The True Cost of Investing

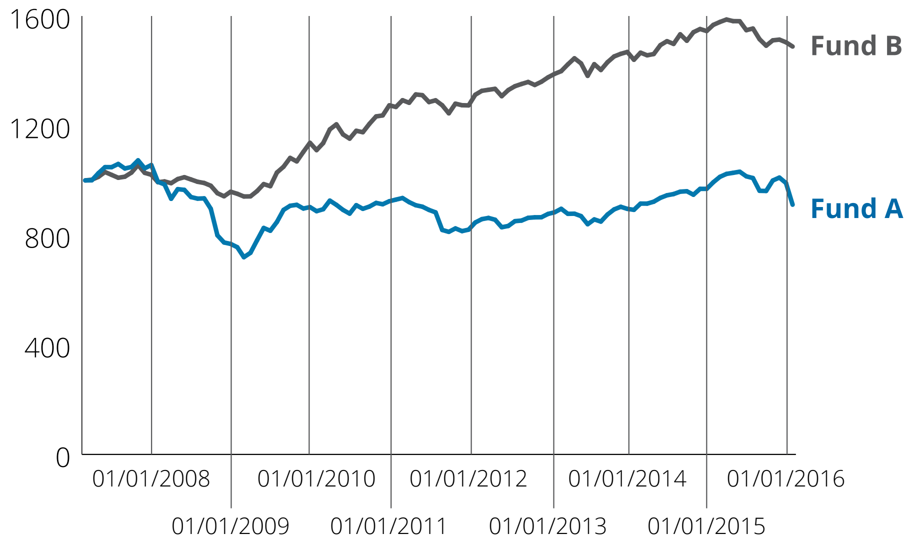
Article

Much has been written on the subject of the true cost of investing. Most revolve around an accounting analysis of trading costs, management and administration fees and commissions above and below the line and link these to the average benefit accrued for fees paid. While knowing what you pay and controlling costs is always advisable (in all walks of life) it is more important to understand what you actually get for your money, who gets what and what their contribution to your overall portfolio performance is.

Before examining the cost side of the arguments, it is important to note the flaw in the arguments that revolve around averaging the benefit accrued from fees paid. There is an old adage in trader folklore that says 'you should never cross a river that is on average 4 ft deep' (if it's wide enough it may be 100 ft deep in the middle!). Averaging makes sense when comparing like to like, however when speaking about the investment markets, one must remember that the average is the market and the market is the average - it is mathematically impossible for the average to beat the average!

What is important is that one can identify and uncover those managers/funds/investments that are diamonds in the rough that do add value after all fees have been paid. A couple of off the cuff examples: Jim Simons' Renaissance Technologies LLC charge their clients 5% management fees and 40% performance fees. Such numbers would make most investors' hair stand on end and certainly many advisers (at least those who don't know Simons) would not even consider investing with them - the truth of the matter is that the returns of Renaissance, after fees, are a whopping 35% annualised over a 20 year period and from 1994 to mid 2014 averaged 71.8% annual return. Actually Mr. Simons would probably not take investors money if they threw it at him, as many top end funds are not available to retail investors since their strategies have limited capacity and this is reserved for large institutions that place large amounts at a go and have the expertise to understand the fee levels.

The second example is closer to home: Below is a comparison of two multi-asset class portfolios offered widely in Cyprus as balanced portfolios (carrying moderate risk). Fund A has 1% annual management fees and Fund B has 2% annual management fees.



“It is more important to understand what you actually get for your money”

	Fund A	Fund B
Total Return since inception	-8.86%	48.86%
Annualised return since inception	-1.04%	4.56%
Annualised volatility	9.10%	5.96%
Maximum drawdown	-32.94%	-10.88%
Time to recover from drawdown	Ongoing (8 1/4 years)	1 year 11 months

After All Fees

In general the fees inherent in investing through some kind of portfolio structure involve:

- **Brokerage and load fees.** These are any fees to get in or out of the said investment. Not everyone charges these anymore.
- **Bid - Ask Spread.** This is the difference in the buying and selling fee of a managed portfolio between the buy and sell price. More and more investment strategies are offered at their Net asset Value price with no bid-ask spread.
- **Management Fees.** The fees the portfolio manager charges for overseeing and managing the portfolios assets. Such fees may also be present in the constituent investments of your portfolio.
- **Performance fees.** Certain managers take a share of the profits in a portfolio according to the type of strategy: these can act as an incentive to managers and align their interests with those of the investors.
- **Fund professionals fees.** These include administration and custody fees, marketing, accounting, audit etc. These are fees charged by service providers to the fund (other than the investment manager) in order to ensure proper governance of the fund and adherence to the offering documents.
- **Commissions** charged on the value of transactions executed by a fund.

"It is a matter of getting what you paid for"

In examining a list of the various fees involved one can start becoming a little paranoid as to who takes what and lose focus of the real issue, which is what you have bought and whether it meets your requirements. Just as when buying a phone, a car, even a sandwich, you need to judge what you get at the end of it (the proof of the pudding is in the eating). You can get a phone for 10 or 1000 euros but they are not the same.

Investment management fees need to be judged by the value that they add to the end investor and only then as an absolute or relative level. For example, a manager may be receiving research and other value adding services for the fees they charge and these make the end investment more effective and result in superior risk-adjusted returns. Also, the fees paid for professional administrators, custodians and auditors are money well spent, as any less than meticulous work in these areas could cost dearly to the investor.

The true costs in investing are, at the end of the day, the real net impact to your portfolio's bottom line. In the example above, an investor may have thought that they were getting overcharged paying a 2% management fee for a multi-asset-class portfolio and opted for the 1% offering. Eight years later however, the true cost is clear. The seemingly cheaper fund has cost the investor a significant amount of value.

The issue of investment cost is broader than the underlying costs of a portfolio and its constituent securities. It is a matter of getting what you paid for and making sure that the cost of all parties involved are accounted for in respect to the value added. The investors to receive a certain level of risk-adjusted returns and that should be the starting point.

The question to ask is "after all is accounted for, do I receive risk-adjusted returns that meet my needs? This opens up a whole new other discussion that can be the theme of several articles. Watch this space...

"If you think it's expensive to hire a professional

wait till you hire an amateur"

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