
Source: Albion Strategic Consulting

Unfortunately investors fail to consider the severe impact upon long-term wealth of the costs they suffer. These include the effects of inflation on purchasing power, the cost of tax, and the significant 'all-in' cost of investing (i.e. fund manager ongoing charges and portfolio trading costs).

In fact, reducing costs is one of the few free lunches in investing. A pound of costs saved is no different to a pound of market performance in monetary terms, yet it is far more valuable due to its consistency over time and the fact that it is achieved without taking any more risk. Minimising costs in an investment programme can have significant benefits, through the effects of compounding, over time.

A paradox exists: in most walks of life, paying up for expert practitioners – e.g. lawyers, mechanics, coaches, architects etc. – pays dividends, as their skills are worth the extra cost. Yet, investing is the one area where paying more to obtain better results usually fails to work.

Trading in the markets is a zero-sum-less costs game. One person's wins have to be funded by another's losses, and the costs of buying, selling and fund management reduce the outcome for both parties. Lower cost funds, in aggregate, will outperform higher cost funds, in aggregate, simply based on maths.

Markets are also pretty efficient, by which we mean that prices generally reflect all known information about a company, in the case of equities, making it hard for fund managers to identify wrongly priced stocks.

Finally, although there are many extremely bright and competent professional investors, relative, not absolute, levels of skill matter as these managers largely compete against one another. Around 85% of all active US equity fund mangers failed to beat the benchmark over a 15 year period[2], and there is no guarantee that the other 15% outperformed through skill, as there will always be some lucky managers in that cohort. In investing, (paying) less is more.

As Warren Buffett stated, when referring to low-cost index funds:

> *The wealthy are accustomed to feeling that it is their lot in life to get the best food, schooling, entertainment, housing, plastic surgery, sports ticket, you name it. Their money, they feel, should buy them something superior compared to what the masses receive. In many aspects of life, indeed, wealth does command top-grade products or services. For that reason, the financial 'elites' – wealthy individuals, pension funds, college endowments and the like – have great trouble meekly signing up for a financial product or service that is available as well to people investing only a few thousand dollars. This reluctance of the rich normally prevails even though the product at issue is – on an expectancy basis – clearly the best choice.*

Warren Buffett, Chairman, Berkshire Hathaway

It would be worthwhile paying higher fees to invest in a fund managed by a uniquely talented manager who can deliver returns above the market after all costs, if we can be certain that their performance is due to skill and not luck (you need around 20 years' track record to split one from the other), and if we are confident that they will consistently deliver market beating returns into the future. Unfortunately those are big 'ifs' with little supporting data. In the absence of that level of certainty, focusing on managing investment costs as tightly as possible makes good sense.

Using low cost investment products in portfolios - the research evidence

The use of low cost products to implement an investment strategy provides a meaningful performance advantage over higher cost alternatives. Cost differentials are certain and are compounded in client portfolios year on year, whereas active management returns are not. Research by Morningstar[3], an independent fund data and research firm, provides a useful insight: expense ratios (Ongoing Charges Figures, or OCFs) are a better predictor of future performance than even their own 'star' rating system. They conclude:

> *"If there's anything in the whole world of mutual funds that you can take to the bank, it's that expense ratios help you make a better decision. In every single time period and data point tested, low-cost funds beat high-cost funds."*

Other studies from Morningstar[4], Vanguard[5] and Dimensional Fund Advisors[6] come to the same conclusion: that there is a direct, negative relationship between costs and performance that holds over most time periods and asset classes. The same applies to costs incurred on account of portfolio turnover.

The impact of costs in practice

A recent a piece of analysis by Albion Strategic Consulting[7] looked at families of funds, available to UK investors, that provide choices along the risk spectrum. In all, this constituted 39 fund families (24 fund providers) offering funds in the Morningstar® EAA GBP Cautious to Adventurous[8] 'allocation' categories that had a 5-year track record as of 30-09-2018. This opportunity set reflects professional fund managers able to structure portfolios as they wish, with the flexibility to make security, fund and market timing decisions.

Figure 2 provides a comparison of each fund family of 'allocation' funds along the risk spectrum. What is evident is the fact that systematic, low cost, buy-hold-rebalance strategies – such as those offered by Vanguard, HSBC and Dimensional Fund Advisors – dominate the opportunity set, with a wide variation in outcomes from other products.

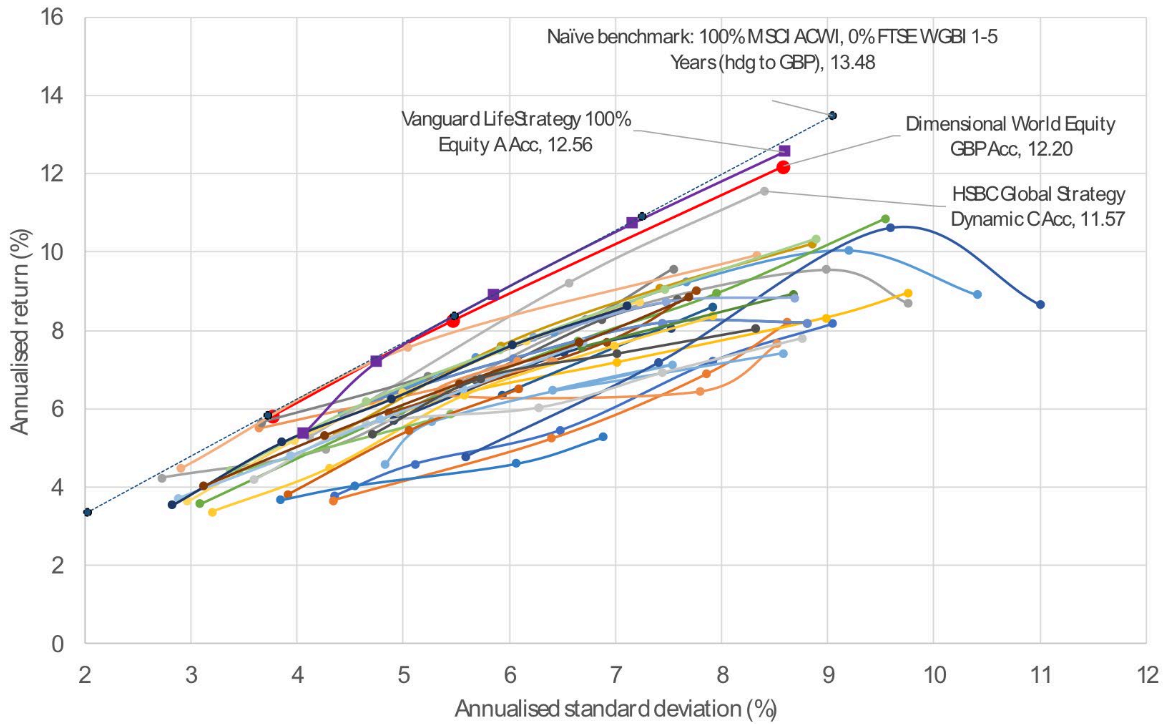


Figure 2: Systematic, low cost funds dominate the opportunity set (5 years to 30-09-18)
Analysis: Albion Strategic Consulting. Data source: Morningstar Direct® EAA GBP Adventurous to Cautious Allocations – 5 years to 30-09-18.

In a large part, this is because of the impact of costs on performance. The relationship between performance and OCFs is clearly evidenced in the figure 3, where the 39 'moderate' allocation category funds (balanced between bonds and equities) are compared.

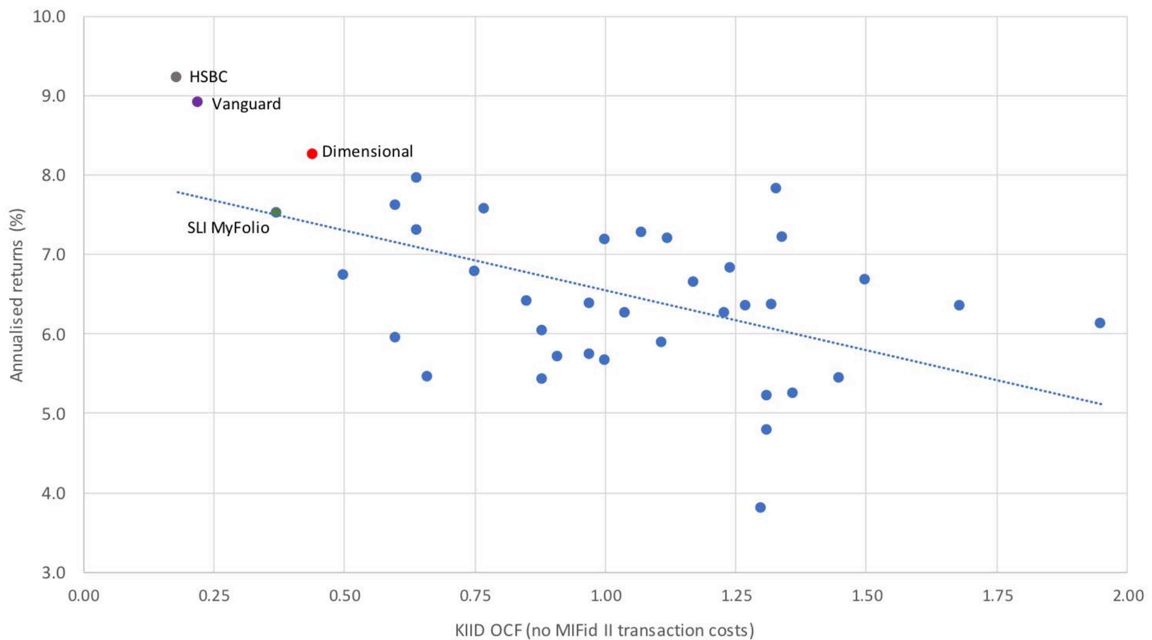


Figure 3: A strong relationship exists between fees (%) and performance
Analysis: Albion Strategic Consulting. Data source: Morningstar Direct® EAA GBP Moderate Allocation (40% to 60% equity) – 5 years to 30-09-18.

Based on a simple statistical test, one can be 99% certain that a negative relationship between costs and performance exists.

In conclusion, costs really do matter

It is remarkable – if not altogether surprising – how effective it is to invest in a systematic low cost manner, where product providers have due regard to the costs that investors suffer both in terms of OCFs and portfolio turnover. Who better to attest to this than one of the world's most renowned investors, alongside the founder of one of the world's largest fund management firms, founded on the power of very low fees?

As Warren Buffett stated in his 2017 letter to his shareholders at Berkshire Hathaway:

> ***The bottom line: when trillions of dollars are managed by Wall Streeters charging high fees, it will usually be the managers who reap outsized profits, not the clients. Both large and small investors should stick with low-cost index funds.***

And as the legendary Jack Bogle often reminds us:

> ***'In investing, you get what you don't pay for'.***

End notes

1. Compounding outcomes are calculated as follows: Starting amount X ((1+rate of return)^number of years), where ^ is 'to the power of'.
2. Standard & Poors SPIVA® - US Year-end Report 2017
3. Morningstar (2010), How Expenses and Stars Predict Success, www.morningstar.com
4. Kinnel, R, (2016), How Fund Fees are the Best Predictor of Returns. www.morningstar.co.uk
5. Vanguard Research (2017), The case for low-cost index-fund investing. www.vanguard.co.uk
6. Dimensional Fund Advisors (2018) Mutual Fund Landscape 2018. Refer to paper for full detail of methodology and data sources.
7. Albion Governance Update 16 (October 2018) – internal document, reviewed by the Investment Committee.
8. Note, we have excluded 'Flexible' strategies as this is inconsistent with broadly risk targeted portfolio choices.

Other notes and risk warnings

Use of Morningstar Direct© data

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